

MAKING GOOD IN SOCIAL IMPACT INVESTMENT

Opportunities in an Emerging Asset Class

October 2011 | by Dr Rupert Evenett and Karl H Richter



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This is an important and useful contribution to the debate on the emerging social investment market and which, as importantly, offers what it calls a prospectus for practical actions to help take that market forward.

It is a useful and complementary piece of work to, among others, Sir Ronald Cohen's Social Investment Task Force and its follow-up report, *Ten Years On*, which together created the agenda for social investment in the UK, and the outline proposal by advisors to the government on Big Society Capital describing its operating and organisational principles. It is also a timely response to the government's own vision and strategy entitled *Growing the Social Investment Market*, which it published in February 2011.

A feature of this Review which I find distinctive, is that it is written from two perspectives – from the bottom-up perspective of social purpose organisations and entrepreneurs, grounded in their needs and comments; and from a financial perspective, beginning to shape what a viable financial prospectus for social impact investment products would look like.

Today we have an exciting opportunity to mature the new social impact investment market. This is a new and growing area of investment in enterprise which aligns with the UK's traditional skills and strengths in civil society and in financial services and links the latter to social purpose. There is every reason why the UK could and should be a global leader in this new global market of impact investing.

A handwritten signature in blue ink, appearing to read 'O Letwin'.

The Rt. Hon. Oliver Letwin MP

PREFACE

In the past year we've seen social enterprise and social investment rise to the top of the government's agenda. However, for the sector to rise to the challenges ahead it is important to recognise and understand the funding gaps that still exist.

Collaborative working is more important than ever. In the social investment arena, building relationships between funders, private and public, will be crucial in attracting new finance to develop the capacity of organisations working to change the world around them. To strengthen the marketplace and take advantage of the opportunities that lie ahead the sector must find new partnerships, develop new financial products and work on creating an environment for sustainable social businesses to thrive.

The Social Investment Business group, which includes our parent charity, the Adventure Capital Fund, has nearly 10 years of experience of providing investment and business support for charities, social enterprises and community groups. Our experience shows there is significant unmet demand for social investment among civil society organisations and a desire for more, and more diverse, funding sources tailored to the needs of the sector.

What is exciting about this review is that it not only captures the current state of social impact investment as an emerging market, but also gives emphasis to the views of social sector organisations we have invested in through the funds we manage. Their insights provide vital and refreshing perspectives on what it is like to work with social investment and highlights opportunities to shape and grow a thriving and sustainable market for the future.

Jonathan Jenkins
CEO, The Social Investment Business

The debate on the right balance between state and social sector has been in full flood as policymakers and those involved with the range of social, community and voluntary initiatives grapple with their respective roles.

Behind these discussions on the desired shape for our society must be consideration for the practical requirements for funding the increased focus on the social sector and ensuring the sector is able to develop and sustain its role. Initiatives such as Big Society Capital set the tone for the way capital can be allocated where commercial considerations are balanced with the desire for social return. To see the social sector thrive there needs to be a broad, diverse source of commercial capital, tailored to suit the different needs, and different maturities, of the groups to be funded. Commercial returns, commensurate with the risk, must be the norm. While measurement of the social impact of those who receive funding will be key to the debate on the role of the social sector, it cannot be at the fore of funding decisions.

The experience of providing capital to the social sector is now sufficiently developed that this is a timely report on the lessons learnt, the standards set and the potential opportunities to take the sector to the next level. The scale of demand, the voice of the "customer" and the meeting point between commercial business and social businesses are all clearly examined in the report.

As a cross-sector body, TheCityUK is well placed to foster the debate on the diverse inputs required for the solutions called for in this review. I look forward to our role in that debate.

Finally, I would like to thank the review's authors, who have been patient in bringing on our understanding of the opportunity and generous in sharing their experience and knowledge of providing funding for the social sector.

Chris Cummings
CEO, TheCityUK

This review sets out the state of play in providing capital for the social sector and puts forward practical solutions for its sustainable funding. Today's social impact investment market is sufficiently evolved to see the interface between commercial institutions and the social sector become better informed and better understood:

- *This is an emerging market that has passed a watershed with sufficient investment track record building to start attracting mainstream investment.*
- *It is a growth market. The social sector that produces so much public good, and which could produce more, is undercapitalised. An expanding new generation of social entrepreneurs is combining the values and motivations of the social sector with business acumen and they are proving their ability to use investment capital to increase their social impact and make their organisations more robust and sustainable at the same time.*
- *The social sector, to maximise its potential for creating social benefit, needs a greater choice of capital suppliers and a broader range of funding products of different types and maturities. These products need to occur within an integrated capital market, which is able to bring together appropriate layers of risk capital with both development funding and working capital, and where speed to market and simplicity are often the virtues of successful funding transactions.*
- *The social impact investment market is primarily an intermediate capital market, where investment capital has overlapping characteristics of equity and debt. Loan capital has a significant role to play alongside quasi-equity products, and philanthropic capital that is invested in organisations is a valuable enabler in attracting commercial investment capital.*
- *Social impact investment can offer investors sustainable financial return, assessable risk and the potential for diversification. It combines the UK's record of a well-developed, not-for-profit, charitable and voluntary sector with its historic strengths in financial services.*

This is an opportunity for social purpose organisations to secure sustainable, predictable and appropriate sources of funding as they increase their commercial discipline. Equally, for the financial services sector the opportunity is to mature a new alternative investment class with a large potential for growth and investment in new early-stage growth industries such as long-term care, preventative health and rehabilitative skills and training. The UK should have a leading role in this exciting new emerging market and could be an unparalleled global centre for social impact investing.

THE CHAPTERS IN BRIEF

CHAPTER 1

provides definitions for the language of social impact investing and seeks to establish clarity of terminology. It argues that social impact investment should be regarded as a new alternative investment asset class and outlines the features of this emerging market.

CHAPTER 2

brings in the voice of the customer, the leaders of the social sector organisations. They make clear the diverse range of solutions needed and desired from investors, with a call for both low-risk and high-risk capital. The direct quotes make clear the readiness of the social sector to adopt the business disciplines required to make them investible, the distance already covered by many and the support the sector requires to continue that journey.

CHAPTER 3

looks to the investment community and the solutions required to meet demand, arguing why social impact investment will be a growth market for investors and providing a map for using a spectrum of different types of capital, such as risk capital, working capital, development capital and property finance. The chapter examines current provision and the role of philanthropy for funding alongside the commercial offer.

CHAPTER 4

outlines the characteristics of a developing market and offers parallels from the global context on how this could be further developed. It sets priorities between direct market experiences gained from quick action and the desire for accurate measures of success in social impact, with strong encouragement to favour the former.

CHAPTER 5

looks at the global experiences and draws lessons from both developed and developing markets. While there are many good examples of initiatives abroad, there are opportunities to create a world-leading skills base for both domestic and international markets.

CHAPTER 6

looks at the experience of the investors, contrasting their voice with the “bottom-up” view of the customer. The journey that has brought the market to today’s readiness is brought out through these top-down views.

CHAPTER 7

is an exploration of how expanding the supply of debt through intermediate capital products can create value for both the social sector and the investment community. Case studies drawn from the experience of The Social Investment Business provide the facts and figures – including yield, risk assessment and demand.

CHAPTER 8

contains the recommendations and conclusions of the authors, arguing for the product set that is needed to fulfil the opportunities of this alternative asset class within this emerging market.

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Tony Holdich, Newlands Community Association	Maggie O'Carroll, The Women's Organisation	Colin Strickland, Riverside Credit Union
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Mike Knight, Riverside Credit Union		

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PART I



KEY TERMS

INTERMEDIATE CAPITAL

Intermediate capital, sometimes called mezzanine finance, refers to capital that lies between pure equity (ordinary shares) and senior secured debt. More generally, it is debt capital (subordinated or unsecured) that has some equity-like characteristics in the sense that it may participate to some extent in the performance of the funded organisation, or debt capital that has stronger equity-like characteristics (often preference share capital) that has some debt-like characteristics with more or less protected capital returns and interest-like income. More generally still, it is the area of capital where debt and equity overlap.

MISSION DRIFT

A phenomenon that occurs when the focus on social issues becomes lost or diluted and, as the organisation struggles for financial sustainability, the original development goals are neglected.

PATIENT CAPITAL

In general terms, a form of long-term capital in which the investor is willing to make a financial investment in a business with no expectation of making a quick profit but in anticipation of returns in the longer term. Patient capital has gained a wider currency with the rise in environmentally and socially responsible enterprises, where it may take the form of equity, debt, loan guarantees or other financial instruments. It is often characterised by:

- *Willingness to forgo maximum financial returns for social impact and an unwillingness to sacrifice the interests of the end customer for the sake of investors*
- *Greater tolerance for risk than traditional investment capital*
- *Longer time horizons for return of capital*
- *Intensive support of management as they grow their enterprise*

In this document, we often use the term to refer to debt and intermediate capital instruments that have either or both an element of interest and capital repayment holiday in order to tailor the terms of the financial investment to the risk capital needs of social sector organisations.

QUASI-EQUITY

A category of debt taken on by a company that has some characteristics of equity, such as having flexible repayment options or being unsecured. Examples of quasi-equity include mezzanine debt and subordinated debt.

SOCIAL IMPACT INVESTMENT

A distinctive asset class of investment capital for the social sector, synonymous with social finance, social investment and impact investment (see detailed definition in Chapter 1).

SOCIAL IMPACT INVESTMENT MARKET

The section of the financial markets that is dedicated to social impact investment. It is used in this review according to a broader interpretation of a market where supply and demand side participants engage, rather than a stricter financial interpretation of a market such as the equity market or bond market, which have specific and distinctive attributes.

SOCIAL PURPOSE ORGANISATION

Organisations within the social sector, including civil society organisations (CSOs), charities, social enterprises and social businesses, non-governmental organisations (NGOs), as well as non-profit, volunteer and similar organisations.

SOCIAL SECTOR

Often referred to as the third sector or civil society and embraces the wide range of social, community, voluntary and non-profit activities.

The social impact investment market has passed a watershed. A generation of social entrepreneurs is becoming more sophisticated and experienced, combining the values and skills of running successful social purpose organisations with business and financial acumen. Existing social investors are developing an investment track record and a detailed understanding is emerging of what drives success in this industry. We position this review as a contribution to the rich debate on social impact investment that has established the concept of the social impact investment market, which we recognise and salute.

2011–12 is an important year in the evolution of social impact investment – we use this term to bring together social investment, as it is known in the UK, and its global name of impact investing. There is increased interest in raising funds and the government has established Big Society Capital to catalyse and develop the market. As an emerging market, it needs early flagship successes to initiate a step-change in interest from mainstream investors. The challenges are to social sector leaders to provide those successes and to the financial sector to provide the capital the social sector needs.

This is a new growth market. It is a market for investment in UK enterprise and it has the potential to be a large market. Globally it could be worth up to US\$1 trillion over the next 10 years¹ and there is every reason for the UK to be a leader in this new global market, which brings together two of the UK's traditional strengths; its wealth in social purpose organisations and its expertise in financial services. There is a great opportunity for the UK financial sector to capitalise on these two strengths to help mature the market and in so doing develop new business opportunities to expand the range of financial services exported globally.

This review is written from two perspectives. First, from the bottom-up perspective of social purpose organisations and their entrepreneurs, grounded in their practical comments, and second, it allies the requirements of the social sector with the financial perspective of established social impact investors. We thank our two sponsors, TheCityUK for challenging and testing us on the financial perspective, and The Social Investment Business which has unrivalled experience, with over 1,100 active investments (grants, loans and business support) in more than 300 social purpose organisations into which they managed investment of a total of £156 million by way of tailored loans.

“ This is an emerging market – it needs early flagship successes to initiate a step-change

.....
¹ *Impact Investments: An emerging asset class, JP Morgan, 2010.*

”

Our vision for a thriving social impact investment market is one in which social purpose organisations at different stages of development and size can access a wide range of financing products of varying types and maturities. A market that provides affordable investment capital to organisations on terms most appropriate to their needs, that rewards success, that backs expansion, supports spin-outs and encourages start-ups. We would like to see a liquid market that provides the radically undercapitalised social sector with the capital it needs, so that social purpose organisations can realise their missions to the maximum extent practicable. A market in which follow-on funding is as important as initial funding, so that successful organisations are supported with second and third-round financings and more, and in which investment capital with a higher risk appetite is used to leverage in new sources of capital with a lower risk appetite. It is a vision of a plural and inclusive market of social impact investors, a market of collaboration and competition that plays to the strengths of existing investors and draws in new investors, investing both directly and indirectly.

We argue that the social impact investment market should be understood as an emerging market, which benchmarks expectations realistically and also points to its potential; we are reminded of Sir Ronald Cohen's comment that "[social] impact capital is the new venture capital".² Feedback from social purpose organisations and the experience of investors

confirms that it needs to be an integrated market with a range of different financial products for different stages of an organisation's development; social purpose organisations need to free themselves from dependency on a "hamster wheel" of successive one-off funding, the ability to be more strategic in their social missions requires them to be more strategic financially through having access to more diversified and longer-term sources of funding. We argue that it should be identified as an intermediate capital market, recognising that many of the most interesting financing structures appropriate to this sector occur where debt and equity characteristics overlap.

“ There is not yet a common language for social investment and this can make it confusing for people in the sector – often the terminology keeps out the very organisations it seeks to target. For example, the term ‘loan’ is deemed by many in the sector to be pejorative whereas ‘investment’ is not.

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

”

As practical next steps, we make the case for the launch of loan and intermediate capital funds, the securitisation of existing loan portfolios, the development of a wide range of tailored debt and intermediate capital products and the establishment of a social impact investment trade forum to promote social impact investment and the independent collation of all-important market-wide investment and credit statistics.

We expand these themes in the following chapters. We summarise the extensive feedback received from social purpose organisations, discuss the shape of this nascent market as well as supply and demand within it, the conditions for its continued development towards maturity and its global context. In Part II, we describe the emerging "prospectus" for debt and intermediate capital investment in this sector and conclude with our recommendations in more detail.

² <http://blogs.reuters.com/great-debate/2011/07/13/impact-capital-is-the-new-venture-capital-part-ii>

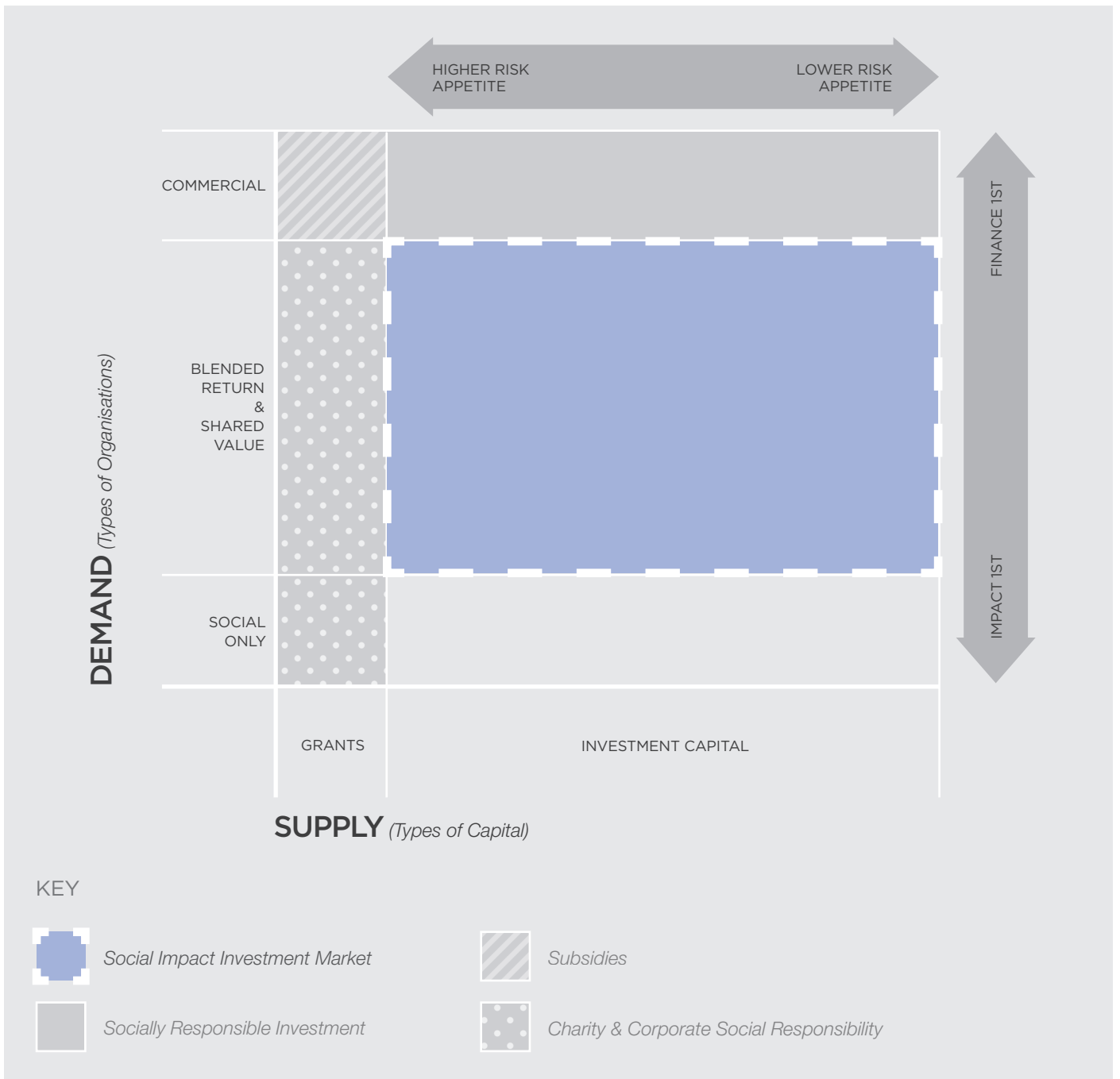


Figure 1: Social Impact Investment Market³

³ An evolution of representations previously published by the Social Investment Task Force and CAF Venturesome

1.1. WHAT IS SOCIAL IMPACT INVESTMENT?

Social impact investment is capital deployed to seek both positive social outcomes and financial returns. To qualify, both must be mandated at the outset irrespective of which is prioritised; reference is often made to “impact first” or “finance first” to highlight the prioritisation. Social impact investment can be undertaken by actors in the public, private or social sectors, as well as by any combination of the sectors acting jointly, with either for-profit or non-profit motives, achieving either market-rate or below market-rate returns. It is distinct from socially responsible investment (SRI) by financial investors in that it requires more than the negative or positive screening of traditional investments. It is also distinct from corporate social responsibility (CSR) by corporations in that social impact investment is an intrinsic part of an organisation’s strategy, whereas CSR policy is often not embedded to this depth.

We use the term social impact investment to jointly acknowledge the existing market for social investment and unambiguously connect these investments to the emerging global asset class of impact investment. It is important to avoid being distracted by language; for all practical purposes social investment, impact investment and social impact investment refer to the same concept.

1.2. MAJOR THEMES IN THIS REVIEW

As noted at the beginning of this introduction, three major themes run through this review to aid the understanding of the social impact investment market: namely that social impact investment is an emerging market; that it should exist within an integrated market that embraces plurality and diversity; and, from a financial perspective, that it should be seen as an intermediate capital market.

A. AN EMERGING MARKET

The social impact investment market should be benchmarked against other emerging financial markets at an equivalent stage of their development rather than judged against fully mature financial markets. This is important because it sets expectations accurately and resists pessimism. The experience of other emerging asset classes, such as hedge funds and private equity in their early stages, provides references to inform us about the practicable steps required in maturing a market. Analysis through this lens also reminds us that an emerging market has intrinsically attractive characteristics such as lower correlation with mainstream markets. Intuitively, emerging data on social impact investment suggests that it has some different volatility characteristics to mainstream markets and exhibits some counter-cyclical attributes. Understanding the emergence of a market as a process helps us to identify and create the conditions required to develop it successfully.

Realistic expectations about the social impact investment market as an emerging market mean that it does not need to become a fully mature market overnight and can more readily become accepted as a market comprising an “alternative investment” asset class. With this approach, it is a viable and achievable project for the social impact investment market to be attractive to mainstream investors within a matter of a few years and not decades. The aim of Chapters 3 and 4 is therefore to present social impact investment as a new, alternative investment asset class and to contextualise it as an inherently appealing investment proposition in its own right.

B. AN INTEGRATED MARKET

The bottom-up evidence in Chapter 2 given to us by social purpose organisations emphasised the requirement for a wide range of capital types that work together, able to deliver a joined-up range of financing products to meet funding needs. Organisations stressed that

they needed strategic investment capital, distinct from successive one-off funding, to enable them to develop financial strategies with reasonable confidence, to enhance their ability to plan for maximum mission delivery, to scale up and to finance innovation.

Social purpose organisations of different levels of maturity and different sizes should have access to a wide range of financing products of different types, maturities and cost that are most appropriate to them, that reward success and that meet the different needs of scale-up, spinout and start-up. The top-down perspective from investors, presented in Chapter 6, reinforces findings by others⁴ that investors require liquidity, tradability and clear information about financial track record to compare investment opportunities and to provide confidence in the market. They also require a return on their investment.

This can only be achieved through a diverse range of capital providers within a market that embraces plurality, offers a wide range of financing products of different types, allows for maturities and cost to be tailored appropriately to individual organisations, rewards success with follow-on finance and is able to support spin-outs and start-ups.

C. AN INTERMEDIATE CAPITAL ASSET CLASS

Chapter 3 explains that there are good reasons why a thriving social impact investment market is going to be, from an investor's perspective, best characterised as an intermediate capital market comprising risk capital and more straightforward working capital, as well as development capital and property finance, and incorporating a spectrum of different types of debt capital and quasi-equity. We contend that many of the most interesting opportunities for social impact investment are going to occur in this area where debt and equity characteristics

overlap because it provides the best fit for social purpose organisations.

Much of the current social impact investment activity already takes place in this intermediate capital space and is by way of debt, with very little genuine equity, because of restrictions imposed by the legal forms of social purpose organisations. Debt is a highly versatile instrument when structured as intermediate capital with flexible term sheets. Rather than being a single product in itself, debt consists of a spectrum of capital from "plain vanilla" mortgage-like secured loans to nearly equity-like products and it can provide the full range of finance required by social purpose organisations. This framework highlights an exciting opportunity for the financial sector to develop new intermediate capital products as well as more conventional loan products that are tailored to the needs of social purpose organisations.

The chapter also highlights why philanthropic capital and grant funding remain essential and complementary components of social impact investment because they function as loss-absorbing risk capital to open the door to other sources of capital, the two sources of capital therefore being mutually supportive.

1.3. WHAT WILL SUCCESS LOOK LIKE?

Our desire is that social impact investment becomes recognised by mainstream investors because it is a legitimate, alternative investment asset class. A successful market will see increased momentum in social impact investment and support the creation and growth of social purpose organisations by rewarding them for success. We would like to see more funds raised, with more capital gainfully deployed and a greater range of capital types available. It will be an integrated market with capital providers working together in providing packages of finance to serve

4
Such as the July 2011 survey of investor perspectives by ClearlySo (ClearlySo, 2011)

as a seamless funding escalator for social purpose organisations. It will enable them to be more strategic in their operations and business planning, from early stages through scale-up, rollout to maturity, and also at times when unforeseen circumstances need to be managed. Good social purpose organisations should not fail because of a lack of funding, nor should they be unable to maximise their social impact for want of the necessary finance.

The ultimate scale and reach of this new and growing market is exciting in its transformational potential. The challenge requires both the social and financial sectors to rise jointly to realise the opportunity.

A further specific challenge is directed to leading social entrepreneurs. An inflection point for any emerging market is when notable success stories place the new market firmly on the investment map. To take two examples: the US biotech sector in its early days was transformed by the emergence and radical success of Amgen – the biotech sector, for all its ups and downs, has never looked back; similarly, investment in internet businesses, for all the boom and bust of the dotcom era, had been definitively put on the financial map by the transformative IPO (stock market flotation) of Netscape in the US in 1995. Who will be the “poster children” of social impact investment to put this asset class firmly on the map?

CHAPTER 2. THE BOTTOM-UP PERSPECTIVE: WHAT SOCIAL PURPOSE ORGANISATIONS NEED

We interviewed social purpose organisations and entrepreneurs to ground our thoughts. This bottom-up perspective has helped us determine whether their funding requirements were satisfactorily provided for by existing products and how the market could evolve to serve them in strengthening their organisations as well as better support them in achieving their mission. One of the most telling comments was from a charity chief executive who said: “We cannot be strategic because we have to go where the money is.”

We interviewed in detail a sample of 20 organisations funded by The Social Investment Business to find out their investment needs: excerpts from their comments have been included below. We reviewed survey feedback from more than 30 further organisations. The Social Investment Business, by virtue of the four funds it manages, represents one of the largest pools of social impact investment in the UK. The sample group was selected from investment made by The Social Investment Business in more than 300 separate organisations over nearly 10 years. Some organisations received multiple investments across different funds and several received both investments and grants. Some clear themes emerged and we have grouped the quotes accordingly.

2.1. MORE CAPITAL

Consistent among the organisations interviewed was a concern about limited available funding for the type of investment they required, in some cases without which they “would not be here today”.

.....
“There is nowhere near enough funding. Development funding especially, not just innovation funding. And not just funding, but a financial relationship that invests in an organisation’s development. Our early loans were an investment in us that jumpstarted our development and in turn made a major impact on the community we are based in. Follow-up loans have continued that development.”

Phil Knibb, CEO, Alt Valley

.....
“...opportunities for loan finance were few and far between.”

David Stockport, Chief Executive,
Chopsticks North Yorkshire

“ We cannot be strategic because we have to go where the money is.

Charity chief executive

”

“The social enterprise sector is very undercapitalised and poorly serviced by banks. We just don’t fit in their box.”

Maggie O’Carroll, CEO, The Women’s Organisation

“Supply needs to improve – you can have a good, investible proposition but the funds aren’t available or you have to find different social investors and/or grant makers with a patchwork of different restrictions to cover different bits of the same project. That can compromise the kind of project being delivered.”

Chris Manze, Chief Executive, The Stone Soup Project

2.2. MORE PLURALITY OF PROVIDERS AND TYPES OF CAPITAL

Coupled with the requirement to correct the problem of insufficient supply is the desire to have more capital suppliers and recognition that the social impact investment market would be stronger if there were greater competition among funders. Organisations want funders to offer a range of products that respond to their particular funding requirements.

“As we were a start-up, there were no other options for loan funding. Commercially it’s not good to have a choice of only one supplier, but in this case there was no other option.”

David Qualter, Sheffield Wellbeing Consortium

“To date, there has not been proper competition among suppliers of loan finance. Many more suppliers are needed, offering more and larger-scale social investment competing with each other, so that organisations like us could seek out different suppliers and a wider range of products which suit differing requirements

from time to time.”

Martin Kinsella, Chief Executive, P3

“The sector is desperately poorly serviced for working capital. We need 1-5 year working capital for new markets that we are creating and development capital for rolling out ideas that are proven and work.”

Maggie O’Carroll, CEO, The Women’s Organisation

“There is a real dearth of financial products to allow social organisations to innovate and take social products to market.. The [Social Investment Business] investment enabled Turning Point to innovate a business model and way of funding new product delivery at a time when [we] would not have found the same sort of working capital finance anywhere else.”

Barry Roberts, Director of Innovation and Sales, Turning Point

“For a genuine social investment market to exist, there needs to be choice in providers and types of finance and greater clarity about what’s available, what it can be used for. There is a need for transparency, better information. Plurality of players creates opportunities.”

Dick Ellison, LARC Development Trust

“A mix of small/short-term loans and larger long-term loans is important. Flexible repayment options is the critical aspect that makes loan financing good for social enterprises.”

Jan Lennox, Director, Watermans

“We’ve shown we can develop a sustainable income stream. This gives us the confidence to expand our activities and income streams in a sustainable way through social enterprise. A social

investment market could help this through a range of investment – from angel funding, access to angel networks, business consultancy, to long-term loans and other sources of funding.”

Steve Shaw, Paddington Arts

2.3. BETTER GOVERNANCE AND FINANCIAL LITERACY

There was strong recognition among the organisations interviewed that social impact investment, particularly in the form of loan finance, is not well understood by their peers in the sector. Many are concerned about the negative attitudes towards debt-financed growth: as the CEO of one organisation said: “it’s clearly rubbish that debt is ‘evil’.” Another commented that other local charities were “horrified” to hear that they had taken on debt to finance an asset-backed project. Strong governance is seen as key and there is a strong need to educate organisations about sustainable finance.

“Cultural change is needed to get the organisation to accept the concept of loan finance, investment involves a whole new language that the organisations may not be familiar with. One of our greatest challenges was convincing our board, but what convinced them in the end was the hard numbers.”

Dai Powell, CEO, and Jude Winter, Deputy CEO, Hackney Community Transport

“Many boards are conservative about loan finance – it’s not always understood that charities and social enterprises are businesses, ‘social mission’ businesses. Our board recognised this and the business case for taking a loan to buy a property. It allowed us to think strategically.”

Rachel Talbot, Chief Executive, Cambridge Citizens Advice Bureau

“There was initial concern from the board about taking on debt, but once they saw how the investment would be structured, and how it fitted with our business model, they were very supportive.”

Colin Strickland, Riverside Credit Union

“There was some initial concern from the board about taking on debt for a new project – but once we had a business plan and project scope they were confident in, they were totally supporting. It did take time.”

Steve Shaw, Paddington Arts

2.4. UNDERSTANDING THAT GRANT FUNDING AND INVESTMENT ARE MUTUALLY REINFORCING

It is clear that many appreciate that grant funding and investment capital can work together to help organisations grow and become more strategic. However, the benefits of intermediate capital are not fully appreciated, not all investments need to be “plain vanilla” loans and further work is required to explain the benefits of intermediate capital and how its flexible characteristics can support further development of the social sector. It was widely recognised among the organisations interviewed that grant funding alone is not viable as a source of sustainable business funding.

“Charities chase funding to stay alive. That’s not how to grow a business... [Debt] is a no-brainer, as long as you have a strong business plan to underpin paying the money back. It encourages a different mindset to grant funding, where you can find yourself always chasing your tail.”

Chris Manze, Chief Executive, The Stone Soup Project

“Of course grant funding is great where we can get it. Who would disagree? But support in the form of loans and business support instils a discipline and responsible approach to our business and we are stronger and better for it.”

David Qualter, Sheffield Wellbeing Consortium

“A mature market should include a mix of loan, grant and business support products, based on an ‘engaged investor’ model – it was this package of products which made our social investment experience so successful.”

David Stockport, Chief Executive, Chopsticks North Yorkshire

“Grant funding and investment funding, equity and debt, need to be ‘both/and’, not ‘either/or’. Grant funding can never be enough... At the same time, many in the sector will never be able to get to the point of generating income without [depending on] grants... But an awful lot could then be taken forward by loan financing. There needs to be a major shift in mentality in the sector on what debt is and what it can mean.”

Yvonne Probert, Prudhoe Community Partnership

“The structure of the investment was critical – long-term funding with initial interest and capital holidays – that gave capacity for infrastructure development and matched our model. It fitted exactly what we needed.”

Colin Strickland, Riverside Credit Union

2.5. DEVELOPING INVESTMENT READINESS

An essential part of developing the intermediate capital offering is to focus on helping organisations with business support

and provide the resources to develop their investment readiness, to move them from “unbankable” to a point where mainstream banks will recognise their creditworthiness. It should also be pointed out that the funds managed by The Social Investment Business allow a mix of loans, grants and business support, depending on the business proposition.

“The time our business support advisors spent with us was extremely valuable, helping us think about the business case and grounding our projections in reality.”

Rachel Talbot, Chief Executive, Cambridge Citizens Advice Bureau

“While an organisation is developing, investment needs to be ‘banking plus’, that is include advice and support as well as the capital.”

Martin Kinsella, Chief Executive, P3

“The Communitybuilders Fund model was a great idea and example of a kind of ‘intermediate capital’ combining equity and debt-type roles. Upfront grant funding financed feasibility studies and project costs (professional fees, etc) that help build robustness into a project. Follow-on debt financing then makes good sense on that more robust platform. That sort of packaged unit of financing made perfect sense as a financial product.”

Jenny Pupius, Chief Executive, Action for Business

“Business support, the entire ‘engaged investor’ model, is important. Individuals interested in a social agenda and working in social enterprises and charities don’t always have sufficient background in business and banking. This also needs to be invested in.”

Chris Manze, Chief Executive, The Stone Soup Project

“The Communitybuilders Fund product of leadership bursary and mentoring support combined with loan finance for our project made for an attractive and highly effective package.”

Dave Clarson, Managing Director,
The Burton Street Foundation

2.6. INVESTMENT TO STRENGTHEN ORGANISATIONS

Social impact investment has been able to strengthen organisations and provide an important signal to attract more mainstream capital. Going through the process of getting funding makes an organisation more investible; it is a virtuous circle that flows from the combination of investment and investment readiness, consistent with our theme of an emerging market. The experience of The Social Investment Business confirms that organisations that do focus on being able to demonstrate greater investment readiness and robust business cases do then go on to attract more mainstream sources of finance, either leveraged in by social impact investment or separate as follow-on funding.

“Being invested [in], and being challenged on our business plan through the investment process, underpinned a sense that we are an investible organisation to be taken seriously. That’s been enormously beneficial in our dealings with the local council on our asset transfer project – the investment has shown that we have a reason to be taken as seriously as any commercial organisation.”

Dick Ellison, LARC Development Trust

“Going through the social investment process helps build robustness into the organisation, into its processes, into the internal questions asked.”

Yvonne Probert, Prudhoe Community Partnership

“Social investment pushed the organisation to grow. It enabled us to access more, and bigger, contracts. It also imposed a financial discipline, putting a mirror up to the organisation. It was good for us.”

Dai Powell, CEO, and Jude Winter, Deputy CEO,
Hackney Community Transport

2.7. MEASURING SOCIAL IMPACT

The importance of demonstrating and measuring social impact is an acknowledged feature of the social impact investment market. Equally, it was emphasised that the level of reporting and associated costs must not be an impediment to the development of the market.

“Social impact can initially only be self-evident [for example, evidence of people using a service and their stories] and can only really be measured over the longer term. Too much emphasis on measurement at too early a stage just becomes another cost.”

Dave Clarson, Managing Director, The Burton Street Foundation

“There needs to be pragmatism on social impact reporting, especially when it’s linked to social investment. If you can borrow from a high street bank at 4.5% (when you can borrow at all), why would you borrow at 6% from a social investor and do excessively burdensome social impact reporting on top?”

Jenny Pupius, Chief Executive, Action for Business

“Impact reporting is vastly important from a beneficiary’s point of view – instead of maximising shareholder returns from a commercial business’s point of view, we need to know whether we are improving our beneficiaries’ lives. But it can get too complex – how do you measure putting

a smile back on a disabled child's face? Personalisation will address that – disabled individuals and their families will know whether they are getting what they want.”

Kevin Williams, Chief Executive, KIDS

2.8. A MATURE MARKET WOULD LOOK LIKE...

Organisations that have taken on social impact investment to develop their businesses seek choice, competition and much greater availability of funding, both volume and type. Some have moved from not being accepted by the high street banks as creditworthy to now obtaining mainstream finance; others are still on that journey but are confident in the sector's capacity to grow. We threw the gauntlet down and asked them what a successful social impact investment market would look like.

“A mature market would be informed, flexible – with every kind of financial product available that a traditional bank would offer. Even more important, a mature market needs to have large sums available, to make loans in multiples of millions and bonds which support multi-million pound projects... an overall market in the billions.”

Martin Kinsella, Chief Executive, P3

“The market will be a success when the social sector is a third of the economy. Given the scale of the public-service delivery need, why not?”

Chris Manze, Chief Executive, The Stone Soup Project

“Closer link to philanthropic capital. Consideration about possible re-investment legislation. Tax benefits for these types of investments/investees. Freely trading of the investment portfolios.”

Burger Edwards, Director, Business Development & Finance, Cambridge House

“A greater range of products from a greater range of providers of capital that allows different social organisations at different levels of maturity to access the appropriate financial products for delivering their mission... That might be replacement of grant dependency with longer-term investment capital or expansion capital for scale-up of a successful service, or it might be shared-gain funding of innovative delivery of public services.”

Barry Roberts, Director of Innovation and Sales, Turning Point

“[Autism care] is a global market. It's just much more developed in countries like the US and Canada. Soon markets like China will turn their attention to it. Best practice often already exists in these other markets and much more mature markets for provision of care including private-sector provision using replicable models. If the investment supply existed, the best way of creating best practice in the UK would be to replicate practice across international borders. Maybe a global impact investing market could do that.”

Jolanta Lasota, Chief Executive, and Alan Larsen, Ambitious About Autism

Finally, sources of optimism:

“Twenty years ago, [in Sheffield,] community organisations, community charities didn't own assets. They were grant-funded. Now they do. The sector balance sheet is changing and so is what the sector can do with it and how others' attitudes to the sector have changed. Local authorities are having to change fast, and suddenly when it's about asset transfers there's a new grown-up attitude in conversations between them and charities.

This is a growing market and it's going to be a big market now."

Dave Clarson, Managing Director, The Burton Street Foundation

.....
"We wouldn't exist without early investment from Venturesome. We have continued to flourish with the help of financing from The Social Investment Business and CAF. High street banks are now talking to us about funding, a journey from turn-around social investment to bankability."

Kevin Williams, Chief Executive, KIDS

.....
"...Many of the new generation of social entrepreneurs (who have come from a business background) are more comfortable with social investment."

Dai Powell, CEO and Jude Winter, Deputy CEO, Hackney Community Transport

CHAPTER 3. THE EMERGENCE OF A NEW ALTERNATIVE INVESTMENT MARKET AND ASSET CLASS

“ Much thinking has been done and the sector is beginning to develop a track record – 2011 will be the year in which we see a lot of new social investment products coming on stream.

Paul Cheng,
Head of CAF Venturesome

The growing investment track record (financial performance, returns and credit statistics) available from early social impact investors is allowing the sector to become better understood and consequently begin to meet the conditions of being a new alternative investment. The interest of mainstream investors has been stimulated by JP Morgan's report¹ of November 2010, which argued convincingly that impact investment warrants classification as a distinctive asset class. We elaborate this argument in Part II and put forward that social impact investment, as an alternative investment asset class with assessable risk, is sufficiently mature to begin attracting financial investors who have an appetite for yield over capital appreciation and diversification within investment portfolios.

The UK government is actively promoting the development of this market. In May 2011 it formally supported the Big Society Bank Outline Proposal (now Big Society Capital), which confirmed that Big Society Capital will have the “twin objectives of acting as a wholesale investor as well as a driver for development of the sector”. NESTA (the National Endowment for Science, Technology and the Arts) and UnLtd (provider of funding and support to social entrepreneurs) set up the Big Society Finance Fund² in 2010 to create prototype wholesale social impact investment activities in order to demonstrate the role Big Society Capital could play; the lessons learned will be essential in making clear how Big Society Capital can further develop the market. NESTA also commissioned the think tank New Philanthropy Capital³ to research the nature of capital demand to inform the mix of financing Big Society Capital will need to support. It concluded that there is a definite demand for capital and that Big Society Capital “may have to make a trade-off between building the market and maintaining its capital”. We support Big Society Capital undertaking this role and acknowledge that it needs to balance its mandate to ensure that it develops the market and opens the door to mainstream capital. Commercial investors, which are one of the groups addressed by this review, should rightly be able to focus on financial returns, confident in the knowledge that the market is being proactively matured by Big Society Capital.

Potential financial investors should be encouraged by the existing political will and the resources being deployed to further develop the market. It is our view that 2011 will be a turning point in social impact investment as it goes from niche to mainstream. The first half of 2011 has already seen a range of new funds such as the Social Impact Fund from CAF Venturesome to the newly established Merism Capital, which set up a social impact seed

¹ *Impact Investments: An emerging asset class*, JP Morgan, 2010.

² *Twenty Catalytic Investments to Grow the Social Investment Market*, Joe Ludlow and Jonathan Jenkins, 2011.

³ NESTA published its findings in its report, *Understanding the Demand for and Supply of Social Finance*.

fund. Loan funds of the type extensively piloted by The Social Investment Business across its different funds should also play a major role in maturing the market and on social impact investment as an asset class.

3.1 SIZE OF THE MARKET

Estimates of the size of the UK domestic market vary greatly – it is generally accepted that it is hard to assess. This should not be surprising in the early stages of a newly emerging market. Who would have been able to accurately forecast the size of the social media market 10 years ago? The point is that entrepreneurship creates new markets rather than just replacing or extrapolating from what is already there.

Current data about market size should not mislead prospective investors about the potential for growth. The UK Cabinet Office recorded £190 million of social impact investments in 2010, but funds managed by The Social Investment Business alone were oversubscribed in the year to March 2010. The apparent disparity between appetite for capital and active transaction volume needs careful analysis to determine realistic demand, but equally we cannot ignore the feedback from the social entrepreneurs we interviewed. They consistently told us that so many more would take on investment capital if the right type were available or if they were better educated about how to use it wisely.

JP Morgan estimates⁴ that globally the impact investment market could be worth up to US\$1

4 Ibid.

“ There is a massive requirement for social investment, as social entrepreneurs we need investment capital to grow our organisations – but not enough know that there are alternatives to grant funding.

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

trillion over the next 10 years. Domestically, ClearlySo notes in its recent authoritative report⁵ that the UK government has to date been the largest investor, offering up to £385 million in its latest programmes with approximately £300 million of additional public capital introduced since 2003. ClearlySo also notes that much funding is via social banking with about £370 million deployed in the UK just by Triodos and the Charity Bank combined. In addition to bank lending, the funds managed by The Social Investment Business have invested £156 million in loans and intermediate capital debt. There are just over a dozen social impact intermediaries and fund managers in the UK, including Bridges Ventures, which reports⁶ has £187 million under management. Earlier this

year, New Philanthropy Capital concluded⁷ that there is currently unmet demand in the UK, ranging from direct investment through financing of intermediaries to capacity building and product development; housing associations alone require about £3 billion of funding over the next four years.

” In summary, the UK has seen the establishment of several investors, intermediaries and funds since 2000, both publicly and privately funded, and the scale of today’s social impact investment market in terms of assets invested encompasses hundreds of millions rather than billions of pounds. There is still much unmet demand, though; for example, all the funds managed by The Social Investment Business were oversubscribed. It is likely that this demand will

5 *Investor Perspectives on Social Enterprise Financing, Clearly So, 2011.*

6 <http://www.bridgesventures.com/our-funds>

7 *Understanding the Demand for and Supply of Social Finance, NESTA and New Philanthropy Capital, 2011.*

increase due to the combined effect of actively placed government funds being withdrawn from the market due to budgetary consolidation and Big Society Capital beginning its activities in capacity building to accommodate more commercial capital. This will pave the way for institutional investors that will benefit from the already existing investment track-record and performance data, which will in turn enable more informed decision-making about social impact investment as both an alternative investment asset class and an emerging market.

We interpret these data and trends to mean that the current market capitalisation is just the tip of the iceberg and, importantly, that there is already sufficient transaction volume to begin building comparative data of the market, including track record and credit statistics to assess risk. The foundations are in place from which to build a substantial market. It is audacious to forecast the size of the market in five years' time but there are a number of grounds for optimism about what this figure could be; current public financial constraints are likely to extend beyond the short term and this will require new forms of sustainable financing to compensate for the reduction of directly publicly funded provision of long-term care and other services. A better-capitalised social sector could support central government and local authorities as they seek greater efficiency in the use of their funds through asset transfers and the like. Similarly, the large-scale potential of health spin-outs would further accelerate the growth of the market.

Entrepreneurs in the social sector are proving their ability to create new markets in addition to replicating existing services as part of the government contracting out services. Entrepreneurs are becoming more expert in finding ways to make their organisations financeable by creating sustainable models for shaping cash flows and generating surpluses. A new generation of social entrepreneurs is coming of age which combines the expertise

and values of running successful social purpose organisations with greater business acumen.

Overall, the social sector is becoming more sophisticated and mature. Sticking our necks out, a “forecast” of the entrepreneurial potential of the UK social impact investment market could be £1 billion in five years or more. For an emerging market that is yet to scale, whatever figure is forecast will inevitably be wrong and so our figure is only guesstimate-based on an extrapolation of the need and entrepreneurialism we have witnessed in the market. It is not built up from detailed cash flow analysis. The actionable point is to build in the conditions for scale upfront so that opportunities for growth are not unnecessarily restricted. We seek to set out in this review how entrepreneurs can build this new market as long as they have access to adequate capital and good enabling infrastructure.

3.2. ANALYTICAL FRAMEWORK FOR A DISTINCTIVE MARKET AND ASSET CLASS

The debate over the past decade has generated several representations of the market and they have begun to coalesce around key themes. We felt it was important to find a simple way of representing the market as an integrated whole rather than an array of discrete funding products or organisations, and for it to represent the function of the market as a funding escalator for social purpose organisations. Our analytical framework, on the following page (Figure 2), maps the market against the axes of supply and demand, as an evolution of preceding work by the Social Investment Task Force and CAF Venturesome. Our main departure from previous representations is to rearrange the supply axis by product type and risk exposure rather than potential financial return. This reveals more about the gaps, bottlenecks and misalignments within the market, which are discussed in the latter sections of this chapter.

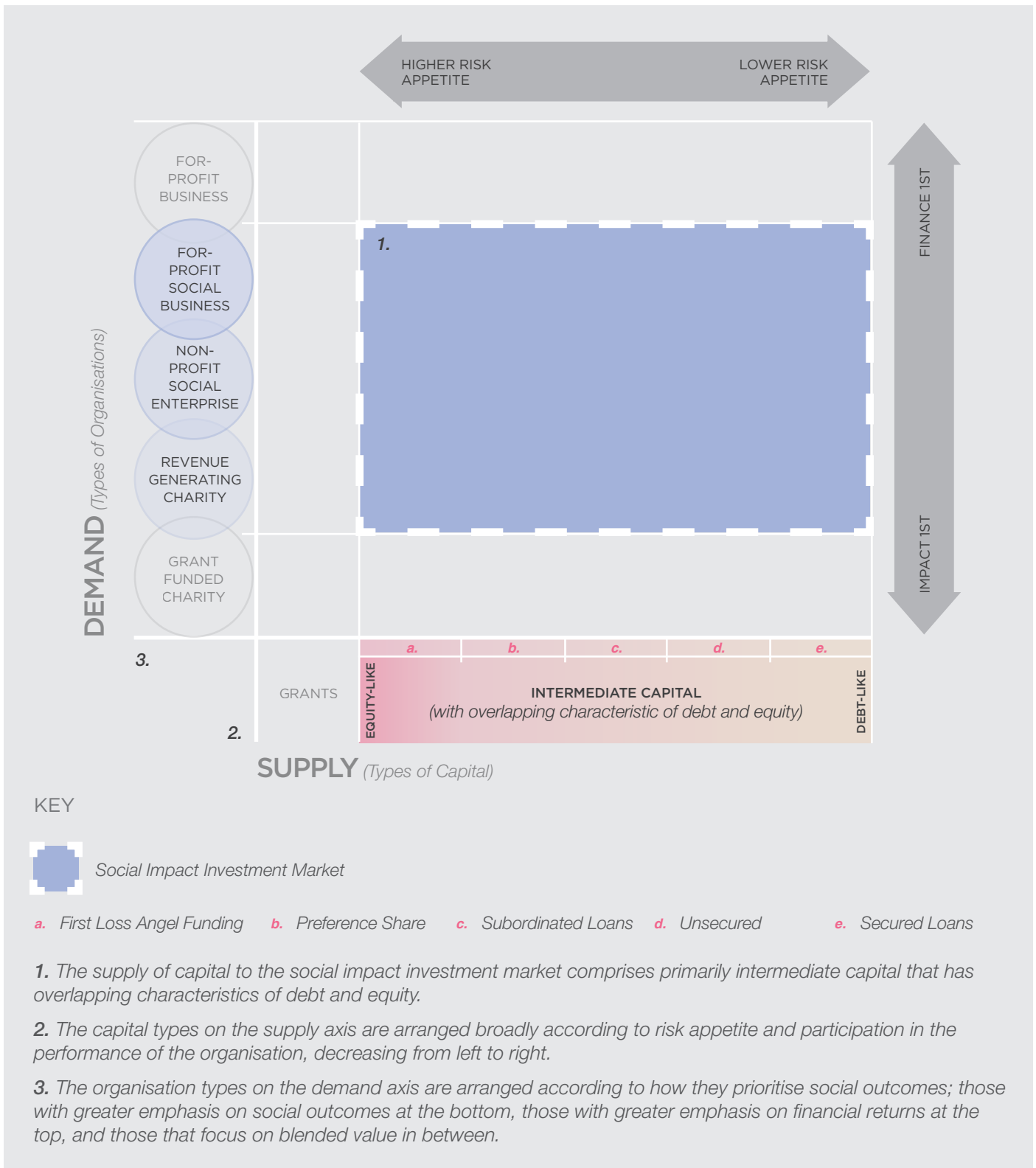


Figure 2: Analytical Framework for the Social Impact Investment Market⁸

⁸ An evolution of representations previously published by the Social Investment Task Force and CAF Venturesome

A. THE DIFFERENCES BETWEEN THE SECTOR, THE MARKET AND THE ASSET CLASS

We are seeking to develop the mainstream market for social impact investment, a market that fuses philanthropy and commercial investment, and therefore believe it is important to provide clarity by delineating some of the terms in use.

We use the term “social sector” to refer to the grouping of all social purpose organisations ranging from grant-funded charities to for-profit businesses, the “social impact investment market” to refer to the realm where providers of investment capital and recipients interact to do deals (it excludes grant funding) and the “asset class” to refer to that portion of the market that comprises capital from investors who seek a financial return on their capital. We draw a distinction between the market and the asset class, and argue that the former includes philanthropically sourced capital as well as commercial investment capital if it is ultimately deployed to organisations by way of investment and not grant funding, irrespective of its origin. “Asset class” is strictly an investment term and therefore we exclude philanthropically sourced capital because philanthropists may not expect their capital to be returned, meaning that it could be loss-absorbing capital and for that reason may not strictly be an investment by derivation. We recommend this distinction to those in the market.

B. PURE EQUITY CAPITAL HAS A LIMITED ROLE TO PLAY

Equity generally seeks to maximise financial value and often prompts behaviours that can be at odds with the objectives of social purpose organisations, whereas philanthropic capital has been seen by the sector as an obvious source of funding for these organisations because it aims to maximise social impact without requiring any financial return. Debt, on the other hand, is a financial instrument that satisfies the minimum requirements of investors because they will accept capped financial returns

and it is consequently able to balance social outcomes and financial returns. It is therefore in principle very well suited to financing the social sector alongside philanthropic grant funding.

People often refer to equity and debt as binary classifications of capital but intermediate capital is a fertile area of overlap where the respective attributes intersect. For example, preference shares have some equity characteristics (long-term capital, often participating) but also have debt characteristics (many are required to be shown on the balance sheet as liabilities rather than shareholders’ funds and some are repaid at par and may carry a market rate of coupon).

Social purpose organisations, like all organisations, require risk capital but equity investment is often not always the most suitable form of investment capital, for the financial maximising attributes noted above and also for the restrictions imposed by their legal forms, which mostly prohibit private ownership and the issuing of shares. Debt capital, particularly when structured as intermediate capital that includes patient capital, does not need to be excessively onerous nor rigidly structured. Term sheets can be drawn up to be as flexible as required to meet the needs of the organisation and match the available repayment profile. Transactions are privately negotiated and an engaged social impact investor can use their experience to inform the way the term sheet needs to be structured to provide the best chance of success. This requires time, expertise and judgement by experienced people.

The sector’s triumph in achieving the already great diversity of intermediate capital instruments should be applauded, whether these are debt-based or philanthropy-based instruments that behave like equity capital or have equity-like characteristics.

CASE STUDY

DEBT CAPITAL AND ITS FIT WITH THE JP MORGAN DEFINITION OF IMPACT INVESTING AS A DISTINCTIVE ASSET CLASS

JP Morgan's¹ now-authoritative definition of what makes a distinctive asset class in modern investment markets, and of how social impact investing fits that definition, is that an alternative investment asset class requires:

- *a unique set of investment/risk skills;*
- *organisational structures to accommodate this skill-set;*
- *industry organisations, associations and education;*
- *development of standardised metrics, benchmarks and/or ratings.*

Based on JP Morgan's definition, loans have a good fit with this asset-class definition and this fit further supports the notion that loans are a core part of the emerging social impact investment market asset class.

Assessing the credit risk and investment readiness of the “unbankable” social sector requires a distinct set of skills that needs to be honed and developed by practice over time. Appraising and correctly structuring loans requires the understanding of:

- *the particular characteristics and*

¹ *Impact Investments: An emerging asset class, JP Morgan, 2010.*

drivers of how the income of social purpose organisations is generated and the specific political and policy risks associated with this;

- *the different dynamics and risk characteristics of different sub-sectors, for example health or welfare-to-work;*
- *management and governance issues in the social sector;*
- *the hallmarks of performing and, indeed, non-performing loans in the sector.*

The importance of understanding local conditions cannot be overstated, including the knowledge and analysis of local procurement routes as well as the strength of two-way relationships with commissioners.

These skills relating to risk analysis, appraisal and loan structuring need to be embedded not only in the investment teams but in the organisation as a whole. There is a distinct learning curve to making loans and the experience of The Social Investment Business is testimony to this through the “engaged investor” approach which it has developed.

Furthermore, a key part of the emergence of social impact investing as a new alternative investment market and asset class is the continuing collection and validation of financial performance statistics, specifically the credit records for loans. We noted in Chapter 3 that this is already emerging.

C. INTERMEDIATE CAPITAL IS CENTRAL TO THE MARKET

Intermediate capital, also often referred to as mezzanine finance and including quasi-equity, has sufficient characteristics of both debt and

equity to provide a broad spectrum of finance. It is a well-established corporate finance tool in the mainstream capital markets. A striking aspect of the social impact investment market is how it has already proven itself to be alive with intermediate capital instruments, even if the terminology is not yet commonplace, whether it is philanthropic capital invested as first-loss equity-like capital or the spectrum of debt capital structured with performance-related aspects, or patient capital debt with tailored repayment and interest schedules, as well as unsecured medium and longer-term debt for working capital and development capital, among others. All of these debt products, except the most plain vanilla loans, display some equity characteristics if they are linked to the performance of the organisation.

There is an almost endless array of possibilities afforded by debt-based intermediate capital, depending on how the term sheets are written, and it can take on a range of risk positions without the barriers of “ownership”. Even secured loans can be classified as intermediate capital if providers are prepared to structure the term sheets accordingly. We assert therefore that there is great scope in approaching product development in social impact investment as variations on the theme of intermediate capital and quasi-equity, and equally a great opportunity to expand the existing array of intermediate products as part of a diverse and pluralistic market. This provides a focus to ongoing product development for the social impact investment market and is aligned with developing an integrated market for social purpose organisations with a range of financing products.

This potential has been highlighted with existing examples such as patient capital investments by The Social Investment Business as part of their engaged investor approach and the innovation by Bridges Ventures of their “social loan” product in their two-round financing of the HCT Group (see case study).

The most topical example of intermediate capital innovation is the Social Impact Bond developed and executed by Social Finance. Its name points to its debt-like characteristics yet it has strong participating characteristics (it is based on a payment by results model) and its resulting risk exposure evidences equity-like characteristics. It is likely that more performance-related debt instruments will be evolved that resemble preference shares, performance-related unsecured loan notes and the like.

CASE STUDY

HCT GROUP (FORMERLY HACKNEY COMMUNITY TRANSPORT)

In November 2010, HCT successfully completed a new and innovative financing round, raising £1.6 million to meet its forecast capital needs for the next three to five years. This was innovative for two reasons. Firstly, the sum was split into two tranches: approximately £0.6 million in the form of a fixed-rate loan and approximately £1 million in the form of a “social loan” in which the return depended upon the level of turnover and social impact achieved. Bridges Ventures and Big Issue Invest were the investors in the social loan element – Bridges had developed the idea in an earlier social loan to HCT. The Social Investment Business was an earlier-stage investor in HCT. Secondly, Rathbone Greenbank, part of Rathbone Brothers, was an investor alongside Big Issue Invest in the fixed-rate loan.

This demonstrated that strong management, a robust business model and a clear track record do make social

organisations attractive investments to mainstream financial investors as well as social investors. It also demonstrated the scope for continuing innovation in the intermediate capital area of social impact investment. HCT, in this financing round and generally, shows, as just one example in the sector, that developing a track record, wider marketability as a social impact investment case, and thus access to a more diversified, more robust and more flexible financing strategy is a very achievable ambition for organisations in the social sector.

Source: 10 November 2010 HCT Group News, "City meets the streets" as HCT signs new funding deal (<http://www.hctgroup.org/index.php?type=ARTICLE&articleid=76>).

D. INVESTMENT AND PHILANTHROPIC CAPITAL ARE MUTUALLY REINFORCING

Both investment capital and philanthropic capital are complementary and necessary components in the social impact investment market. Some pundits say that to function effectively, the market requires 10% to 20% philanthropic capital and the rest can be investment capital. This ratio will need to be refined over time by independent data. The important principle to note is that their mutually reinforcing relationship is one of the market's distinguishing features, which also help facilitate pluralism and diversity among providers of social impact investment capital and broaden the range of financing products.

- *The advantages of debt capital*

We explained in the preceding section that the legal forms of many social purpose organisations prohibit them from issuing equity, but they are allowed to take on debt. The very flexible nature of debt instruments allows the sector to evolve a broad range of financing products that fit the needs and risk profile of social purpose organisations with appropriate terms, maturities and interest and repayment

obligations. Debt instruments are simple to understand, can be refinanced to promote liquidity and offer investors speed to market for volume products. They can be structured into complex packages if required, although simplicity is a good preferred default option. Above all, debt capital can provide "base-load" financing for social purpose organisations that is consistent with their missions and that can leverage in other forms of capital. The underlying principle that investment in social purpose organisations is primarily by way of debt instruments also aligns with the definition of social impact investment as an alternative asset class. Chapter 7 explores the advantages of debt products to social purpose organisations in an intermediate capital context in more detail.

- *The advantages of philanthropic capital*

The presence of philanthropic capital in the market provides a major positive benefit to investors in reducing the risk of social impact investment as an asset class. Philanthropically sourced capital, through its ability to absorb financial risk by taking a first-loss position, can open the door to other investment capital with a more conventional risk appetite. This arrangement can either be achieved by tranching within a structured fund or through leveraging in co-investment from other investors. Philanthropically sourced capital is often invested in social organisations by intermediaries. Again, this mostly takes the form of a flexible debt instrument for legal reasons, sometimes as loans but often as extremely patient capital fulfilling the role of high-risk equity-like capital, angel funding or other subordinated capital tranche.

- *Grant funding is complementary*

The experience of The Social Investment Business and others confirms that some grant funding is both a necessary requirement in strengthening the social impact investment market and can help some social purpose organisations gain a foothold in the market by

securing social impact investment. It can also be used separately as a strategic enabler to provide organisations with dedicated funding streams to undertake deeper “modernisation” change and prepare their organisations to be more investible.

3.3. BALANCING SUPPLY AND DEMAND

We need to explode the myth that there is insufficient demand, but it is equally true that investors need to approach the market in the right way because it is possible for investors to miss the demand if they bring out products which do not fit the market. We expand how this is possible in Chapters 4 and 7. An often-made comment by some social impact investors is that they are unable to find sufficient investible opportunities to place the capital they are willing to invest. For example, the £3 million Opportunities Fund, set up by Triodos to make equity investments in growing social enterprises, closed in July 2010 after making only one investment in two years. Social purpose organisations, on the other hand, often say that they are inhibited by the unwillingness of funders to invest or that there is a lack of suitable forms of capital. As a result, they remain dependent on short-term grant funding cycles that absorb substantial resources to secure and inhibit strategic planning.

“ There is no recognition of the value we create in correcting market failures or putting things right when government has failed. We are often just seen as do-gooders, but many new social entrepreneurs are capitalising on the financial value they create and developing sustainable business models. We may not be able to offer equity in our organisations but we produce a lot of innovation which could be harnessed.

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

The experience of The Social Investment Business confirms that the difficulty in securing medium to long-term financing means that social purpose organisations are frequently unable to break the dependency on grant funding cycles. Furthermore, the piloting of a “modernisation fund” designed specifically to build capacity in management skills, financial systems and other developmental activities delivered encouraging results; it proved that with the right support organisations can

become more strategic and move towards more non-grant funding.

Extensive feedback from social purpose organisations that are part of The Social Investment Business customer network shows that they are often frustrated by the lack of capital on offer. The increasing demand for their services means that they report a large future demand for capital in growing this sector. Addressing any lack of “investment readiness” of these organisations in terms of skill sets, governance and robustness of financial planning (all of which are indeed highly important) should be part of an engaged social impact

investment process, because social purpose organisations may lack the motivation to address these issues unless it is required of them. Studying both the supply and demand side of the market highlights that the major challenge is a mismatch of supply and demand side requirements; these issues are expanded upon in the following sections.

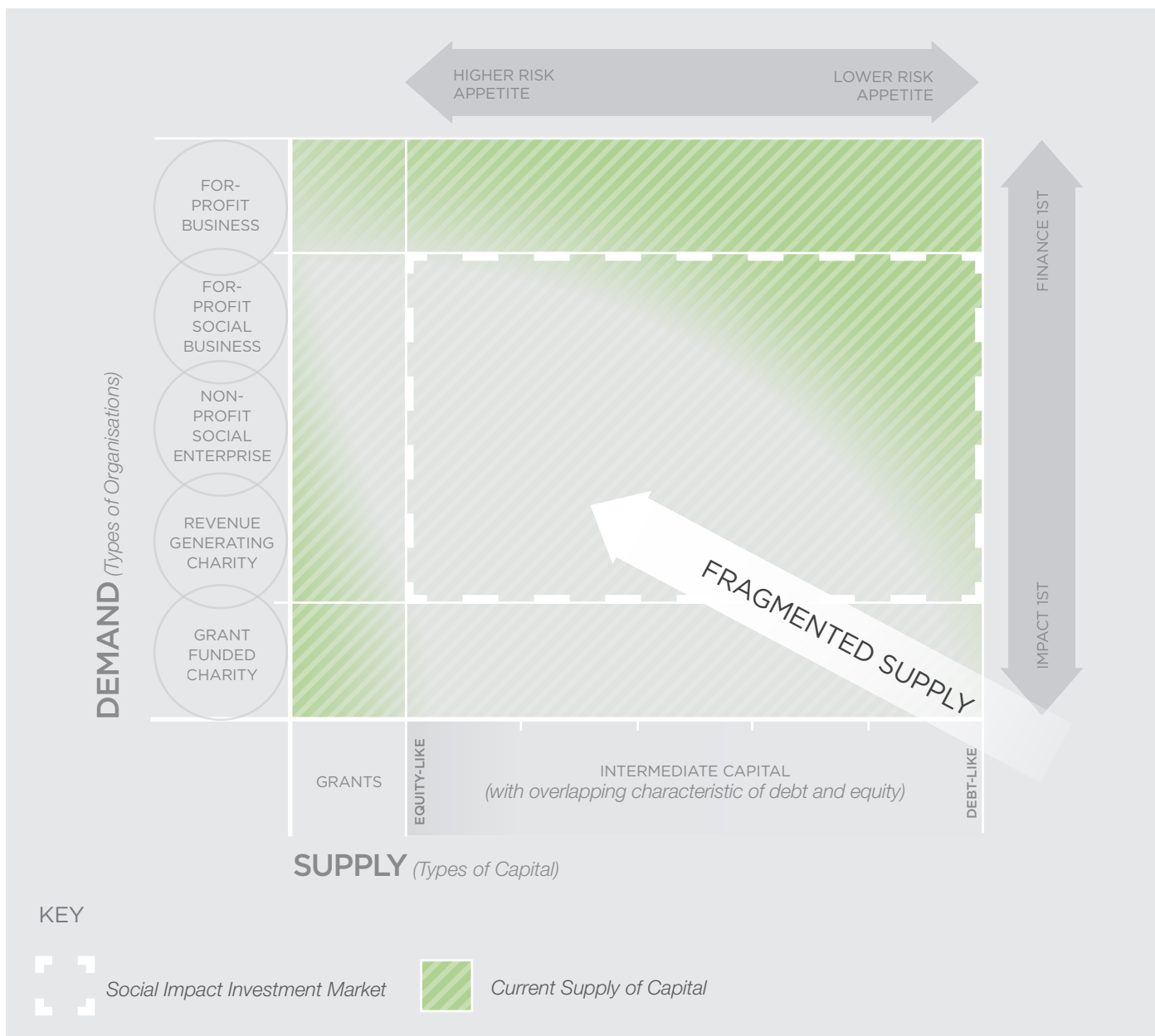


Figure 3: Capital Supply⁹

A. SUPPLY SIDE

The analysis of market size earlier in this chapter confirms that capital does flow into the market but not at the levels that social purpose organisations require. The feedback from recipients of funding reveals that finance is not available in sufficiently diverse forms and is also often lacking in capacity-building support. Key stakeholders, including social impact investors and Big Society Capital, need to support ongoing drives to increase the internal robustness of organisations because this will be critical in making sure that capital can be

realistically invested.

The distribution of capital is fragmented and the range of products could be expanded with more longer-term and flexible capital to support the strategic business planning of organisations. There is insufficient supply of capital in the forms that can be gainfully utilised and not enough pluralism and competition among providers and intermediaries to stimulate diversity. Supply is augmented by mainstream lenders, causing the market to be somewhat skewed, in terms of volume, towards apparently lower-risk property-based loans rather than start-up or growth capital. Mainstream capital providers are also more readily able to support for-profit social purpose organisations because of their “business as usual” approach.

⁹ An evolution of representations previously published by the Social Investment Task Force and CAF Venturesome

Initial indications suggest that Big Society Capital will support the development of new products and actively seek to catalyse the market as it begins to address these issues. Our firm belief rests on the proposition that focus must be maintained on the success of investments rather than scale alone to avoid the mission drift of deals straying into the adjoining territory of socially responsible investment (SRI) or corporate social responsibility (CSR); this is also something that NESTA and UnLtd have identified in their recommendations to Big Society Capital.

As a general observation, more commercially minded investors are likely to be more comfortable on the right-hand side of the supply spectrum (see Figure 3), which resembles more plain vanilla debt and loan products, and probably also more likely to provide capital to for-profit social purpose organisations than non-profits, while more socially minded investors will be likely to accept higher risk exposure as well as engage non-profit and charitable organisations.

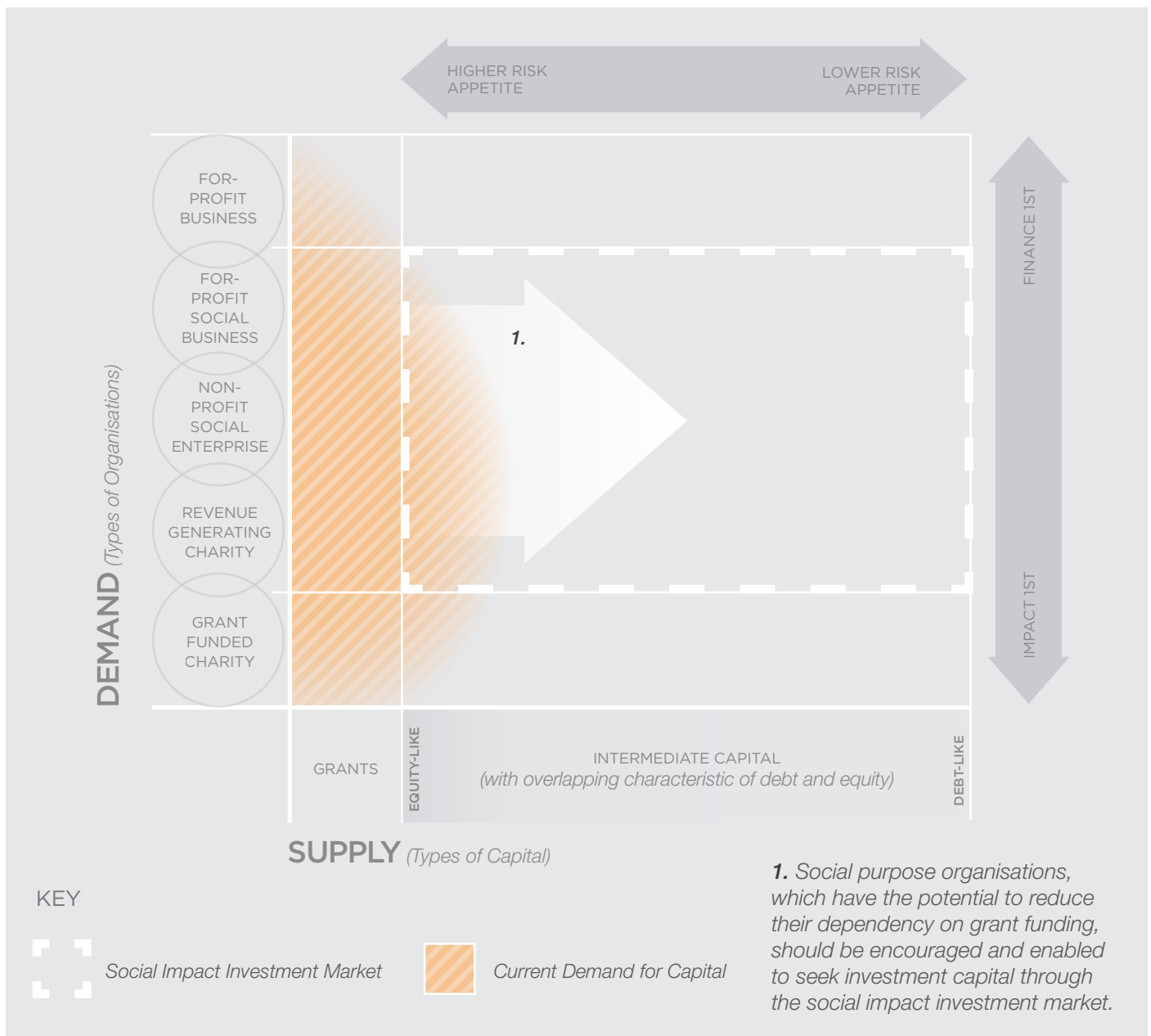


Figure 4: Capital Demand¹⁰

¹⁰ An evolution of representations previously published by the Social Investment Task Force and CAF Venturesome

B. DEMAND SIDE

Most social purpose organisations are geared up to receive grants instead of investment capital, whether for start-up capital, strategic growth capital or working capital. For some this is and will remain the most suitable form of funding. Many others, including the most enterprising, are often caught in the “hamster wheel” of continual one-off grant funding cycles. And many social purpose organisations report a growing appetite and need for capital. The result is a radical mismatch of supply and demand and, as Figures 3 and 4 show, a radical mismatch particularly across the intermediate capital area. There is an opportunity to proactively combine packages of finance with upfront funding designed to help organisations improve their investment readiness and follow-on funding to support their primary activities.

3.4. CHALLENGES OF CREATING AN INTEGRATED MARKET

A well-functioning and integrated social impact investment market will have a diverse range of overlapping products and see providers of capital working collaboratively to provide funding packages, with capital coming together from multiple sources rather than one product that funds everything or fits all needs. This is beginning to happen, as we highlighted in the HCT Group case study, although there still some challenges that will be addressed as the market moves towards maturity.

- *Fragmentation of capital supply*

The feedback from funding recipients highlights that many simply cannot find suitable forms

of funding to match their ideal business models, but have to adapt their business strategies in response to the limited types of available funding. The absence of a joined-up and plural range of capital is limiting the social sector in developing more strategic social purpose organisations with more sophisticated, innovative and sustainable business models. This is a challenge to existing and new providers of social impact investment capital to introduce a greater range of funds and intermediaries, with more choice and competition for social sector organisations, and to develop a greater range of products that include follow-on as well as initial funding. Collaboration and the ability to form partnerships as well as competition

between providers, as appropriate, will be both a condition and attribute of the emerging market.

- *Business support for social purpose organisations*

Both cultural and technical factors contribute in part towards this need. As an example, applying for grant funding requires different skill sets

to writing an appropriately robust business plan or an investment prospectus. Marketing skills are often lacking and there is a real need for technical assistance to improve financial skills, from cash forecasting to understanding basic investor requirements such as for-information reporting. Social sector organisations, which can have strong, hard-to-replicate core competences of their own and are often working successfully in very demanding areas of high operational risk, with often hard-to-reach beneficiaries and where private-sector operators would often not venture, can feel patronised to be told they

“ A surprising number of social sector boards need to be educated in the advantages of investment capital over grants – too many don’t yet know that they need it to make their organisations function better.

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

”

are still “unprofessional”, especially when they recognise their own needs. These needs are not insuperable barriers, as the feedback in Chapter 2 confirms. Good finance managers or executive advice (something that is currently undersupplied for this sector) can be brought in from outside the organisation. These activities all require capital to implement, yet at the same time these factors should not be overstated as barriers because they can be resolved by engaged investors, a characteristic in itself of social impact investment that helps differentiate it from other types of investment.

- *No universally agreed metrics for social outcomes*

Measurement of social outcomes is agreed by many (including us) to be a vital component for this sector, yet there is no common unit of measurement or system to compare the social benefit of different investments. Many “finance first” investors are concerned with social outcomes, at the very least to provide assurance that they invest in something that delivers social benefit, but from a pragmatic perspective they will typically be more focused on usual issues such as investment risk, financial return and robustness of trading data. Some metrics for social outcomes are gaining global support, such as SROI (social return on investment) and GIIRS (global impact investment rating system), although they can be bureaucratic, labour-intensive and costly to implement.

Feedback from social purpose organisations says that no one template for measuring social impact will fit all organisations, thus causing difficulty in comparing like with like. The importance of social impact reporting, not least for internal strategic purposes, is well recognised but at the same time meaningful impact measurement (that is, in a form that organisations could hold out to be to “prospectus standard”) is seen as a function of long-term data series that are often not yet available. Good proxies or leading indicators for

impact can be developed but an overemphasis on “precise” measurement of social impact can quickly become burdensome and just another cost.

It is practicable to undertake broad-brush tiering of social purpose organisations by impact, in terms of those organisations that indisputably demonstrate “high impact”, can only demonstrate “good impact”, have “unproven impact” or “no quantifiable impact”. Social impact investors could set targets or disclose proportions of their investments split according to those headings. Self-evidently, social impact should feature highly when social impact investors undertake their investment and credit appraisal; an organisation that cannot demonstrate its impact is unlikely to be a sustainable organisation in any case. In the absence of standard metrics, whichever methodology an organisation chooses to use should be applied consistently across projects to assist with comparability.

- *Absence of clear market signals*

The social impact investment market is complex and sometimes contradictory without universal market norms of how philanthropically sourced capital and commercial capital can be conflated into social impact investments. The lack of commonly accepted benchmark data as well as the inherent pluralism can cause confusion when making relative comparisons and evaluating good practice. For example, there is an energetic debate about whether social impact investments should be expected to deliver market-rate returns or whether below-market returns must be accepted to counterbalance social outcomes. Both arguments should be accepted as valid descriptions of the two ends of a spectrum. Market participants, particularly new entrants, require clear signals and “showcase” examples to clarify ambiguity and guide market composition. It is anticipated that Big Society Capital will help achieve this by in effect endorsing those funds and intermediaries it

invests in; its support will be a form of kitemark to help more mainstream investors recognise good social impact investment models.

- *Restrictive regulatory and legislative environment*

We have argued why a range of capital sources can serve the needs of the social sector, yet when it comes to taking on debt, the social sector has traditionally been risk-averse and regulators have in the past been sceptical of blending commercial and philanthropic capital, in other words capital that seeks both financial returns and social outcomes. It is encouraging that the Charity Commission has recently consulted on the principles of investing charitable funds (CC14) and new guidance to help trustees with these issues is expected to be issued shortly. Further, new legal forms are being advocated such as the social enterprise limited liability partnership (SELLP), which would allow charitable and commercial interests to be combined within a single and transparent legal vehicle.

- *Insufficient incentives*

A new market needs to be catalysed, requiring incentives to accelerate its development, attract new market participants and increase the enthusiasm of existing participation until the market is established. The government has recently announced plans to increase the ISA limit by £200 for social projects to encourage investment in social purpose initiatives. Ideally, a package of tax incentives and guarantees will be available to encourage institutional and private investors, particularly because investors are often driven to look to tax advantages as a primary criterion for investment decisions,

making performance secondary; it has also been suggested that tax incentives such as the enterprise investment scheme (EIS) and venture capital trusts (VCT) could be extended to apply to social impact investment structures to attract new capital. Incentives could be withdrawn over time as the market matures, as ultimately the costs and risks that make the social impact investment market distinctive need to be internalised.

- *Need for deal-broking*

Broking as a necessary part of the overall social impact investment model should be a central feature of how this market emerges.

This is because there is misalignment between the sort of opportunities investors are typically seeking and the range of opportunities on offer. It is often difficult to bring together suitable capital and capable social purpose organisations because there is poor signposting, application procedures vary and the requirements of investors are so specific that applicants often cannot satisfy all the criteria. Capital often does not know where

“ I have people bashing down my door in need of my services, I could do so much more if I had the money – I need help with finding the right sort of investment capital because I don't know where to go or who to ask.

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

”

the best opportunities in the social sector are or how to identify them. Social purpose organisations do not know where the most appropriate sources of capital are or how to access them most appropriately. A good broker is an essential intermediary in bringing them together and can also help with other issues such as the procurement of business support.

The problem is that broking is labour-intensive, though highly value-adding, and its costs needs to be factored into the equation. Many social impact investors have found that their

own economics cannot support the provision of very much business support or broking. These costs may need to be borne by external market shapers such as Big Society Capital in the short term, but should be internalised as far as possible over time. Social investors should give consideration to where their own core competences lie, how much business support they provide themselves and how much is best done (for both economic and competency reasons) by specialist third-party suppliers.

Fortunately, most of these issues are well known and are being addressed through various published recommendations¹¹ to the government and Big Society Capital about how the market can be catalysed.

Instead of adding our own detailed recommendations to this lengthy and comprehensive list, we have summarised key themes in the following chapter as a general guide to maturing the market under the headings “What would an efficient and thriving market look like?”, “Delineate through doing” and “Measure what is important”.

3.5. PARALLELS

The emerging trend that the social impact investment market is now following is not without precedent. Other markets have followed similar or at least comparable paths and emerged successfully. One example is finance for the social housing sector: a case study is set out below and is held out as a comparable picture rather than any kind of necessary developmental path or close equivalent. In Section 3.6 below, we set out a more generic model for how financial markets evolve to help understand and manage expectations for the development of the social impact investment market.

11 For example, by CAF Venturesome in its publication, *Financing the Big Society*; the suite of reports recently commissioned by NESTA including *Twenty Catalytic Investments to Grow the Social Investment Market with UnLtd*, *Understanding the Demand for and Supply of Social Finance with New Philanthropy Capital*, *Investing in Civil Society with Bates Wells & Braithwaite*; and by ClearlySo in *Investor Perspectives on Social Enterprise Financing*.

A fundamental feature of an emerging market is that one cannot have absolute certainty about future scale or reach; judgement and wisdom need to be exercised. In this context, another comparison can be drawn with Islamic finance, which over the last 10 years has moved from niche to mainstream, with most global investment banks such as Barclays¹² and asset managers such as Schroders¹³ now either offering Islamic products and services, or actively planning to launch them.

CASE STUDY

THE EVOLUTION OF SOCIAL HOUSING SECTOR FUNDING

The trends in social housing providers' capital financing offer some intriguing analogies for the social impact investment market and for the social sector, for all the two sectors' differences as well as similarities. Over the last decade or more, the sources of social housing finance have followed a path evolving from, first, diversification from government grants through increased private finance in the form of growing banking facilities and then further diversification through utilisation of bond markets.

The social housing sector is, of course, a more homogenous sector than the wider social sector, includes some substantial organisations, is asset-rich, well credit-rated and has a simpler income generation story. It is also just at a different stage of development financially, although that fact is, of course, also the source of interest. However, some points of analogy from its financial evolution stand out.

12 <http://www.barcap.com/About+Barclays+Capital/Press+Office/News+releases/PR,Barclays+Capital+tops+Bloomberg+Q1+Islamic+Bond+League+Table>

13 <http://www.schroders.com/StaticFiles/Schroders/Sites/Europe/Channel%20Islands/Islamic-Investment.pdf>

Firstly, and simplest, the development of a more diversified and flexible financing strategy is possible. It is not a nul project and pessimism is to be resisted.

Secondly, it is a medium-term project, not a short-term one, and expectations should be set accordingly (although once well embarked on, a medium-term strategy can pay good short-term rewards as the social housing sector found in 2008–09 when the potential of access to bond finance helped make up a shortfall from squeezed government grants and increased margins on bank lending).

Thirdly, building a track record of financial information on the operating sector and a track record of credit and investment statistics for the investment market in that sector is a key condition of success for that medium-term project. Plus, it is not just about building those track records per se but about the way in which they are made accessible.

Fourthly, marketing a clear and consistent story about the sector as a whole matters as much as constituent individual organisations and the key drivers and conditions of their success.

Fifthly, a low or at least a lower than expected and assessable default rate is a necessary part of that story. Early investments by social investors and achievement of investment funding by individual organisations should be done with that in mind.

Sixthly, as is mostly true of all capital markets, initial fundings should be conducted with a view to supporting access to follow-on fundings, from the point of view of both the social impact investment market and social sector as a whole and also individual social

organisations. Early-round funding that jeopardises access to subsequent financing is inconsistent with the evolution of a financing strategy for the organisation concerned and with the evolution of a social impact investment market for the sector as a whole.

As a point of reference, as at April 2011, the Tenant Services Authority's quarterly review of the regulated social housing sector showed that its capital funding included agreed loan facilities reported at £62.8 billion, of which £49.7 billion (79%) was drawn down and £3 billion was arranged in the year to 31 March 2011. Of the total drawn debt, 93% was repayable in more than five years, indicating a low level of refinancing and replacement risk, with 33% forecast to be repaid by bullet repayment and 67% by instalments. Just over half of new and total facilities (and two-thirds of drawn debt) was at a fixed rate and the average security cover on drawn debt was 137%.

Meanwhile, bond finance continued to be a significant element in sector financing, contributing a third of total new finance in 2010/11. As a new development, Places for People was in 2011 the first UK social housing provider to market a bond aimed at retail investors (listed on the London Stock Exchange's ORB, or Order book for Retail Bonds), raising £140 million paying a 5% coupon fixed to 2016. This followed £850 million of institutional bond issuance by Places for People over the previous 10 years and shows the advantages of developing a track record for both Places for People individually and the sector as a whole.

This is a picture of a social housing sector well advanced down the path of developing a more diversified, more flexible and sustainable financing strategy

capable of supporting its social outcomes. At the same time, to capital market investors it is still a relatively new and unknown sector but shows what can be achieved despite that; all new investment opportunities are unknown at the start. Clearly, even adjusting for the differences between the social sector and the social housing sector, a straight comparison would still be wildly ambitious for the social sector. Their financial characteristics are different. But in getting a new market going, shouldn't it be built with scope for ambition and scope for scale?

Sources: April 2011 Quarterly Survey of Housing Associations, Tenant Services Authority (www.tenantservicesauthority.org/server/show/ConWebDoc.21333) and Places for People (www.placesforpeople.co.uk/news.aspx/latestnews downloaded 29 July 2011).

quantify the risks and therefore beginning to establish the grounds for attracting mainstream investors; and that it has lower correlation with mainstream markets and can therefore offer some help in improving portfolio diversification.

3.6. HOW NEW FINANCIAL MARKETS EMERGE AND HOW THIS MARKET IS EMERGING

We believe that it is helpful to understand the social impact investment market as an emerging market and compared with other emerging markets that have moved towards the mainstream over time, such as commodities, social housing (see case study), hedge funds, the biotech and internet sectors, to name a few. Presenting social impact investment as part of an emerging market is also important to establish realistic expectations about what it can achieve for investors in a reasonable timescale. Focusing on the conditions for emergence of a nascent market also help guide action to encourage the continued maturing of this market.

It is our conviction that social impact investment is beginning to be a demonstrably credible alternative investment asset class for three primary reasons, which we expand upon in Chapter 7, namely that it can offer attractive yield in a yield-shy environment; that good data and track records are beginning to emerge to



Figure 5: How emerging markets emerge: a model¹⁴

In Figure 5 above, we set out our model for the process an emerging capital market follows and specifically our model of how this asset class is emerging.

¹⁴ The model presented here is different to comparable models, however together they highlight the prevailing understanding that industries and markets emerge through different stages, they do not just appear at once. See *Investing for Social and Environmental Impact 2009* by Monitor Institute, and *Impact Investing 2011* by Antony Bugg-Levine and Jed Emerson.

The model tracks two key factors of emerging markets, namely the investment readiness of organisations within the associated sector and the amount of robust information available to investors. Using this framework, we would place the social impact investment market on the crosshairs of this chart. We contend that this is a fair reflection of all the work done by and for the social sector in becoming more investible and the confirmation from social

impact investors that investment and credit risks for the market have ceased to be “black hole” risks as a consequence of the investment track record now beginning to develop. Equally we acknowledge that it is a nascent market, which is characterised by a few investors who have developed an understanding of it.

This interpretive model illustrates to us that continued development towards the top right-hand quadrant, to be accepted as an Alternative Investment Class, is achievable over the coming years. Although we note that this is, of course, not the same as becoming a fully mature investment market, it is realistic for social impact investment to become recognised as an alternative investment asset class if continued emphasis is placed on:

- *More transparent and independent financial information and other performance data about the sector;*
- *Bringing on board more investors prepared to develop an understanding of the particular characteristics of the sector and to collaboratively develop a common set of expectations for social purpose organisations to respond to;*
- *Developing more detailed analytical comparisons between key attributes of different social sector organisations;*
- *Continued investment in developing the internal robustness and investment readiness of organisations;*
- *The continued collation of investment track-record and credit statistics, both at an organisational level and also for the market as a whole.*

The incentive for this move into the top right quadrant has to be that adequate capital is available to those organisations that can demonstrate the appropriate qualities.

Evolution does not always follow a straight line but instead regularly proceeds with some digression. This may result in a broad development path occurring, with some organisations taking the route of the top left quadrant (X Factor) and others the bottom right quadrant (Respectable Strangers). The individual routes will depend upon an organisation’s internal focus and will indicate the need, respectively, for improving investment readiness or robust and transparent information. It also reinforces the requirement for good broking, based on understanding and informed mutual contact between providers and recipients of capital.

CHAPTER 4. DEVELOPING THE MARKET TOWARDS MATURITY

This chapter explores how we can further establish social impact investment as a thriving alternative investment asset class. Developing the market in the future requires the combined actions of investors, social purpose organisations and market agents to realise an integrated capital market, and for social impact investments to be an attractive asset class. Like all markets, it will be imperfect and need an appropriate level of intervention combined with proficient supervision and regulation to function well and minimise systemic risk.

4.1. WHAT WOULD AN EFFICIENT AND THRIVING MARKET LOOK LIKE?

The market should serve as a seamless escalator of finance for social purpose organisations and prioritise their needs. It would be pluralistic and diverse, yet also inclusive, integrated and collaborative. These apparent contradictions can be reconciled and would be part of the attributes that make social impact investment a distinctive asset class. Organisations would demonstrate greater investment readiness, business planning and financial acumen. Robust long-term financial strategies would include refinancing options that offer shorter-term investors a commercial exit. An increase in skilled intermediaries and brokers would mesh the interests of investors and funding recipients, not through a one-off transactional service but by way of engagement across the whole life of an investment, including deal-broking, intermediation, capacity-building and conciliation.

In Chapter 3 we highlighted that the cost of these activities ultimately needs to be internalised as part of a mature market. The costs of developing market-wide investment statistics on a comparable basis is an example of where costs may need to be externally borne in the shorter term. This sort of financial subvention is beneficial in developing any market but it is essential if the process is to be fast-tracked. Big Society Capital has acknowledged that its role will include market-shaping activities and it is reasonable to expect, given the advice from NESTA and others, that it will indeed shoulder the costs associated with catalytic activities.

A mature social impact investment market will be large; this is a growing market as well as one that is fostering new forms of enterprise. It is therefore an opportunity to invest in a growth area of enterprise and gain an early understanding of the long-term trends associated with it. The priorities should be increased plural provision of capital, a rebalancing of the skewed distribution of capital types and maturities of financing products, increased liquidity, the continued development of market-wide investment

and credit statistics, and improved investment readiness. The intensifying interest from the government, private and social sectors suggests that the timing has never been more favourable to develop the market.

We advocate throughout this review that investors need to adopt an engaged approach to deal with market nuances and also to coach investments towards success. As an extension of this more engaged approach, and only in exceptional circumstances, there is a requirement for work-out facilities to support the acquisition and restructuring of non-performing investments or their orderly termination, particularly if vulnerable people are dependent on concomitant services. An analogy would be the “London Rules” that used to apply between domestic London-based banks – these were a set of agreed principles for how banks could work together to deal in an orderly way with the financial restructuring of non-performing commercial businesses loans. Big Society Capital is ideally placed to oversee a comparable function in the social impact investment market.

4.2 DELINEATE THROUGH DOING

An internationally accepted understanding of social impact investment has largely been achieved, although this needs to become embedded with practice. While there is still a sense by many practitioners that an appropriate analytical framework has not yet been achieved,

it is hoped that this review demonstrates that such framework does exist. When institutions such as Big Society Capital, and others globally, refine definitions, we recommend they accommodate local nuances but also acknowledge that social investment, impact investment and social finance are all part of a single asset class within one global market, whichever nomenclature ultimately succeeds and whichever variations and segments exist within it. In an efficient market, standard terminology should be used that is transparent, explicit and universally understood to mean the same by all, as well as be flexible enough to reflect plurality.

“Some of the metrics we are asked to adopt are practically useless because they don’t relate to the real value we create. We can provide evidence of impact, but it’s difficult to provide hard proof in numbers – the best way an investor can gauge our impact is to visit us and judge our impact on the ground.”

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

”

4.3. MEASURE WHAT IS IMPORTANT

Although metrics are extremely important when considering the impact of social investment, the lack of an accepted standard is not debilitating provided that organisations can demonstrate in an auditable way that social outcomes are being achieved and that “mission drift” has been eliminated. From the perspective of investors evaluating an asset class, it is

more important to obtain robust information on risk, return, credit standing and related issues; these are the issues that will enable the social impact investment market fully to emerge or not. By contrast, the ever more complex social impact metrics industry runs the risk of allowing the perfect to become the enemy of the good. Valid and accurate measurement of social impact depends on long-run data. Attempts to be precise based on shorter-run data can be methodologically flawed and merely add cost

without real benefit. The need for longer-run data means that impact measurement should be seen as an important area of continual incremental development and, in the shorter term, as described in Chapter 3, bigger-picture categorisation of social impacts should be pursued.

As an example, we believe that the approach taken by NeXii (which offers a Mauritius-based stock exchange listing for global social purpose organisations) gets the balance right. NeXii is metric-agnostic provided that a recognised system is used, such as GIIRS,¹ SROI² or similar, and that measurement is consistently applied. They also acknowledge that it took many years for standardisation in the credit rating industry and that social impact will also evolve over time, but that this should not inhibit progress.

We accept that in the short to medium term, best-practice guidance for the measurement of social outcomes is required to assist with signalling to the market. We suggest that at this stage it is good enough to have a lighter-weight, high-level measurement system according to a sliding scale (such as the National Home Energy Rating). For example, it would be sufficient to point out whether an investment has achieved “high impact”, “good impact”, “unproven impact” or “no quantifiable impact”. This could be supported with a voluntary label or kitemark, similar to the Social Enterprise Mark in the UK or the B-Corp Certification in the USA, which could assist in unambiguously identifying legitimate social impact investments without requiring onerous evaluation.

In the absence of universally accepted metrics, it would be satisfactory to demonstrate that an auditable methodology had been adopted in evaluating social outcomes to determine whether an investment has achieved “high impact”, “good impact”, “unproven impact” or “no quantifiable impact”. For example, by asking the following questions:¹

1. Have deliberate social objectives been specified at the outset?
- Say what you will do.
2. Are measurement systems in place to record whether those objectives have been achieved?
- Do what you say you will do.
3. Are results evidence-based and independently verifiable?
- Transparent, objective and unambiguous.
4. Are results linked to incentives for the organisation and/or staff?
- Outcomes-based rewards/payment by results (PbR).
5. Is there a mechanism for learning lessons and continuous improvement?
- Feedback loops to improve quality and best practice.

.....
¹ This is similar in approach to the five questions of the Charting Impact framework (<http://www.chartingimpact.org/about/five-questions/>) or by New Philanthropy Capital published in *The little blue book, their guide to analysing charities* (http://www.philanthropycapital.org/publications/improving_the_sector/charity_analysis/little_blue_book.aspx)

.....
¹ Global impact investing rating system

² Social return on investment

CHAPTER 5. THE GLOBAL CONTEXT

The social impact investment market occurs within the context of a globalised economy, with movement of capital across international borders and a global regulatory environment presiding over all financial activity, including social impact investment. The purpose of this chapter is not to put forward a compendium of exemplar social impact investments, but to highlight key issues that either are relevant from a contextual perspective, highlight important trends or present an opportunity for international collaboration.

The UK has the potential to leverage both its reputation as a premier global financial centre and its well-established social sector, and to fuse this expertise in developing the UK as the pre-eminent global centre for social impact investing. Two examples highlight that this is ostensibly already the case: the Social Impact Bond, which was pioneered in the UK, is receiving enormous interest globally with organisations in the USA and Australia seeking to replicate the concept; and there is interest in the model underpinning Big Society Capital from as far afield as Hong Kong.

The sharing of best practice is a two-way street. We should bear in mind that while social impact investment may be receiving new impetus, it is not new and has been undertaken for decades and centuries elsewhere, particularly continental Europe. This hard-earned experience can only be beneficial in accelerating the UK market. For example, the proposal to establish Big Society Capital in the UK with the proceeds of dormant bank accounts seems novel, but France already makes use of similar legislation to give social use to unclaimed assets.

“ If the investment supply existed, the best way of creating best practice in the UK would be to replicate practice across international borders. Maybe a global impact investing market could do that.”

Jolanta Lasota and Alan Larsen,
Ambitious About Autism

”

5.1. MACRO-PRUDENTIAL REGULATION

The social impact investment market is a subset of the broader capital markets and participants need to conform to the regulatory framework as it exists. For example, the Basel III accord applies equally to the social impact investment market as to other financial markets. These issues are beyond the direct scope of this review; however, they do highlight the contextual environment and potentially also opportunities for social impact investment.

- *Firstly, the unique attributes that make social impact investment a distinctive asset class require that it is knowledgeably regulated. The social impact investment market comprises both debt-based and philanthropy-based capital. As a result some market participants require regulation by the Financial Services Authority (or its successor), some by the Charity Commission and some by both. We recommend that in time this justifies the establishment of dedicated teams within these respective bodies; moreover, they must work in unison on common issues to ensure an efficient and simple regulatory environment.*
- *Secondly, many of the inherent principles of social impact investment are consistent with what the regulatory reform is trying to achieve such as less short-termism, greater diversity to reduce contagion and more socially useful finance.*

5.2. INTERNATIONAL DIMENSION

The perception of the global social impact investing market is likely to be influenced by the respective outlook from within countries relative to their existing trading relationships and the degree to which regions share legal, cultural, political and economic features. From a UK perspective, it seems natural to organise global activities according to three broad spheres: the Anglophone developed world; the non-Anglophone developed world; and the developing world. We highlight below several key issues within each of the three spheres.

A. THE ANGLOPHONE DEVELOPED WORLD

The principle of using market-based systems to generate both social as well as financial returns has been notably promoted in the USA over preceding decades, witnessed by the introduction of the term “impact investing” and related themes such as “blended value”¹

¹ Coined by Jed Emerson to recognise that value is non-divisible and naturally incorporates social, ethical, environmental or charitable elements, see www.blendedvalue.org

and, more recently, “shared value”.² The term PhilanthroCapitalism³ was coined by British authors to highlight how principles of business can be successfully combined with the creation of social good. San Francisco-based SOCAP⁴ organises conferences around the globe to promote “social capital markets” that increase the flow of capital towards social good. The Rockefeller Foundation⁵ is actively lobbying private foundations to invest more of their capital endowments into “mission-related investments” rather than merely mainstream managed funds. It also established the Global Impact Investment Network⁶ and actively promotes taxonomy structures (such as IRIS⁷ and GIIRS⁸) for measuring social outcomes. The Calvert Foundation⁹ offers a range of products for both philanthropists and social impact investors, to either “give for impact” or “invest for impact”.

The UK, notwithstanding its strong heritage in charity illustrated by the Victorian industrialists with their large-scale private philanthropy, only more recently began to explicitly promote the concept of blended returns with the establishment of the Social Investment Task Force¹⁰ in 2000. This successfully jumpstarted the UK market from which internationally acclaimed product innovation stemmed such as the Social Impact Bond, which is currently being piloted by Social Finance.¹¹ Social Impact Bonds are now receiving increasing support in the Anglophone developed world, particularly by the USA and Australian governments, each evolving the mechanism to suit the specifics of their local situations.

² Michael E. Porter and Mark R. Kramer, *The Big Idea: Creating Shared Value*, Harvard Business Review January, 2011

³ <http://www.philanthrocapitalism.net>

⁴ <http://socialcapitalmarkets.net>

⁵ Rockefeller Philanthropy Advisors, *Mission-Related Investing: A Policy and Implementation Guide for Foundation Trustees*, 2008

⁶ <http://www.thegiin.org>

⁷ <http://iris.thegiin.org>

⁸ <http://giirs.org>

⁹ <http://www.calvertfoundation.org>

¹⁰ <http://www.socialinvestmentsandtaskforce.org>

¹¹ <http://www.socialfinance.org.uk/sib>

The philanthropic sector in the USA has traditionally been considered more financially innovative than in the UK. This has often been attributed to the legal requirement for minimum annual grant-making payouts (5% of endowment capital), which calls for much more aggressive investment strategies to sustain. For example, the USA introduced the Low-profit Limited Liability Company (L3C) legal form to bridge the gap between for-profit and non-profit organisations. It was intended to help simplify compliance with Internal Revenue Service rules to facilitate the combination of philanthropic and commercial capital within the same legal entity. A similar legal form, namely the Social Enterprise Limited Liability Partnership (SELLP), is currently being advocated for the UK and if enacted will allow philanthropy-based and debt-based social impact investment to be brought together more readily within the same investment vehicle in a tax-compliant way.

The Community Reinvestment Act (1977) in the USA requires commercial banks to lend money to underprivileged people in the neighbourhoods within which they do business. There has been much criticism of the Act since it came into force and it has been amended numerous times in order to make it function more effectively and remedy market distortions. Notwithstanding these criticisms, the Act presents a valuable precedent for the UK government as it grapples with the question of how to capitalise Big Society Capital and the social sector sustainably. In the context of global competition, particularly for multinational financial institutions, the UK government should consider replicating the principles of the Community Reinvestment Act in the UK. This would provide a mechanism for encouraging more capital towards social impact investment as the market matures, potentially via Big Society Capital, at the same time avoiding the perception of a stealth tax or market distortion because it is adopting a mechanism that is already in place elsewhere.

B. THE NON-ANGLOPHONE DEVELOPED WORLD

Europe, the UK's largest trading partner, has prioritised social impact investment as a crucial means by which it can strengthen the European single market as well as social and economic cohesion. EU Commissioner Michel Barnier, responsible for the internal market and financial services, launched a consultation in July 2011 on how private investment can play a greater role in supporting social business. He has also called for the establishment of a European social bank to catalyse the market. The prospect of attracting private capital to finance the social sector across Europe is particularly welcome at a time of severe budgetary constraints at European Commission level and also fiscal austerity at national level.

Long-standing EU principles of free movement of capital and the cross-border supply of financial services create an opportunity for UK and European organisations to collaborate in the development of hybrid social impact investment models that combine the respective strengths of market-based systems and solidarity-based investment. Precedents of this already exist; an example is UK microloan provider Fair Finance, which secured £2 million worth of commercial banking package from European banks Société Générale, BNP Paribas and Santander, leveraged using £750,000 of patient philanthropic capital and a £350,000 loan from the Big Society Finance Fund.¹²

The vision for the UK social impact investment market should include both the attraction of more European finance organisations into the UK, such as social, alternative, mutual and cooperative banks, as well as to encourage UK social impact investment organisations to export their services into Europe and expand their operations. This will provide a channel for increasing the liquidity of the social impact investment market in the UK and Europe as

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¹² <http://www.philanthropyuk.org/quarterly/articles/case-study-3-fair-finance>

well as increase the diversification of capital providers to help moderate systemic risk in the UK and European financial markets.

C. THE DEVELOPING WORLD

Social impact investment is truly a global phenomenon – not only is there great need for social impact investing in the developing world but there are also brilliant exemplars and highly innovative organisations such as the California-based Omidyar Network,¹³ a global philanthropic investment firm that invests in non-profit and for-profit organisations to improve peoples’ lives through harnessing the power of markets. The wide range of locally developed models is also encouraging, such as the Sitawi¹⁴ social fund in Brazil, which provides loans and advice to social purpose organisations, and Aavishkaar¹⁵ in India, which provides risk capital to social entrepreneurs at the “base of the pyramid”. The CiYuan¹⁶ initiative in China is an incubator that builds cross-sector partnerships to enhance the value of social impact investment in China and improve the capacity of local foundations and NGOs. NeXii¹⁷ in South Africa is an organisation that focuses on building marketplace infrastructure for social impact investment and is currently collaborating with the Stock Exchange of Mauritius to create a dedicated board on its exchange that will enable social purpose organisations globally to publicly raise debt or equity in US dollars, euros and sterling.

International aid and development agencies are also exploring the field of social impact investment to investigate how they can make more effective use of their resources, particularly how to attract more mainstream private capital alongside their own. For example, the Department for International Development (DfID) in the UK established a

Private Sector Department¹⁸ in January 2011 specifically tasked with developing public-private funding partnerships. The US State Department runs the Investing with Impact¹⁹ programme to use “the power of the free market to drive social and economic progress” to create “revenue-generating solutions to the world’s most pressing problems”.

5.3. A GLOBAL FINANCIAL CENTRE FOR SOCIAL IMPACT INVESTMENT

This brief study of the global context of social impact investment reaffirms to us JP Morgan’s assessment²⁰ that there is tremendous scope globally for social impact investment. Furthermore, it suggests that there is good global infrastructure, experience and track record to scale this market and asset class globally. Other global financial centres appear to be equally convinced, for example Banque de Luxembourg launched its European Impact Investing Luxembourg initiative in November 2010, designed to promote the role of Luxembourg’s financial centre in this arena.

We have stressed throughout this review that a healthy social impact investment market will embrace and require plurality and diversity. This will inevitably also apply to global financial centres that will be able to attract and service different aspects of the market based on their traditional strengths and entrepreneurial insight into the potential of this new market. Given the UK’s already excellent reputation as the premier global financial centre and its well-established social sector, we believe that it would be a lost opportunity if the City did not capitalise upon this and develop the UK as an unparalleled global centre for social impact investing.

13 <http://www.omidyar.com>

14 <http://www.sitawi.net>

15 <http://www.aavishkaar.in>

16 <http://ciyuan.bsr.org>

17 <http://nexii.com>

18 <http://www.dfid.gov.uk/Media-Room/News-Stories/2011/New-DFID-Private-Sector-Department>

19 <http://www.state.gov/s/partnerships/impact/index.htm>

20 *Impact Investments: An emerging asset class, JP Morgan, 2010.*

CHAPTER 6. THE VISION OF LEADERS: CURRENT AND FUTURE

We asked a number of existing social impact investors and intermediaries, as well as leaders adjacent to the sector, to highlight from their perspective what the key issues are to mature the social impact investment market, or to sketch their vision for the market. This is only a snapshot of opinion and is included to highlight the range of views. In the spirit of analysing the industry through a candid lens, we have invited comment even if it differs from the major themes in this review. We have included the comments to hold up a mirror to the diversity of the market.

6.1. HUGH BIDDELL, HEAD OF CHARITIES & PUBLIC SECTOR BANKING, CORPORATE AND INSTITUTIONAL BANKING, ROYAL BANK OF SCOTLAND

“There is definitely a market but it will not evolve in a straight line – this is a market which will progress in fits and starts. For financial investors, there is a real attraction to investing in entrepreneurs – i.e. a research and future potential motive not a social policy motive. There is a growing consideration that social investment may also prove more sustainable.

“For the market to develop there are then three components:

“**first**, cash flow available to the entrepreneurs that will support investment capital - which it is the job and skill of entrepreneurs to find ways to unlock;

“**secondly**, growth in organisational capability – organisations need to continue to grow in investibility and part of what they need is the ability to grow their capacity. They need space and ability to invest in people, processes, IT and systems if they are going to continue to progress. It is recognised the conditions for investment and the use of proceeds of investment are wrapped up together (analogous to the way a listed company that is fundraising from investors for new investment will also secure working capital to enable that investment to be effective; it is a condition of the fundraising that working capital will be adequate after it);

“**thirdly**, pools of investors with similar objectives willing to invest.

“Social impact investment is a challenge for the traditional banking and investment models, which have regulated and established norms for cost of capital, hurdle rates and fair value. Social investment and social loans are difficult to achieve in a way which does not involve a prohibitive cost of capital but this is where Big Society Capital could, among other things, bring about a new cost of capital consideration and we should not forget that traditional banking and investment models have a history of changing and being innovative. Mixing investment with social return risks the social return element being seen as a “grant” which might unpick the investment concept. But the ideal would be somewhere new between a grant and a purely commercial market – where there is a role for social return and its value will be seen as a part of the sustainable and compelling business model into which the investor has committed rather than a financially derived value. Mainstream investors will need much more visibility and take a long time to come round to this market in scale (by capital markets measures). More social investors as a class are therefore needed to keep developing the market so that it can, over time, keep building its attractiveness.”

6.2. JOHN BROOKS, DIRECTOR OF SALES & MARKETING, UNITY TRUST BANK

“In terms of straightforward lending to the sector, we have capacity to do more but there is a need to find the right deals. It’s a sector which is changing, but remains risk-averse and reluctant to fund growth through debt.

“Investment readiness can also be a challenge, but there has been a step change in the sector over the last few years in terms of governance and financial awareness. It’s one of the most significant changes. There seems to be an increasing number of people coming into the sector with business and professional backgrounds, which makes a difference, and umbrella bodies have led the way in encouraging good practice. There is also a clear recognition of the need for a sustainable income stream and the increased role of contracted income – these have all played their part in strengthening the sector.

“Providers of finance and investment to the sector should actively work together with joint funding initiatives.

“Big Society Capital is a very welcome development but it is both a huge opportunity and a threat – it will need to guard against mission creep and avoid the temptation of trying to get money out of the door too quickly.

“Normal working capital finance has not been a significant product for us because the sector has traditionally been encouraged to fund this from reserves. But with the move to contract income and payment by results, this is likely to change. The prospects of a mismatch in supply and demand can clearly be seen – with organisations needing this form of finance much more than before, but not having the capital base to secure it from mainstream sources. This is where development of a wider market and new products could have a role to play – for example, there would be a role for Big Society Capital to support a loan guarantee scheme tailored specifically to the sector.”

6.3. MARK CAMPANALE, FOUNDER AND EXECUTIVE DIRECTOR, THE SOCIAL STOCK EXCHANGE

“I strongly believe that risk finance – primarily equity finance – is what the sector needs, because debt (unless it is subsidised) is just so expensive. We see the main challenge not as the availability of debt, but the unavailability of equity finance. Social enterprises are under-equitised and need to build stronger balance sheets to enable them to compete with conventional for-profit enterprises. This is why we are establishing the Social Stock Exchange. I know that not all organisations in this sector are able to issue equity, so one of the next challenges will be to create a functioning capital market for debt that has equity-like characteristics. It is early days yet for the Social Stock Exchange and this is something we could explore after we get established.

“Maybe there should also be a peer-to-peer online platform to capture the demand which is not suitable for exchange listing – like Zopa does for loans except on a risk-adjusted basis – but that is going to be a challenge to implement. A properly regulated capital market that enables ordinary savers and investors to participate has to be our goal. We certainly see it benefiting social ventures and social investors alike.”

6.4. PAUL CHENG, HEAD OF CAF VENTURESOME

“The social investment market is an exciting space in which both philanthropic and commercial capital can be mutually

reinforcing. The sector needs risk capital and therefore CAF Venturesome has already developed a number of quasi-equity investments and new financial structures which use capital given by philanthropists to invest in social sector organisations. We need more of these hybrid products and there is an opportunity for the City to participate in innovative capital structures that have social purpose. This would give greater credibility to social investment as an asset class.

“The sector is beginning to develop a track record. For example, in the 10 years CAF Venturesome has been running, we now have a cumulative write-off rate across all our funds of only 4%, and on some of the lower risk funds it is about 2%. We as a sector need to be transparent about what we have actually achieved, and we need to avoid hiding bad investments by merely rescheduling them.

“It’s strange that philanthropic investors (who are happy to give away their money) are subject to the same FSA regulations as commercial investors when they wish to engage in social investment. We need to create an easier, simpler way for charities and private investors to set up FSA-compliant social investment funds. For example, the current collective investment scheme principles set out under the Financial Services and Markets Act (FSMA) 2000 restrict charities from accepting monies from organisations and private investors on anything other than a donation basis. The government should consider granting exemption for monies raised and held solely for charitable purposes from the collective investment scheme definitions under the FSMA 2000.”

6.5. SIR RONALD COHEN

“There is a lot to be excited about in this emerging market. Entrepreneurs in the social sector need access to risk capital, often in the form of hybrid securities. The sector needs multiple capital providers whose management teams understand finance. There is also a need for brokers who bring together those who require capital with those who would like to provide it. I encourage anyone with the right skills to get involved in developing this important social market.”

6.6. GRAHAM HODGKIN, SENIOR ADVISOR TO DEUTSCHE BANK

“There are encouraging prospects for social impact investment to emerge as a true asset class in the UK. The US experience might give certain pointers as to how it might evolve, though it’s important to recognise the differences between the US and UK markets and the significance of market shaping regulation and initiatives, such as the Community Reinvestment Act in the US market. Big Society Capital has the opportunity to be transformative, investing in market infrastructure as well as taking positions which draw in new investment. The market should not look to Big Society Capital alone however, but to other market and financial participants who have a critical role to play, with intellectual capital being as important as the financial variety. Deutsche Bank’s recent launch of a £10m fund of funds is an example of a fund established to develop the social impact investment market.

“Social impact investment is not CSR, but an alignment between the two will be important to leverage both corporate volunteering programmes, investment readiness grants & donation programmes, which can help provide some of the other key components associated with professional and sustainable social impact investing.”

6.7. DAVID HUTCHISON, CHIEF EXECUTIVE, SOCIAL FINANCE

“It is exciting to see the significant talent increasingly being drawn towards social enterprise. As these social entrepreneurs develop their ambition, they need reassurance that there are intermediaries and capital available to support their growth and act as their long term partners. Specifically they need confidence that they can reliably raise risk capital which understands and supports their mission - capital which sees the social purpose as a strength in the business model and a crucial part of the investment return rather than a potential distraction diluting financial returns.

“There is strong evidence that a growing number of individuals are keen to explore whether they can invest this way. Providers of social investment capital are excited that they can use their resources to drive social change and support innovation in a much more sustainable way. Social investment connects these two powerful constituencies. It’s an exciting time. There is so much to be gained. These are investments that everyone can be proud of.”

6.8. IONA JOY, HEAD OF CHARITY EFFECTIVENESS, NEW PHILANTHROPY CAPITAL

“A social investment market that really involves ‘investment’ needs a much more reliable evidence base than we have today to calculate the social element of the total return. We need a far greater understanding of how to measure and assess social returns if the social investment market is to thrive. Without that understanding how will social investors decide where to invest? Although many in the sector recognise the need to prove impact, and also recognise the value of measurement in helping organisations to improve what they do, we are still a long way off being able to measure social returns consistently and robustly. However, an emerging social investment market could provide the stimulus for better assessment of return.”

6.9. NIGEL KERSHAW OBE, CEO, BIG ISSUE INVEST

“We are in the process of launching a Social Merchant Bank – by the social entrepreneurs for the social entrepreneurs. The aim is to offer social entrepreneurs, enterprises and businesses whatever is the best type of investment they require, whether it be early-stage funding, loan funding or private equity. We provide everything from grants and investment through to advisory services and networking and learning together. It’s also where investors come to get the most appropriate returns to achieve social transformation, whether it is giving it away or investing it.

“There is sometimes a false distinction between SRI [socially responsible investing] with positive screens and impact investing. We turn the SRI argument on its head; instead of negative screening we invest in organisations that target positive social impact and that help dismantle poverty, and if we can do that we will have a sustainable planet. Everything we do is underpinned by our Social Impact Index.

“Big Issue Invest, like many social enterprises, was set up to address a market failure and, particularly in light of the recent financial crisis, I don’t want those who created the failure to start defining social investment. I hope that the sector doesn’t become sanitised with evaluation matrices too early by mainstream investors. We need to set the terms, this is a pioneering space, there are no precedents, and we need the social entrepreneurs to define the thinking, not the traditional financiers.

“I am concerned that if it becomes defined as an ‘asset class’ by the City that it will attract those who only seek financial maximisation without driving social values – we have seen this with microfinance in some areas where people are being kept in poverty through over-indebtedness to microfinance institutions and we don’t want it repeated with social investment. It is about appropriate returns to investors while dismantling poverty and sustaining the planet.”

6.10. JONATHAN LEWIS, FORMER CEO, THE SOCIAL INVESTMENT BUSINESS

“A successful social investment market is one in which socially transformative ideas

can be funded and brought pervasively to market so that the most troublesome social problems can be more effectively tackled.

“To achieve this, three things need to happen. First, there needs to be more money via ‘social investment’ to help bring them to market. Second, commissioning needs to reach out and find the best solutions as opposed to being some kind of Kafkaesque process that suits only those with scale and resources. And, third, the sector needs to organise itself into a series of businesses that meet the standards of the commercial banks so they can access some of the £55bn they lend each year (social investment even with the Big Society Bank will only account for c.1% of this, so, logically, the sector won’t get to serious scale until it is serious about commercial funding).

“A successful social investment market will see more commercial money going to charities and social enterprises, a new type of company springing up to drive the sector forward to win the largest contracts and social investment at scale – simple! This may not be a precise answer to the question about the nature of the ‘social investment market’ but these are the key building blocks of success.”

6.11. STEPHEN LLOYD, SENIOR PARTNER, BATES WELLS & BRAITHWAITE

“There are some interesting parallels such as the housing association market, which has already emerged as an investible asset class where the presence of a strong regulator – and, of course, an asset base – was important in shaping the market and giving confidence to investors. The wider

social enterprise market is far too diverse to regulate in the same way but it’s worth noting the important role that transparency and robustness will have in the market progressing.

“Another key issue is the scope for scale – many social enterprises have a strong local focus and the driving force behind them is mainly local. That does not make them uninvestible, but the funds available need to be able to filter down to support them and be in the form that they need. The prime product would be debt-based, e.g. unsecured loans.

“On the other hand, clearly the market is still evolving and it is a dynamic point in time. One of the most exciting factors seems to be an emerging younger ‘next generation’ of social entrepreneurs who are looking for more from business, for whom a blended social and financial return is a given. That implies a real prospect for strong social enterprises to develop in the future, and perhaps the emergence of franchise models, which has not yet happened in the social enterprise sector.

“Changes to tax legislation would have a massive transformative effect, for example tax relief on lending to social enterprises, if anti-avoidance problems could be solved.

“Philanthropic and commercial capital both have an important, and complementary, role to play but the market should develop structures (such as the Social Enterprise LLP (SELLP)) that ensure the interests of each are properly served and in particular, charitable use of the philanthropic element, if that’s relevant.”

6.12. JOE LUDLOW, DIRECTOR SOCIAL VENTURES, PUBLIC SERVICES LAB, NESTA

“Social ventures can be a source of great innovation which can make a big difference in tackling some of the largest challenges facing society, such as climate change and an ageing population, but we know that these social ventures need access to finance. Developing the social investment market is critical in providing that finance. We need a range of intermediaries to connect capital providers with social ventures who require capital, so that the right type of money gets to social ventures and the right types of offers are made to social investors in order to attract them.

“NESTA has commissioned a number of pieces of research related to this topic, including an examination of wealthy individuals’ interest in social investment (conducted by The Fairbanking Foundation and Ipsos MORI) and the demand for capital among social enterprises (conducted by New Philanthropy Capital). We see little evidence that social investors are currently achieving returns comparable to those achieved by mainstream investors investing in higher-risk equity or equity-like instruments. However, in the future wealthy individuals may not demand this from a new class of clearly differentiated social investment products.

“The size and shape of the capital available is not necessarily the largest constraint in scaling the impact of a social venture. Our work with Social Venture Intermediaries suggests that a range of support is needed to grow the impact of a venture, including access to business advice, recruitment

and retention of management, support to measure and evidence impact, and brokerage of public service delivery contracts.

“In particular, we need to see a greater use of measurement of outputs and outcomes in the social investment field alongside greater understanding of the use of evidence connecting the outputs of investee organisations and the outcomes experienced by beneficiaries. This is critical in ensuring capital and revenue is directed to increasing the impact of the most effective social ventures.”

6.13. NICK O’DONOHOE, CHIEF EXECUTIVE, BIG SOCIETY CAPITAL

“We know that social enterprises are undercapitalised and that there is interest in the investment community for investment opportunities that seek social impact and financial return. But the necessary intermediary layer is still embryonic, so capital and social entrepreneurs do not meet as frequently as they could. Big Society Capital will invest in intermediary organisations to strengthen the capacity of this layer and build bridges between social investors and social purpose organisations - which we define as organisations that have their social purpose embodied in their constituting documents and define how financial surplus is distributed to support their social purpose. Big Society Capital will not provide grants but will work closely with grant funders to support the government’s drive to promote social enterprise and payment by results contracts.

“Big Society Capital is being created upon four guiding principles:

- Independent of government and political influence.
- Operational transparency.
- Wholesale capital provider to avoid distorting the market.
- Financially self-sufficient to cover operating costs and any losses that may occur.

“We anticipate that Big Society Capital should become operational in the first half of 2012 after it has received ‘state aid’ approval by the European Commission. The Commission needs to confirm that the funds Big Society Capital has been allocated from dormant UK bank accounts do not contravene EU rules regarding state aid - this approval is expected by the end of 2011.”

6.14. STEPHEN ROCKMAN, FOUNDER, MERISM CAPITAL

“A lot of entrepreneurs have, I think, tended to skew their business models because traditionally most of the funding that’s been available has been grant or debt-tailored to suit charities and non-profits. We feel that many entrepreneurs have established as a charity or a CIC simply because that’s where the money has traditionally been, but that they could have established as a for-profit social venture if the right capital had been available. There is no reason why equity investment shouldn’t work in the social sector, it won’t work for all social purpose organisations, but for those social

businesses that are more commercial then in my view equity is a great way of seeding them. We’re being selective, not judgemental: we will not invest in ventures that are genuinely not for profit or have structures that are not equity-friendly.

“Merism Capital is a seed investor and a feeder fund for others; we want to be the first outside investor in commercial social ventures investing up to £150,000 in each and working closely with the social entrepreneur to scale their business. Seed investing is all about relationships and that’s one of the reasons we’ve co-founded Hub Venture Labs – the only incubator in Europe dedicated to social and impact entrepreneurs. We want to support and nurture not only those we invest in but also encourage and champion other impact founders and investors.

“We are taking a proven commercial business model and taking it into the social space, so we want to see an entrepreneur that is focused and driven, we want to see a business model that is scalable and which is capable of producing profit. We are looking to invest in businesses that deliver blended returns: a mix of financial ROI and measurable impact. Some people may see us as being quite disruptive and heretical in the market because we are seeking ventures that have sustainable profits and a clear commercial exit, but having a commercial exit is a sign that the business and the market is working.”

6.15. DANYAL SATTAR, FINANCE FUND MANAGER (SOCIAL INVESTMENT), ESMÉE FAIRBAIRN FOUNDATION

“There’s a lot of goodwill to develop the social investment market but it’s still at an early stage – there is not a lot of evidence of commercial entrants. One factor is the absence of intermediaries – these are a necessary component to developing the market.

“The sector must guard against ‘pipe polishing’ – developing ever-more refined products as a conduit to market without concentrating on the supply of capital and requirements of investors and what organisations actually need – bringing together the investors and the organisations who need investment is the starting point.

“The way philanthropic capital and commercial capital need to work together in the social investment market is complementary but finely balanced. Philanthropic money isn’t there to carry all the risk ahead of commercial investors, but where it’s used in an effective way, which helps bring mainstream investment into the market, it clearly has a critically important role. And, of course, philanthropic money can prioritise social return over financial return, which will be the opposite for commercial investment. There is a case to be made for layering deals in a balanced way which reflects the roles each source of funds can play.

“I’d question whether capacity-building and developing investment readiness should be solely funded by grant money

– if an organisation is entrepreneurial, and investible, it will be able to do a lot for itself. I’d be sceptical about funding an organisation just to develop investment readiness.

“What’s currently missing from the social investment market is the whole range of different funders you find in the commercial sector, from seed capital, venture capital, private equity, loans, mass retail etc; the sector needs to develop this kind of ecology.

“There needs to be clarity about the track record of those active in the market – a clear understanding of how portfolios have performed, and the differences between them which may impact on performance.”

6.16. JOE SAXTON, FOUNDER, NFPSYNERGY

“The demand for social investment is potentially huge. But the market’s not one-dimensional – it should include products for the full range of needs – working capital borrowing, but also loan guarantees to free up reserves, lending to grow future income and so on. That said, demand is restrained by cultural barriers in the voluntary sector, risk-averseness and a failure to see borrowing as legitimate for charities. Good – informed – risk-taking should generate returns and be the foundation of a sustainable, investible, social enterprise, so should be strongly encouraged. It would be great if trustees who are keen for a more entrepreneurial approach could be supported by more peer-to-peer learning and quality mentoring opportunities.”

6.17. RICHARD WILCOX, HEAD OF SOCIAL BANKING UNIT AND PAUL MARTIN, CHARITY AND SOCIAL ENTERPRISE BANKING, CO-OPERATIVE BANK

“Attracting commercial sources of funds and investment is a fundamental to establishing a social investment market which could be regarded as mainstream. Commercial investors will need to be convinced there is sufficient track record to define an asset class. When used in a very focused way, government and philanthropic sources of funding can play a really critical role in defining the asset class – both have the capacity to act as patient capital and to accept the uncertain risks of an undeveloped market. Microfinance would be a good parallel – this was developed with philanthropic capital and though there have been bumps along the way, the market is now better understood. The use of government funds to develop the social loan market will also be important. With these sources of funds working beside commercial finance, each performing their own role, you can see a way the market could evolve.

“We follow the developments with social impact bonds closely. Realistically though, it is very early days for the product and it’s not yet clear how it will develop. It’s a complex product and there are challenges such as defining social outcomes and measuring them. These need to become better understood and demonstrate their robustness as the structure is developed. As a traditional bank with a social edge we’d certainly see a role supporting these products by providing working capital finance to the organisations delivering the bond, rather than as a bond investor.

“Mixing and matching social and commercial finance is difficult – there is always a risk that by focusing on the social return you lose sight of the financial case to take to the credit committee and become something other than a bank. But patient capital, philanthropic funds or government money, working beside commercial funding, can work well and enable us to provide finance to organisations that would not otherwise meet credit criteria.

“Big Society Capital must use its resources strategically so that gaps in the market and barriers to an efficient market can be eliminated. It should define its success by the amount of funds its money leverages into the market and by the social return it delivers. And it must accept a higher level of risk than a commercial funder, and be a source of patient capital.

“The market is fragmented and there is probably a case for more players and intermediaries. The sector needs to guard against fragmentation and individualism, it should focus on common structures and approaches.”

6.18. WHAT HAVE WE LEARNED FROM THE SECTOR LEADERS?

This collection of quotes and vision statements reveals that the social impact investment market is a lively emerging market. We have included them all to reflect the diversity of the debate. There are signs of consensus developing around some themes, with different views about others; but what is common is the shared sense of opportunity.

PART II



CHAPTER 7. SOCIAL IMPACT INVESTMENT: THE ATTRACTION OF AN ASSET CLASS THAT DEPLOYS DEBT AS INTERMEDIATE CAPITAL

Debt capital, as a spectrum of debt instruments that are a core element of intermediate capital for the sector, needs to play a major role in capital provision for social purpose organisations. Debt deployed as intermediate capital can occupy the full range of finance from very loan-like long-term secured finance to debt with more equity-like characteristics such as patient capital debt.

Feedback from social purpose organisations that have experience of debt indicates that debt investment meets their requirements and has often been transformative for them. A good debt investment is an additive investment that adds to the capital stock of the organisation. The Social Investment Business' experience of lending to social purpose organisations supports this conclusion.

In Part I of this review, we explored the undersupply of investment capital as a whole and the mutually supportive relationship of debt capital with other layers of risk capital such as philanthropy. Both are needed. Yet the appeal of debt is often understated in debates on social impact investment in favour of the pursuit of equity, an approach that inadvertently acts to reduce the supply of a major potential source of capital for the social sector, namely debt capital. This argument, combined with the fact that many social purpose organisations are legally prohibited from issuing shares or equity in their organisations, unintentionally contributes to the overall undersupply of capital to the sector.

In this chapter, we set out unambiguously the general attractions and case for radically expanding the supply of debt capital to the social sector in addition to the general attractions of this asset class as an investment. We then present the specific financial case for investment in the sector via debt instruments and intermediate capital products. Together, these make up the first draft of a compelling prospectus for debt investments into the sector, which will evolve over time with further product development and the continued improvement of credit statistics for the sector as more debt is invested. Finally, we set out in practical actionable form the areas (and need) for the development of new debt products, as a core part of intermediate capital, that will better meet the financing needs of the sector and help close the gap between capital supply and demand.

“

Social impact investment is not about taking a lower return, but about making a good return which can be enumerated.

”

7.1. PROSPECTUS PART I: THE GENERAL CASE FOR DEBT INVESTMENT

A. SIMPLICITY

Debt capital is straightforward to understand. It meets the needs of social purpose organisations for shorter-term financing such as working capital, for longer-term development capital to support the creation of new business opportunities, for capital to underpin expansion via scale-up and rollout of proven successful services and products, for “creative capital” to give space for innovation and also capital for very specific purposes such as mergers, modernisation and upgrades of management capacity and internal systems. It does not require complex engineering or time-consuming negotiation to develop new sophisticated products and can therefore be a straightforward route for social purpose organisations to access capital efficiently. Simplicity of process means that the volume of debt-like capital provision can be scaled up by investors without compromising investment appraisal processes and credit standards.

B. IMMEDIACY

Because of its simplicity, debt capital offers speed to market. When conditions are changing rapidly, social purpose organisations need to be able to react quickly to opportunities or take necessary defensive action. Debt capital supports that in a way that more complex or more customised financing products cannot.

C. RECYCLABILITY

Debt capital, across its spectrum of products,

is recyclable. Capital invested by way of successful debt investments can be reinvested again and again rather than being consumed on first use. This is efficient use of capital, especially when capital is in short supply.

D. FLEXIBILITY

Debt, across its spectrum, can be packaged with grant funding and plain vanilla loans. It can also include patient capital characteristics to tailor the debt obligations to the particular circumstances of a social purpose organisation. It can be secured, unsecured or a mixture of both and can offer a wide variety of maturities. There is scope to develop a broad range of intermediate capital products specifically tailored to the social sector, including risk

capital products that are quasi-equity-like and it would also be possible to develop products for a focused market, such as Sharia-compliant social impact investment products.

E. LIQUIDITY

Debt capital provides liquidity to social sector organisations, thus being able to meet their short-term

financing needs in the simplest of ways. A plural and competitive market for debt capital will enable social purpose organisations to be more strategic because they are then freed from the hamster-wheel tyranny of reliance on successive one-off grant funding just to keep going.

F. “OWNERSHIP” AND LEGAL FIT

Debt capital and intermediate capital suits the legal and ownership characteristics of social purpose organisations, which are often held either for charitable purposes (social enterprises owned by charities) or are asset-

“ We don’t have the time to wait for lengthy decision-making – when we tender for contracts, we need to know quickly that we have access to the necessary finance in order to bid.

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

”

locked (such as Community Interest Companies and those under the Social Enterprise Mark¹). Intermediate capital products such as unsecured loan notes or preference shares without an ownership dimension can be readily deployed without requiring changes to the legal forms or regulatory environment. This sort of intermediate capital offers an immediacy of fit to legal and regulatory structures and can therefore assist in developing the market without delay.

G. REFINANCING AND FOLLOW-ON FUNDING

Debt capital lends itself well to providing refinance facilities for successful organisations to allow them to roll forward their financing obligations and scale them up as appropriate. An important part of our vision of a thriving social impact investment market is that it rewards success – successful organisations with proven products and services should have access to capital for second, third and fourth-round funding. The availability of follow-on funding for successful organisations is a key measure of success for the social impact investment market.

H. LEVERAGING IN OUTSIDE CAPITAL

By doing the heavy lifting of meeting the basic liquidity and working capital needs of social purpose organisations, as well as longer-term financing often in riskier situations, social impact investment debt capital provides the conditions for leveraging in outside capital from mainstream lenders or investors. Additional finance is more likely to become available once outside capital providers can see that an organisation's finances are more secure. The Social Investment Business has commonly experienced that its loans act as a prior tranche of relatively riskier capital that do leverage in new outside capital in this way. Co-investment

of social impact investment capital and more mainstream capital is an attractive package.

I. ENABLING OTHER INVESTMENT PRODUCTS

Debt capital also facilitates diversity and pluralism of financing products so that more complex or more engineered products, such as social impact bonds, can more readily be rolled out. This is because simpler debt capital can provide much of the necessary base-load liquidity and financing – it can take the burden of providing long-term finance as a whole, or a major part, for the organisation, thereby enabling newer and more complex products to be used to finance specific product or service areas. Ultimately this makes such products more practical to structure and deploy. These more complex products can then be used as an important upper tranche of performance-linked capital for organisations, which in turn are able to have greater risk appetite for more complex products.

J. ATTRACTIVE YIELD AND LOW CORRELATION WITH MAINSTREAM MARKETS

Social impact investment can deliver healthy yields when compared with other debt markets, particularly in the current climate of low interest rates, albeit with commensurately higher risks, as one would expect from an emerging market. Like all emerging markets, it will be less correlated with mainstream financial markets, certainly initially, and arguably also as a mature market because demand for services of the social sector is generally countercyclical. However, it should be noted that some social sector revenues are linked with government policy regarding the procurement of services and goods from the sector and also general fiscal policy, therefore performance will be nominally correlated with relevant elements of public sector spending.

¹ The Social Enterprise Mark is a certification for businesses that have society and the environment at their heart. Social enterprises have to prove themselves against a set of qualification criteria, which is overseen by an independent Certification Panel to ensure fairness and consistency. See <http://www.social-enterprisemark.org.uk>

K. INTERMEDIATE RISK, NOT FIRST-LOSS CAPITAL

Social impact investment, including the debt capital investment we are making the case for, is part of the investment spectrum and occupies a distinctive space between philanthropy and purely commercial investment. It does occupy a higher-risk category, with commensurately strong potential for yield, but we would argue it is not in the “black hole” territory of unquantifiable risk or financial speculation requiring extremely high returns. Social impact investment is not exposed to the highest risk because it has a symbiotic relationship with philanthropic capital that can take the place of first-loss equity,² and thereby reduce the risk for senior tranches of social impact investment.

7.2. PROSPECTUS PART II: THE FINANCIAL CASE FOR DEBT INVESTMENT

The general outline of a specific and marketable financial prospectus for social impact investments that comprise intermediate capital products can now be conceived. This is the first practical step in being able to market social impact investment more broadly, premised on the requirement for more investment and credit data over longer time periods, including independently verified performance and credit statistics for the sector generally and for individual organisations. It is for this reason that we recommend in Chapter 8 the establishment of an independent trade forum that can promote the collation and presentation of this information to the market objectively and on a comparable basis.

Based on the information and track record revealed by studying the investment portfolio of The Social Investment Business in detail, and others anecdotally, we believe that in addition to the general attraction of social impact

² Such as the Fair Finance example cited in Chapter 5, see <http://www.philanthropyuk.org/quarterly/articles/case-study-3-fair-finance>

investment (that it is an early-stage emerging market) there are three key aspects in making the financial case for social impact investment; namely attractive yield, assessable risk and diversification benefits with lower correlation.

A. ATTRACTIVE YIELD

The Social Investment Business charged out its loan capital on most of its funds at a fixed rate of 5–6% per year. This is consistent with other capital providers in the sector such as CAF Venturesome, which also charges a fixed rate of 6.0%³ on its unsecured loans, and Charity Bank, which charges between 5.5% and 7.5%.⁴ Typically capital providers and intermediaries are set up as non-profit organisations, which by definition do not need to make a profit and can therefore set the rate as low as possible and recover the cost of capital, management fees and absorb defaults based on the given risk exposure; net yields would then be expressed after those factors. The Charity Bank offers retail savers fixed rates between 0.5% and 2.0%⁵ depending on the savings product selected. In the USA, the Calvert Foundation offers investors up to a 2% return depending on maturity (see case study).

Such yields, in what is still mostly a lower yield environment, offer the possibility of yield pick-up for investors. Over time, further independent performance statistics and the expanded provision of different financing products with different maturities will also allow a yield curve to develop for this asset class, which will help further establish its transparency as an asset class and better enable comparisons of yield relative to credit standing with other asset classes. Such an asset class and alternative investment market will be attractive to some investors as long as the risks are assessable and not “black hole” risks.

³ <http://www.socialenterpriselive.com/section/social-investment/csr/20110525/market-profile-caf-venturesome>

⁴ <http://www.charitybank.org/interest-rates-and-terms-charity-funding-and-loans>

⁵ <http://www.charitybank.org/interest-rates>

B. ASSESSABLE RISK

Risk in social impact investment, certainly in the debt segment, is assessable. An assessable risk level comes from the emerging track record and credit statistics of social impact investors and the established rate of write-offs in the sector. Similar to the path taken by all emerging markets more transparent information and robust track records are emerging, which remove the initial “black hole” risk characteristics associated with the asset class (as with many new markets at inception) and over time will instil more confidence in investors. The cumulative write-off rate for investments made by the Social Investment Business is less than 5.0%⁶ across the portfolio, while for CAF Venturesome the aggregate is 4.0%.⁷ The Charity Bank, as a retail bank, runs a different risk model; its write-off rate is 0.5% in total over 13 years.⁸ Although these figures may not be like-for-like on a comparable basis, they do provide a very useful indicator of the way the market is beginning to stabilise. They also point out that the market is evolving into one of pluralism and diversity, as one would hope, with a spread of risk appetite across the respective investors depending on their preferred business model.

Overall, the social impact investment market offers higher but now assessable risk in exchange for a reasonable level of yield, consistent with emerging markets. The social

impact return on these investments is then an additional return that helps provide the motivation for investing in the sector at all.

C. DIVERSIFICATION BENEFITS AND LOWER CORRELATION

A challenge of mainstream investment over the past 10 years has been the increased correlation between many different mainstream financial markets and the increasing difficulty of finding real diversification. Certainly the days 25 years ago when equity investors could get substantial diversification benefits just from investing in international equity markets are gone. This rise in correlation has been one motivation for investors to explore other new

emerging markets, including the hedge fund market but notably others too.

Instinctively, investment in the social sector should offer some lower correlation and some real diversification benefits. We acknowledge that longer-term data series will be needed to validate statistically the correlation coefficients of social impact investment with other financial markets, but

the initial experiences of social impact investors are very encouraging. Indeed, demand for the products and services of the social sector is intuitively either non-cyclical (for example, demand for care driven by mostly demographic factors) or in some cases countercyclical (for example, demand for charitable services typically increases during recessions). There is currently some alignment of sector cash flows with the public financial cycle, which is to be expected. Generally speaking, lower correlation with mainstream financial markets will be appealing to investors seeking diversification.

“ The social sector is experienced in managing financial risk because our boards are mandated to do so. Too often we don’t harness this skill in taking entrepreneurial risk – but a new breed of social entrepreneur is changing this.

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

”

6 Adventure Capital Fund (Group) Report and Accounts as at 31 March 2011

7 <http://www.philanthropyuk.org/news/2011-06-20/caf-launches-social-impact-fund-donors>

8 <http://www.charitybank.org/depositor-protection>

CASE STUDY

CALVERT FOUNDATION COMMUNITY INVESTMENT NOTES

The Calvert Foundation's well-established Community Investment Notes programme in the US demonstrates the social value of loans as part of an integrated social impact investment market in boosting the flow of capital sustainably to deserving projects and playing to the advantages of loans in impact investing, including simplicity, accessibility, directness and recyclability. It is a good example of a blended value business model that generates, as they put it, "a win-win". "You can lift people out of poverty through an investment that earns a financial return." It also shows the viability of a model that offers a fixed interest rate for investment in higher but assessable risk organisations that have high social impact but are not conventional bankable propositions.

In essence, its Community Investment Note is a pooled investment available to retail investors on a range of maturity terms and at interest rates up to 2%. The full value of your principal is lent out. As loans are repaid they are recycled into other organisations. At maturity, you get your money back with interest. Investors receive reports on the social impact of their investments. Currently, Calvert Foundation has nearly US\$200 million, professionally managed using Calvert's due diligence experience and invested in 250 community organisations across the USA and internationally, and US\$28 million in security enhancements with the aim of providing capital protection for investors. Over the 15 years of its current

programme, losses of less than 1% have been reported and the Calvert Foundation reports that none of its investors have ever lost money.

This is a working example of impact investing/social investment as an asset class for investors. (The Calvert Foundation also offers a programme-related investment offer for foundations.) The Calvert Foundation's mission is "to maximise the flow of capital to disadvantaged communities in order to create a more equitable and sustainable society" and is based on a distinction between investors who want to invest to maximise impact and both mainstream investing according to an ethical or social responsibility screen on the one hand and charitable donation without expected financial return on the other. The Calvert Foundation says: "Investors today are rethinking their relationship to money and what it can do to make the world a better place – even as they work to reach their own financial goals. With the Community Investment Note you can realise the financial benefits of an investment with the social impact you expect from a charitable donation. Dedicating just a small portion of your portfolio to community investment allows you to multiply your impact while increasing your own financial diversification."

**Source: Calvert Foundation,
www.calvertfoundation.org/invest downloaded
29 July 2011.**

7.3. NEW PRODUCT DEVELOPMENT: NEEDS AND OPPORTUNITIES

Feedback from social purpose organisations makes clear the need for new intermediate capital debt products to meet the requirements of the social sector. This translates directly into an opportunity for the development of these

products to help expand the range of capital provision, support a more integrated market by encouraging a more seamless array of products and ultimately help social purpose organisations become more strategic.

We have highlighted below some of the products that are needed and whose availability will be part of the realisation of a mature social impact investment market. The list below also demonstrates that complexity need not always be a part of this product development. The example of Social Impact Bonds, launched in the UK and now receiving strong interest globally, is a reminder also of the potential for product development to be applied to a global market. This presents an exciting opportunity for existing and new social impact investors as well as to elements of the mainstream financial sector to rise to the challenge. We would also welcome stronger partnerships between the social impact investment sector and mainstream finance, where the higher risk appetite of social impact investment debt is used to leverage in additional tranches of lower risk appetite more mainstream debt. We should also note that social sector borrowers have the option of refinancing their social impact investment loans by other loans from mainstream high street banks if they consider the rates on their social impact investment loan too high. This would be a success not a failure, particularly if a social impact investment loan has successfully got them to the stage of becoming bankable. The terms of social impact investment loans should certainly not deter such progression.

“ We need more types of investment capital which respond to the requirements of the sector, and the benefits need to be better articulated so that we can understand how this capital can help us.

from roundtable discussions with social entrepreneurs (Chatham House rule applied)

A. EXTENDING CLASSIC LOAN STRUCTURES TO THE SOCIAL SECTOR

- Different maturity loan products, to provide a range of shorter and longer-term maturities;
- Working capital revolver loans, one-year and longer-term working/development capital;
- Other revolving facilities that allow loans to be redrawn within the facility period;
- Set-off loan and deposit products;
- Greater range of unsecured loan products;
- Loan products with risk-adjusted interest rates;

- Guarantee products and underwriting of mainstream loans (or tranches of them) to the sector;

- Loan guarantees.

B. FOLLOW-ON FUNDING AND MATCH FUNDING

- Second, third and fourth-round financings to reward success;

- A greater range of match funding and co-investment products,

based on formal or informal partnerships with mainstream financial institutions (this could involve a shared agreed approach to credit appraisal, covenants and information requirements).

C. TAILORED PRODUCTS FOR THE SOCIAL SECTOR

- Continuation and development of an “engaged investor” approach to loan-making, with business support included but not necessarily within the same investment organisation;
- Patient capital approach within loans –

matching capital and interest payments to income flows and/or social impact profile;

- *Performance-related loans, potentially allied to longer-term unsecured loan note products that provide simpler alternatives to social impact bonds.*

D. SPECIFIC PURPOSE LOANS

- *Refinancing loans;*
- *Merger loans;*
- *Modernisation/management development/financial system development loans;*
- *Bridging loans.*

E. PACKAGED PRODUCTS

- *Packaged loan and grant offers;*
- *Packaged loan and business support offers.*

F. PRODUCTS FOR FOUNDATIONS

- *Programme-related investment (PRI) and mission-related investment (MRI)⁹ products across a range of intermediate capital types and a range of programme areas.*

G. COLLECTIVE PRODUCTS

- *Pooled funds and stakes in funds-of-funds for retail and institutional investors*

⁹ Programme-related investment (PRI) is a specific investment category defined by the IRS in the USA, which typically relates to below market-rate investments that promote the purposes of the foundation. Foundations in the USA are legally required each year to disburse 5% of their capital assets as grants and PRIs can be included in this calculation. Mission-related investment (MRI) is a term used to identify the investments of foundations that are aligned with their mission and are typically market-rate investments.

CASE STUDY

WHAT MAKES A GOOD LOAN?

Based on the experience of The Social Investment Business, there are five key factors for a successful loan.

1. **Strong management:** *successful investment in any sector depends on competent people and cannot be dependent on organisational structures or opportunities alone. Managers must be able to execute effectively and deliver on their promises.*
2. **Good governance:** *a robust and committed board with a diversity of skills to deliver the organisation's plans, with a balanced sense of responsibility to investors as well as beneficiaries.*
3. **Financial reporting and financial systems:** *a reliable and competent finance director is a must-have and any creakiness in basic financial reporting, especially on cash flow, is a warning sign.*
4. **Healthy local market conditions and relationships with local commissioners:** *there is rarely a single national market in the social sector or for the services it provides, but often an agglomeration of intensely local markets. The organisation's concrete position in its local market and good relationships with local commissioners are key to its success or failure, and not merely whether its plans broadly address important issues.*

5. **Services that directly improve the life chances of individual beneficiaries:** *people will come back to an organisation that delivers hard improvements in beneficiaries' lives. This is more important than more general "nice-to-haves" or community solidarity type services.*

CASE STUDY

LOAN INVESTMENT PORTFOLIO OF THE SOCIAL INVESTMENT BUSINESS

NATURE OF DEMAND

As at 31 March 2011, the funds managed by The Social Investment Business had made loan investments to 343 organisations with a total committed value of £156 million with total funds invested or committed (including loans, grants and all other products) of £260 million. As at 31 March 2011, the majority of these loans were in the portfolio of the largest fund, Futurebuilders England (FBE). All data in the rest of this case study are given as at the same date unless otherwise stated. 21% of investments across the portfolios managed by The Social Investment Business were in Yorkshire and Humberside, and the West and East Midlands, 18% were in the North East and North West of England, and 21% were in London. There was a wide spread of loan-taking organisations by both size and maturity, therefore, and also geographically. Although demand is likely to be affected by the availability of grant funding, it remains the case that all of The

Social Investment Business's funds were oversubscribed, in terms of there being an excess of demand over supply. More capital could have been lent to acceptable investees on acceptable terms.

USE OF FUNDS

The portfolios comprise secured loan investments as well as loan investments made for the purpose of funding working capital in one form or another, whether start-up working capital, or growth working capital (for a new project or a new scale of activity), or simple ongoing working capital for existing activity. In each case, greater visibility and certainty of funding provided the investees with a better and more robust financial platform as a basis for strategic planning of its own future. Many investments attracted co-funding, including from Charity Bank, Triodos and from commercial banks.

GROSS YIELD

The Social Investment Business charged out loan capital on most of its funds at a fixed rate of 5–6% per year.

CREDIT RECORD

The current cumulative write-off rate for investments made by The Social Investment Business is less than 5.0%¹ across the portfolio.

CO-INVESTMENT

Co-investment, involving other funds as shown in the statistics above, is an important characteristic of The Social Investment Business loans. Other lenders,

¹ Adventure Capital Fund (Group) Report and Accounts as at 31 March 2011

including commercial lenders and also other social lenders, have been able to rely on The Social Investment Business loans to complete and make adequate an overall financing, and indeed vice versa. From The Social Investment Business's practical loan-making experience, being active in the social impact investment market means being an active partner of other social investors as a result of the activity itself, at least if the investing activity is carried out on any scale and with any consistency. This highlights that lending as a social impact investment activity is a collaborative as well as competitive activity as you would hope and expect in an emerging market.

This shows, importantly, how the beginnings of an "integrated market" are already in existence in loans. One loan provider's loans can leverage in loans from other loan providers, from other social funders and from commercial funders and thus can go some way to enabling a whole financing package – both a contemporaneous financial package of different funding sources agreed and utilised all at the same time and also a funding package of different funding sources over time, which we could also call a financial or funding strategy for a social organisation.

TAILORED PRODUCTS

As a deliberate experiment, specific funds and products have been launched through Futurebuilders, aimed at funding mergers, consortia creation and tendering, and "modernisation", which included management development and training, improving financial systems and financial management capacity, management recruitment and similar developmental costs. The Communitybuilders Fund

managed by The Social Investment Business explicitly offered packages of upfront grant funding, such as for feasibility studies or leadership and management development, and coupled this with follow-on loan finance. The combination of these provided a form of synthetic, intermediate capital-type product appropriate to the needs of social sector organisations. These were another example of an engaged investor approach, seeking forms of investment and loan products that will meet the bottom-up needs of the sector.

A further example of the breadth of loans lies in its applicability in practice to different sectors within the social sector as a whole and the development of degrees of specialist know-how. In total, the portfolios of the funds managed by The Social Investment Business can be split 27% health (physical and mental) and disability support, 18% children and young people, 17% education and training plus 7% re-skilling and employability-related, 13% adult care and support for long-term conditions, and with the balance spread across a wide range of social outcomes. The Social Enterprise Investment Fund,² managed by The Social Investment Business for the Department of Health in partnership with Local Partnerships, was an initiative specifically targeted at the health and social care sector. Other sector concentrations (and indeed investments in the health and social care sector in other funds managed by The Social Investment Business) were not expressly targeted as a matter of policy but purely reflect demand.

The breadth of sector exposure

² The Social Enterprise Investment Fund (SEIF) was set up in 2007 to stimulate the role of social enterprise in health and social care, it is managed on the behalf of the Department for Health by The Social Investment Business.

therefore demonstrates that loans work in many different industries and that there is potential for closer tailoring of loan practice to the bottom-up needs of organisations and to facilitate the transition from grant funding to other forms of sustainable finance.

FLEXIBILITY

The flexibility of loans was illustrated by The Social Investment Business by putting into practice an “engaged investor” approach, specifically through the application of what is often called patient capital, involving either interest holidays or capital repayment holidays or both.

Patient capital could instead be called simply “social loans” or “social sector-tailored loans”, meaning loans that are structured, via informed and engaged investment, to meet the bottom-up needs of social purpose organisations. Seen from this perspective, patient capital simply means tailoring the shape of the payment or servicing obligations that make up the creditor side of loan funding to match the expected timing and shape of the income and other benefits flowing from the loan investment that make up the debit or investment side of the loan. This is really no more than commercial organisations would expect of lenders, especially, for example, in situations like private capital, which analogously finance transformative change or growth, where the cash outflows of debt-servicing are matched to the expected cash inflows that the loan investment finances. This is what loans are and have to be to do justice to the sector they are seeking to finance. This confirms their suitability in practice, and not just in theory, to be a core element of a social impact investment market.

BUSINESS DEVELOPMENT SUPPORT

Another characteristic of the loan approach that The Social Investment Business has found works is support for change on the demand side as well as on the supply side.

In other words, a successful loan market depends on changes in the approach, attitudes and capacity within social organisations as well as on an engaged, patient approach by those financing them. Support for the internal development of social organisations is therefore a constituent part of a thriving loan market (and, more widely, of a well-developed social impact investment market).

Of course, there are many organisations that provide advice and support services to social organisations. There is no reason why a loan-providing organisation need, or even should, provide all of the necessary advice and support itself. A division of labour in support for the sector can be efficient.

However, The Social Investment Business’s approach has been to provide business support services to investee social organisations as an inherent part of its lending and investing activity. This has been well received and may be reflected in the credit record (lower write-off rate) of its loans.

LOANS AS INVESTMENT CAPITAL

A final part of The Social Investment Business case study is to note that independent appraisal of the FBE fund

by Sheffield Hallam University³ found that loan-making can be and has been successful in creating additional capacity in the social sector. Loans are authentically “investment” capital therefore. Such loan investments and the social outcomes they fund are genuinely additional, loans increase the capacity of the social sector and the process of loan-making helps social organisations make the internal changes in investment readiness. More longer-term longitudinal research is, of course, needed to continue verifying this. Sheffield Hallam noted that The Social Investment Business has been effective at selecting strong organisations that perform well compared to “comparator organisations” from the “wider sector”.

.....
³ *Evaluation of Futurebuilders, Centre for Regional Economic Social Research, Sheffield Hallam University, April 2008, <http://www.shu.ac.uk/research/cresr/future-builders.html>*

This is an exciting moment in the emergence of social impact investment as an asset class and the relatively low capitalisation of the market suggests that it has the potential for substantial growth. “Black hole” uncertainty has been removed from the picture because the risks are now quantifiable, track record is emerging and credit statistics are available – it is now poised for success.

The ever-increasing interest and public debate about social impact investment is very welcome although it also means that the industry is not short of recommendations about what needs doing to mature the market, many of which are published in the reports listed in the bibliography. These typically highlight what government, the social sector and Big Society Capital should do to mature the market.

We take a slightly different approach in this final chapter and list below four broad but practical steps that existing and new social impact investors should action, helped where appropriate by Big Society Capital, and which the mainstream investment community can help accelerate. We conclude by summarising the three guiding principles to help explain the social impact investment market; that it is an emerging market, an integrated market and an intermediate capital market.

8.1. NEXT STEPS

A. LAUNCH NEW FUNDS

- ***A watershed has been reached:*** *there is sufficient political will, performance data and investment and credit track records now available to start presenting an attractive investment proposition to investors.*
- ***An exciting alternative asset class:*** *this emerging market provides informed investors attractive yields for higher but assessable risk as well as some diversification benefits and the opportunity to invest at an early stage in new end-user industries such as care and community health.*
- ***Launch new pooled funds or funds-of-funds:*** *the main challenge to existing and new social impact investors is to capitalise on their experience and expand the market by launching new funds, specifically debt and intermediate capital funds, to meet the growing needs of social purpose organisations.*
- ***Anchor investment and seed capital:*** *Big Society Capital and established foundations should offer anchor investments and seed capital in these new funds to catalyse the market and leverage in other investors.*

- **Begin with private rounds of fundraising:** pooled funds and, in time, funds-of-funds should initially be marketed privately, following the model of private equity fundraisings, to foundations, institutional investors and banks.
- **Retail products in time:** funds should be marketed to retail investors in the medium term, first to higher net worth investors and then more widely to retail and institutional investors, building confidence over time with the allocation initially of small parts of their investment portfolios (following the model of some US precedents).

B. EXPAND THE POOL OF CAPITAL

- **Improve market capitalisation:** the diverse needs of social purpose organisations call for a well-capitalised market in which investors (existing and new) provide an expanded offering of overlapping products, primarily in the debt and intermediate capital space, with different types of products, different maturities and different interest rates (see Chapter 7 for a longer list).
- **Funding packages and capital tranching:** by working together, investors can provide social sector organisations with greater choice, play to specific competences of different investors, spread risk and pool experience to improve the chances of success.
- **Tailor intermediate capital products:** to create a more seamless and plural funding escalator for social purpose organisations, enabling them to develop sustainable financial strategies and reduce their dependency on continual one-off funding.
- **Follow-on financings:** the social impact investment market should reward success through providing successful organisations with access to second, third and fourth-round funding.

C. DEVELOP FOLLOW-ON FUNDING FACILITIES AND BROKING SERVICES

- **Access to capital and the availability of follow-on funding:** should be a characteristic of a thriving social impact investment market and successful organisations should be rewarded with access to follow-on funding.
- **Collaboration and competition:** a mature market will manifest both of these characteristics among investors, which will further strengthen the market and its participants.
- **Demand and supply balancing:** at different times, different funds will have different levels of capital available and existing customers' follow-on funding needs will not always match either the available funding products or the particular risk appetite of individual investors, but this can be balanced with broking and collaboration among capital providers.
- **Broking:** will be a key role in a thriving investment market and is essential in bringing together supply and demand sides, as well as co-investors in providing packages of investment.
- **Strong customer networks:** are key to a sustainable business model for social impact investors who should identify existing customers with follow-on funding needs and help them by packaging and broking them to other social impact investors and even mainstream investors/lenders, with part funding or support from themselves.
- **Price signalling:** successive rounds of follow-on funding will help strengthen data about longer-term credit statistics and how they change over time for respective organisations, contributing towards better information and risk assessment for the market.

D. SECURITISE EXISTING PORTFOLIOS

- **Increase liquidity:** by securitising or selling on (in part or full) existing social impact investment portfolios which are performing well.
- **Keep “skin in the game”:** original investors who source new investments should keep a significant stake in their investments over the full lifetime of the investment to keep quality incentives well aligned. This would:
 - a. recycle investment funds and create an efficient division of labour between long-term holders of investments and those with the skills to do the initial investment appraisals and source new deals;
 - b. put a value on social impact investments, boosting confidence in the market and provide benchmarks for other new entrants;
 - c. be a valuable step towards creating a follow-on financing market and, in time, the conditions for a secondary market.

E. ESTABLISH A TRADE FORUM

- **Promote market statistics:** to be a recognised reference point for aggregating, collating and publishing like-for-like comparative data as well as market-wide performance and credit statistics for all types of social impact investments.
- **To share best practice:** an inclusive body to share experience and uphold good standards, perhaps with the encouragement of Big Society Capital as a flagship wholesale capital provider.
- **A coordinated voice:** to promote the interests of UK social impact investors, within the UK and globally. It could be similar to the British Private Equity & Venture Capital Association (BVCA), doing for social impact investment what the BVCA does for private equity (and did for private equity/venture capital when it was an emerging market in its earlier days).

- **Promoter of an efficient regulatory environment:** to engage the Financial Services Authority (or its successor) and the Charity Commission to harmonise and simplify regulation.

8.2. CONCLUSION

Three major themes surfaced in undertaking this review, namely that social impact investment exists within an emerging market, that to succeed it needs to be an integrated market, and that these investments primarily comprise intermediate capital. We introduced these themes in Chapter 1 and summarise our findings about them below.

A. AN EMERGING MARKET

The social impact investment market should be recognised as an emerging market, and compared with other now-emerged financial markets at similar early stages of their development. There is a catalogue of comparisons worth listing; for example, private equity, hedge funds, the high-yield corporate-bond market, developing country markets, mainstream investment in commodities, the housing association finance sector, the biotech sector and the internet sector. All provide valuable lessons in how they evolved from being a relatively untested emerging market to now being part of the portfolios of many fund managers.

Comparing the social impact investment market to a baseline of early stage emerging markets rather than to fully mature mainstream markets is a more accurate benchmark that manages expectations appropriately, is an antidote to pessimism and makes the social impact investment market's journey towards mainstream investibility less demanding. We assert that there is now already sufficient momentum that it should be a five-year project, not a 25-year one, to mature the social impact market to the point where it is unexceptional for mainstream investors to be engaged in it as an alternative investment market.

B. AN INTEGRATED MARKET

Social purpose organisations need access to a broad range of capital types from an expanded range of capital providers to meet their individual needs. The vision for this market is that organisations of different levels of maturity and different sizes should be able to access (at a competitive cost) the types of financing most appropriate to them, whether from individual capital providers or combinations of capital providers working collaboratively. Social purpose organisations should be able to confidently develop financing strategies to support their missions and growth plans, and they should not be forced to rely on sequential one-off rounds of funding but rather have access to a funding escalator that rewards success with follow-on investment.

C. AN INTERMEDIATE CAPITAL MARKET

The social impact investment market is particularly suited to intermediate capital, the areas of financing where debt and equity characteristics overlap. With much current emphasis in the sector on quasi-equity, the advantages of debt products need emphasis. They offer the advantages of simplicity, speed to market, recyclability and can do the heavy lifting of providing base-load financing to social purpose organisations. Debt in an intermediate capital context is a very flexible financing instrument and can be tailored, such as patient capital and participating capital, to meet the needs and risk profiles of social purpose organisations. Debt investments that are structured as intermediate capital also have the potential to offer investors attractive yield, portfolio diversification through weaker correlation with mainstream markets and assessable risk resulting from the growing performance data of existing funds and investments.

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“ Potential financial investors should be encouraged by the existing political will and the resources being deployed to further develop the social impact investment market. It is our view that 2011 will be a turning point in social impact investment as it goes from niche to mainstream. ”

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