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# NOTHING VENTURED, NOTHING GAINED

## ADDRESSING THE CRITICAL GAPS IN RISK-TAKING CAPITAL FOR SOCIAL ENTERPRISE

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*WITH LOREN BERLIN AND KEELY STEVENSON*

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# INTRODUCTION

THE WORLDWIDE GROWTH OF SOCIAL ENTERPRISE IS THREATENED BY A DEARTH OF CAPITAL. SOCIAL ENTERPRISES NEED INVESTMENT TO GROW AND TO INNOVATE – INVESTMENT THAT TAKES ON THE RISK OF THE ENTERPRISE. THIS KIND OF CAPITAL CANNOT EASILY BE PIECED TOGETHER FROM LIMITED GRANTS, CONVENTIONAL EQUITY AND ILL-FITTED DEBT. AS INCREASING NUMBERS OF SOCIAL ENTREPRENEURS AND MISSION-BASED FINANCIERS SEEK TO ENTER THE FIELD, A QUESTION ARISES: *CAN THE SECTOR DEVELOP NEW INSTRUMENTS AND STAKEHOLDER RELATIONSHIPS TO MEET THIS CHALLENGE?*

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CHAPTER 1

# DEFINING THE PROBLEM

## THE CAPITAL GAP

Social enterprises are creating new and exciting solutions to society's problems. Increasing numbers of ventures are being launched to address challenges – from poverty to health, education to the environment. Despite many of these emerging successes, most of these enterprises face a common problem: inability to secure growth capital. Specifically, there is an abject lack of risk-taking capital. The result is that proven social enterprises are starved of the capital required to grow to an appropriate size. Yet there is also an increasing number of mission-based investors looking for opportunities that go beyond traditional grants and into the realm of debt and equity, and are willing to consider new models of risk and return. However, these two groups are struggling to find one another.

Our collective inability to transcend this capital challenge limits the effectiveness of both entrepreneur and investor. More importantly, the lack of appropriate capital means needed services, support and opportunities remain beyond the grasp of many in the US and Europe, not to mention the developing world. With this paper we want to help move the discussion forward toward diverse solutions to the growth capital challenge facing many high-performing social enterprises throughout the world.

### KEY CONCEPTS OF SOCIAL ENTERPRISE AND THE CAPITAL MARKET THAT SERVES IT

By "social enterprise" we mean the application of business models and acumen to address social issues, whether through nonprofit or for-profit corporate structures. The capital counterpart to social enterprise, "social finance", may be understood as a broad area wherein various forms of capital are structured in ways that consider and value both financial performance *and* social value creation. Put simply, between the traditional

approach to financing nonprofit ventures through grants, fundraising and limited use of debt, and the traditional approach to financing for-profit ventures through market-rate private equity and debt, there is a funding gap into which an increasing number of social enterprises are falling.

Organisations that are growing fast need capital to increase production capacity and develop their products and markets, as well as for everyday working expenses. Debt is usually only applicable for certain needs. Equity or equity-like capital forms the majority of this capital need. In the case of nonprofits, grants can play a role.

Start-up **nonprofit corporations** (which can be one form of social enterprise) are usually able to access gifts to support demonstration projects and innovative strategies. In fact, many foundations pride themselves on making grants to the "new" or the "innovative." While not necessarily an easy process, the fact remains that in the US and Europe funds are available to catalyse, incubate, launch and operate social enterprises at a small scale. Many social entrepreneurs attain initial success by piecing together small grants of a few thousand to a few hundred thousand dollars in order to meet their initial start-up requirements. However, growth capital (also known as "expansion capital") remains difficult for entrepreneurs to access. In many cases it is simply unavailable.

Start-up **for-profit corporations** (which may be social enterprises) are able to access funding from "friends, family and fools" (as the saying goes), cobbling together enough to test out their new business concept or strategy. In the same manner as their nonprofit counterparts, they may find funds to get going, demonstrate proof of concept and – if they were traditional, for-profit corporations focused upon profit-maximising strategies – go on to compete for private equity investments mixed with some level of debt. If, however, they are social enterprises – for-profit corporations that balance financial returns with a social mission – they face a similar dilemma to their nonprofit cousins. For-profit social enterprises of this sort often find they are able to raise initial, launch funding, but lack access to expansion capital that does not seek a full, conventional market-rate return on investment.

The bottom line is that in all too many instances neither the for-profit nor the nonprofit social enterprise is able to secure adequate capital to enable it to move from start-up to the next level of development. The appropriate form of capital to support the enterprise's development simply does not exist at any scale. It is worth noting that venture capital and early private equity is by its very nature competitive and scarce, even in the relatively mature US markets. In Europe it is even scarcer and in the developing world almost non-existent. Although there is certainly growing interest in building up equity access for conventional small and medium-sized enterprises, social enterprises, with their unconventional risk-return model, will still find growth capital hard to access.

Therefore, the 800-pound gorilla in the social enterprise capital market has become the very real absence of *expansion* stage capital with a true risk-taking profile. What makes for success in traditional business development is access to funds that allow the firm to grow and take chances. This same capital is equally necessary for a thriving social enterprise market. This is not to say that the broader, more conventional "socially responsible" businesses and certain social enterprises that perform well financially cannot tap market rate capital at some level. The fact that these socially motivated enterprises exist is to be applauded, and when these business models are conducive, capital follows conventional returns, but the core of social enterprise activity falls outside the conventional definition of market-rate, risk-adjusted returns.

Furthermore, we are not talking about capital such as:

- asset-backed real estate and facilities funds more easily financed by debt
- receivables financing, or factoring, that is increasingly being used in social enterprise business models
- small, manageable allocations of funds from fundraising dinners, nor the periodic "large grant" from one-off donors.

What we *are* talking about is the need for large chunks of capital that play the role of equity capital (or "equity-like" capital, in the case of nonprofits) that may then be used by social enterprises to aggressively grow and replicate their operations, penetrate new markets, build intellectual property, brand presence and so forth.

In the following chapters we will explore why this capital gap exists and why this type of capital is so critical, explain what forms of capital are available, and put forward some ideas regarding capital innovations.

CHAPTER 2

# THE NEED

Consider the following scenario:

You are the seemingly successful leader of an exciting break-even social enterprise. You've proven you can deliver a crucial social outcome for one-third the cost of traditional approaches, and you've just completed your first two years of successfully demonstrating the effectiveness of your approach at a local level. You have an ambitious plan to replicate your venture more widely across your region and then the entire country, and you need expansion capital.

Where do you get it?

You can't generate it from your revenues. While you have shown the viability of your enterprise, you are just leaving the start-up stage, which means you're probably operating at breakeven and are undercapitalised at that. Trying to accumulate retained earnings to fund growth will lower the quality of your product and undercut your successful model.

You can't borrow the funds you need. No lender wants to extend you credit to invest in an expanding management team and the ensuing launch and "burn" costs until you reach break-even with the regional roll-out (not to mention the national roll-out).

The third-party payers for your social outcomes are interested in buying your services, but not in investing to expand their availability to other populations. They are also risk-averse, so may delay buying your product until you've proven it in their area with other people's money.

The traditional suppliers of equity financing, angel investors and venture capitalists, look at your plan to be break-even on a regional and then national basis and don't understand why you're talking to them at all. No chance for a 35%-plus annual compound rate of return for the risk they'd be taking. And, if you're at the helm of a nonprofit social enterprise, nonprofit legal structure doesn't allow you to take on equity investments anyway.

Finally, you're asking for more capital than your existing local capital providers are willing to supply. As the CEO you are already spending more than half your time raising funds for the local venture, perhaps piecing together small operating grants from traditional donors averse to funding overheads. Your early stage connections are long tapped out. How are you now going to raise five times that amount to support a regional approach and 20 times that for a national launch? Your local funding base doesn't have that kind of funding capacity.

So, you spend 18 months scraping together enough money to do a credible launch in the rest of the region, while people elsewhere do not get the benefit of your innovative approach. Opportunities pass you by, key members of staff move on to greener pastures and dreams of a national roll-out slip further and further into the future.

This is not just hypothetical, it is the story of an increasing number of high-performing social enterprises – such as these successful social entrepreneurs who have struggled to find a new kind of unconventional capital.

### TRANSFAIR

Paul Rice founded TransFair USA in 1998 to bring the Fair Trade movement to the US. TransFair is the primary certifier of Fair Trade coffee in the US, and earns approximately 8 cents per pound of coffee that it certifies. The growth curve of Fair Trade coffee is dramatic. There are similar growth opportunities in other Fair Trade commodity markets, such as bananas and chocolate. Like many growth companies, TransFair now needs to invest to build capacity and sustain its growth. Like a for-profit, it would use much of this capital to enhance market demand. Yet, because it is organised as a nonprofit organisation, it has found raising money very difficult. Plus, helping poor farmers in the developing world build more income by investing in demand generation for Fair Trade coffee in the US is not something that most foundations "go for" or seem to understand.

TransFair has been able to borrow some of its needed capital, but now that it has US$4m of debt on its balance sheet, it is unable to borrow more. Since nonprofits cannot offer equity in the same fashion as for-profit ventures, there is no equity on TransFair's balance sheet to provide leverage for more debt. Rice and his team continue to seek grants to provide the growth capital they need, and find it meeting only a quarter of their planned capital requirements.

A different way TransFair could raise the capital would be to request grants for direct income support for poor farmers. These kinds of grants could be thought of as "social good consumption" – a foundation paying funds more or less directly to the poor farmer to deliver pennies on the dollar of impact. It turns out this kind of funding is easier to get than investment capital, even though TransFair can show that US$1 invested in demand generation for Fair Trade coffee results in seven dollars of increased income for poor farmers. This is a paradox of the nonprofit funding sector: it's often easier to find a grant that will deliver US$0.85-0.90 of value (after overhead and programme costs, assuming a very lean operation) than it is to get a grant that will deliver US$7 per dollar invested.

### PURA VIDA COFFEE

Pura Vida has a retail approach to Fair Trade coffee: it operates coffee shops, mainly on college campuses, that sell only Fair Trade coffee. Pura Vida's problem is success: its coffee shops are incredibly popular and there is increasing demand to establish more outlets. Each requires a significant investment at the outset, yet the financial returns are more than sufficient to support this investment.

Pura Vida's original plan was to borrow money to finance its expansion. Like TransFair, once it had several million dollars of debt, it could no longer borrow. Yet its market is expanding and the timing is crucial. Pura Vida's solution has been to create a for-profit affiliate with an unusual governance structure. The nonprofit parent owns a controlling interest in the form of a class of "super-common" stock. Debt holders in the nonprofit have been converted into preferred stock holders in the for-profit affiliate. Pura Vida has pulled off this debt-to-equity conversion while maintaining mission commitment through the super-common voting control of the for-profit affiliate. The new challenge is to find investors to buy more of the preferred stock to provide the growth capital Pura Vida needs to continue to grow. On the surface, this could be the challenge facing any successful for-profit enterprise – the difference is that the risk/return structure creates a proposition unattractive to conventional capital.

### SOCIAL INNOVATION DEMANDS INNOVATION IN CAPITAL FORMATION

TransFair and Pura Vida are two examples of social innovation. The core concept is that Fair Trade coffee is a more effective vehicle for improving the lives of coffee workers than traditional government programmes or charitable income supports. To truly achieve the potential of this social movement, these groups (and groups like them) need to grow. The profile of the expansion capital these archetypal entrepreneurs need is relatively straightforward, but not conventional in traditional capital market terms (whether grants or equity or debt). These investment opportunities require a new kind of capital, with

a new set of expectations from both the social entrepreneur and the investor.

The venture needs to be able to leverage debt. Lenders should be able to see this capital as a true risk layer, which means it has to be uncollateralised and not put a drain on the cash flows during execution of the business model. And, it has to be patient capital. If it's structured as a liability (deeply subordinate risk-taking debt), then it must have interest and principal payment holidays, and/or be repayable through royalties, revenue or profit only.

But, more importantly than its exact character and structure, the core capital requirement is to establish a new set of expectations between entrepreneurs and investors. This pertains to linkages on agreed outcomes for repayment of principal and/or returns, including forbearance and/or forgiveness if certain downsides (or even upsides) occur. And this means investors must become true risk participants in the enterprises they finance.

Finally, this isn't traditional equity (or equity-like) capital. Although there may well be opportunities for healthy returns – even, on occasion, conventional market rate risk-adjusted returns – by and large these hybrid propositions, whether they be for-profit or nonprofit ventures, have internalised social costs in their business models which may decrease financial returns.

Put another way, there is often a "a premium for doing good." Philanthropically-minded stakeholders should have no trouble reconciling themselves to these costs, but more conventional investors might. This attempt to shift the risk-return paradigm has to be addressed positively. Yes, some enterprises need outright grants. Yes, some other enterprises can support very close to, if not actually deliver, risk-adjusted conventional market rate returns. But, *there is a growing middle ground of enterprises that are structured for optimised delivery of impact and strong business models that land somewhere in the middle*. The clearer we make this, the better. But, to complicate matters, this middle ground is highly variable from region to region. Put simply, there are radically different challenges to attracting capital, conducting business and blending social costs into enterprise models between Scotland and the Sudan.[1]

And what of demand? Is there truly a hunger for this type of capital among maturing social enterprises? The jury is still out, but anecdotal evidence does seem to support the proposition. Two cases in point: a survey conducted by the Social Enterprise Alliance in North America, in autumn 2003, found roughly US$58m in appetite for expansion capital among 77 maturing social enterprises. In summer 2006, Good Capital found a need for US$50m across just 25 enterprises fitting a narrow profile (US-based with broad US and global impact and operations, specifically looking for equity and equity-like capital for expansion stage development).[2]

If society is serious about positive change, we must examine the most effective ways to achieve it. Innovation in the allocation of capital for social change is needed if existing vehicles are falling short of accomplishing our objectives.

More than anything else, what is needed at this time – rather than studies – is action. There is profound appetite on the demand side. There are certain resources available on the supply side. What is missing? It is the affirmative execution of institutionalization that connects the sources and uses of expansion capital to social enterprise globally.

[1] Of course, the legal structure of the organisation will also differ depending upon the country in which the corporation has its incorporation.

[2] Source: Teaching them to Fish conference presentation, 2003, Social Enterprise Alliance, and data provided by Wes Selke, portfolio analyst, Good Capital.

CHAPTER 3

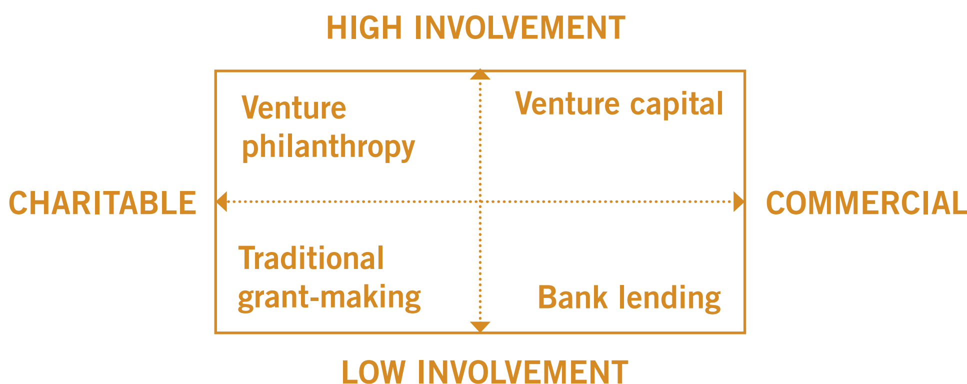
# THE CAPITAL MARKET LANDSCAPE

Before exploring solutions to the gap in risk-taking growth capital for the social enterprise sector, we must first understand the financing landscape as it currently exists. This chapter will present a broad but necessarily anecdotal survey of the field.

There are several types of capital available to social enterprises, and there are a large variety of actors in the social capital market serving them.[3] As the chart shows, there are a number of axes across which these players and capital instruments may be mapped. The centre vertical line indicates where most social enterprise investment resides, regardless of the enterprise's legal status as for-profit or nonprofit. Whether the financing is relatively low or high engagement is determined by a given investor's model. The degree to which the risk/return paradigm drifts from "charitable" to "commercial" depends on the business model, but not necessarily on the enterprise structure as a for-profit or nonprofit entity.

There are three types of capital that, in the aggregate, best epitomise characteristics of the gap we are discussing. First, there are Community Development Venture Capital (CDVC) funds, which generally fall just to the left of where "venture capital" is placed on the chart. But CDVC funds are limited to for-profit enterprises, with a particular focus on community development job creation, and tend to target the commercial end of the spectrum of risk/return. Therefore they only nibble at the edges of the lion's share of social enterprises, which are largely nonprofit, with diverse business models beyond community development and falling along a spectrum of risk/return all the way to models

[3] Social capital markets are what fill the gaps most nonprofits experience between revenues they can earn by providing services or selling products for a fee, and total outlays. Meehan, W., Kilmer, D. and O'Flanagan, M. (2004), Investing in Society, Stanford Social Innovation Review, pp 34-43. See also Grants, Debt and Equity: The Nonprofit Capital Market and its Malcontents in New Social Entrepreneurs (1996), REDF.



that require significant grant or donor money to function. Second, there is "equity-like" capital, the closest institutionalised example of which, in the US at least, is Equity Equivalents. These sorts of investment fall still farther to the left of the above strategies, and are seen much closer to the low engagement end of the spectrum. Third, a number of venture philanthropy funds with 100% donor-sourced monies have experimented with capital along the middle vertical (NewSchools Venture Fund and Acumen Fund perhaps best epitomise these in the US).

In the table below, REDF (formerly the Roberts Enterprise Development Fund) outlines one version of the conceptual landscape of financing on the nonprofit side. It goes so far as to posit an appropriate mix of capital types and contrasts those with actual capital proportions.

A number of conclusions may be drawn from this table, not the least of which is that social enterprises are neither highly nor effectively leveraged. But contrasted with the fact that grants, at their current levels, are a relatively finite source of capital, which is largely ill suited to scaling-up enterprises that are rapidly expanding, a dire picture of undercapitalisation takes shape. Let us explore in greater detail the various instruments currently available in the capital market.

## PRIVATE EQUITY

Equity investors in the for-profit slice of the social enterprise sector provide risk capital to new funds and enterprises that generate social and environmental impacts as well as economic value and returns.[4] "Equity" generally refers to such financing vehicles as common and preferred stock.[5] Social enterprises with for-profit legal structures can raise equity from finance providers who are aligned with the goals of the venture to create social and environmental value. Equity typically takes on the following characteristics:

- long-term investment with unrestricted use of resources to facilitate significant growth
- owner/partner provider
- flexible/tailored
- uncollateralised
- management support
- repayment from growth.

Not all organisations can issue equity due to their nonprofit status. However, the UK's Department of Trade and Industry has approved a new legal form for social enterprises, the Community Interest Company (CIC). Primary legislation was approved within the Companies (Audit, Investigations and Community Enterprise) Act 2004 and secondary

[4] Emerson, J., Spitzer, J., World Economic Forum 2006 Article.

[5] Common stock is acquired through the purchase of shares. It comes with no guaranteed rates of return but does allow the investor to exercise voting rights and, in some cases, hold a seat on the board or appropriate committees of the corporation. Preferred stock provides a set rate of return per share but does not allow for full voting or other rights. Preferred stock often has a "put" or conversion date when the stock may be liquidated, whereas common stock has no "maturity date" and is usually bought and sold at will.

### TABLE 1: INSTRUMENTS OF THE NONPROFIT CAPITAL MARKET

| TYPE OF INSTRUMENT → FACTORS ↓ | GRANTS | PRIs* | DEBT | EQUITY |
|---|---|---|---|---|
| Cost of Capital | 0 | 3 to 5% | 8 to 10% | ROI**, Variable rates |
| Board/Investor Role? | No | No | Maybe | Yes |
| Available for Housing | Yes | Yes | Yes | Yes |
| Available for Nonprofit Business | Yes | Very limited | Very limited | No*** |
| Appropriate Mix**** | 15% | 15% | 20% | 50% |
| Present Mix | 90% | 0% | 10% | 0% |

* Programme Related Investments. See discussion to follow

** Return On Investment

*** We refer here to equity available for nonprofit managed business – not co-operatives

**** Estimates of Appropriate and Present Mix refer specifically to the nonprofit business sector and not to fund/capital diversification in the affordable housing real estate market.

legislation governing CICs came into effect on 1 July 2005. This form – the only new company structure to be introduced in the UK in the past 100 years – should make it easier for social enterprises to raise the finance they need. CICs can, for example, issue preference shares. Other countries, such as South Africa, are also looking into similar models. The table below provides examples of several UK social ventures that have issued equity in the past decade.

Some of the challenging issues for-profit social enterprises face when raising equity include:

- founders/managers fear losing control due to changing ownership structure
- potential for mission drift
- managers or board unfamiliar with equity, due to the "philanthropic" cross-over
- lack of exit strategy/limited liquidity due to reduced returns
- unacceptable risk/return trade-offs for economic value creation
- lack of expertise to support management capacity alongside investment to go to scale

Most importantly, one of the major limitations of equity is that most equity investors remain profit seekers, and actions taken by the company to maximise profits may compromise its social mission. Even if fund managers are not profit maximisers, these funds have, to date, been targeting investments with the highest potential for economic value creation. Thus, a large gap in the market remains for those social enterprises that have created outcomes that are more balanced between economic and social value creation, or even emphasise mission over economic profit.

## SOCIAL EQUITY ISSUES (UK)

| ORGANISATION | DATE | TYPE | AMOUNT (£M) |
|---|---|---|---|
| **Shared Interest**<br>A co-operative lending society offering ethical investment in Fair Trade with developing countries | 1995; 1996; 1997; 1999; 2001; 2002; 2003; 2004 | Bond (5yrs) | 8.3<br>(1.0; 1.0; 1.3; 1.0; 1.0; 1.0; 1.0; 1.0) |
| **Ethical Property Company**<br>EPC buys properties and develops them as centres that bring charities, co-operatives, community and campaign groups together under one roof to share skills and ideas | 1999; 2002 | Shares | 5.5<br>(1.3; 4.2)<br>21% to inst. investors |
| **Traidcraft**<br>A Fair Trade company that works with more than 100 producer groups, helping them to build sustainable livelihoods for the future | 1984;1986;1991; 2002 | Shares | 5.15<br>(0.3; 1.0; 0.6; 3.25) |
| **Cafédirect**<br>The UK's largest Fair Trade hot drinks company | 2004 | Shares | 5.0<br>Founders retained 40.5% |
| **Baywind**<br>Creates renewable energy schemes and is the first UK co-operative to own wind turbines | 1996; 1997 | IPS Share | 4.8<br>(3.1; 1.7) |

Source: Nicholls, A., lecture, Saïd Business School, Oxford University, April 2005

There are interesting experiments and ideas regarding how best to break down this capital mismatch.[6] As for implementation, several organisations are advancing new approaches:

- Triodos Bank now manages Ethex, an ethical stock exchange where social enterprises can float shares in the knowledge that investors will hold similar ethical values. But, on this alternative exchange platform, liquidity remains one of the key constraints.
- The Business Alliance for Local Living Economies initiative in the US is working to catalyse local equity exchanges that can be better rooted in patient capital, and more balanced return propositions in line with many social enterprises.

Each of these projects represents efforts to provide a more effective platform for connecting mission-driven ventures with the capital they need to grow.

Equity investments in social enterprises are beginning to find their way to emerging markets as well. For example, ShoreCap International ("ShoreCap"), an affiliate of Chicago-based ShoreBank, is an international private equity company "seeking to invest in small business banks and regulated microfinance institutions in developing and transitional economies." In 2005 ShoreCap invested, or committed to invest, US$4.1m in XacBank in Mongolia, Eskhata Bank in Tajikistan and BRAC Bank in Afghanistan, increasing the seven-year-old firm's total portfolio to US$9.5m in eight institutions across Africa, Asia and Eastern Europe. To date, ShoreCap has achieved both impressive financial and social returns. The company has an average return on assets of 23% and an average return on equity of 18%. The company's impact includes the growth of the institutions in which it invests – enabling them to collectively lend US$200m in new loans to 207,000 micro and small borrowers. The borrowers will use that US$200m to start small businesses, pay for their children to attend school, secure safe housing, and generally stabilise and improve their lives.[7]

## ANGELS: START-UP FUNDING

Socially motivated angel investors are important actors in this sphere. A recent McKinsey report analysing the experience of Investors' Circle in the US found that very little sacrifice is required in terms of financial returns when it comes to social purpose equity investing into for-profit enterprises. Investors' Circle is a group of 100 US angel investors that screens 350-700 social ventures per year. These annual screenings usually result in 50-70 deals being presented to the network by primarily for-profit entities. Thus far, members of Investors' Circle have invested US$90m in 150 equity deals since 1992 and the financial returns generated by member funds have ranged between 5% and 18% – which is only slightly lower than that of other early-stage angel investors in traditional for-profit private equity investments[8]. With recent emphasis being added on "patient capital", Investor's Circle is entering the social enterprise space more positively by overtly examining the risk/return and time horizon issues of angel investing.

## SOCIAL AND COMMUNITY DEVELOPMENT VENTURE CAPITAL FUNDS: GROWTH FUNDING

Social venture capital funds generally target conventional market rates of return but focus on industries with inherent social benefits, such as renewable energy, environmental technologies, healthcare and education-related information technologies.[9]

Examples include Foursome Investments Limited, Commons Capital, Calvert Venture Partners, Expansion Capital Partners and Solstice Capital.[10] One of the earliest pioneers of social finance is a Dutch financial group founded in 1968, Triodos Bank. Alongside a suite of many other financial services, Triodos' Innovation Fund BV was designed as a venture capital vehicle for companies focused on culture, "wellness", renewable energy, organic food, Fair Trade and clean technologies.

As previously mentioned, another type of venture capital (or "VC") fund in the US targets community development-related enterprises that aim to create jobs, support ownership by marginalised communities or spur local economic development in impoverished areas. Examples of this type of fund include: Pacific Community Ventures (PCV), Baltimore Venture Capital Fund, Bridges Community Ventures, The Abell Foundation Venture Fund (equity is 15% of its programme-related investment – or PRI – portfolio), Community Development Venture Capital Alliance, Morino Institute, and Community Development Venture Capital Alliance Central Fund. [11]

In a May 2006 paper, Pacific Community Ventures' executive director, Penelope Douglas, made a compelling argument for the creation of a sub-asset class within private equity.[12] PCV has demonstrated that it can provide competitive

[6] Emerson, J. (2000), Riding the Bleeding Edge presents the vision of a nonprofit stock exchange and framework for tracking social equity.

[7] Providing Capital and Expertise to Financial Institutions Serving Micro and Small Businesses (ShoreCap International & ShoreCap Exchange, Annual Report 2005) http://tinyurl.com/23fsk4.

[8] Carden, S.D., Darragh, O. (2004), A Halo For Angel Investors, The McKinsey Quarterly

[9] In 2002, the number of venture capital social/environmental deals grew at 19%, compared with 13% growth in overall venture capital deals. The typical deal size was US$250,000-US$3m. In 2002, social/environmental investments represented 6.2% of the total number of venture capital deals and 0.6% of the total capital invested, according to the 2003 Columbia Business School Research Initiative on Social Entrepreneurship (RISE) report.

[10] Olsen, S., and Tasch, W., (editor), Mission-Related Investing, Investors' Circle http://tinyurl.com/247v2q

[11] www.cdvca.org

financial returns and risk diversification, along with community benefits. It also draws attention to historic returns of funds managed by Kentucky Highlands and Coastal Enterprises, at 18% and 17% respectively.

In the global landscape, equity investment funds in the area of microfinance are perhaps the most prominent and recent developments. One mature example is ProFund, which closed in 2005 after investing for ten years in Latin American microfinance institutions. Even with the systemic financial failures and social or political chaos in some regions where it was investing, ProFund achieved a 6.65% internal rate of return while maintaining operating fees below 3%. ProFund, as an experiment, made it much more attractive for Latin American commercial banks to supply capital to microfinance institutions. Since then, the US$10m Bellwether Fund in India and US$15m AfriCap Fund in Africa have been modelled as country-based funds aiming for similar positive outcomes.

Beyond microfinance, there remains a gap in equity funds for other social enterprise industries globally. One newly created fund trying to address that gap is Aavishkaar. Aavishkaar is targeting 32% per investment return by providing financial and business building support to growth stage microventures serving the development of rural and semi-urban India. Additionally, the energy sector has several equity funds created to stimulate future investment capital from commercial finance providers. The IFC's Photovoltaic Market Transformation Initiative launched in 1998 with US$25m of flexible financing, including equity, aimed at promoting the sustainable commercialisation of solar technology in developing countries. It has committed to nine projects in India, Kenya and Morocco.

It is important to note that these funds serve a relatively small percentage of the market of social enterprises because their requirements for financial returns usually take priority over those of social returns. For example, Foursome Investments Limited is an investment management company that manages two private equity funds in early stage and development stage growth businesses, and it seeks businesses with a measurable benefit to people's lives. Foursome reports that 10-20 deals per year cannot be financed because the social mission would reduce the amount of expected financial return.[13] Bridges Community Ventures turned away 40 applications for social enterprise funding in 2004 for the same reason. This is a common theme for equity investors, which leaves a huge number of organisations without access to start-up and expansion capital.

## NONPROFIT AND FOUNDATION "PRI" AND "MRI" EQUITY INVESTORS

Nonprofit organisations and Foundations are beginning to consider investment of their fund balances and endowments (respectively) in social enterprises. In the US, when catalysed first and foremost by a social purpose, and only secondarily by expectation of financial returns, this type of capital is categorised as "programme-related investment" (PRI).[14] PRIs therefore tend to be "below market". When financial returns are sought, and expected to be at market rate, the term "mission-related investing" (MRI) is used.

As a US foundation programme, Rockefeller Foundation's ProVenEx has reviewed over 250 deals and made 12 investments since 1999, totalling US$12.2m with expected returns of 3%-10%.[15] The FB Heron Foundation[16] is another example of a US foundation which actively invests in housing, employment and enterprise opportunities for the poor, using both debt and equity instruments. It has distributed more than US$17m in PRIs and US$45m in MRIs. This constitutes more than 25% of its assets.[17] A further US$150bn could be released for social purposes if all foundations did the same with their assets, given that there are approximately US$600bn in foundation assets.

The third example is not a foundation, but a US-based nonprofit organisation named Acumen Fund. Acumen Fund raises donor capital and, through a portfolio approach, uses debt and equity instruments to aid in the development of social enterprises delivering critical goods and services to the global poor.

The growth of the social enterprise sector has inspired grant-making from nontraditional sources, including the International Finance Corporation (IFC), the private sector arm of the World Bank. To support the development of high-impact social enterprises in emerging markets, the IFC launched its "Capturing Value" competition in which it awards US$500,000 in prize money to emerging market companies that are both generating an economic profit and accounting for social, environmental and corporate governance practices. According to the IFC, the competition functions not simply to provide

[12] Douglas, P., Sirull, B., November, P. (2006), Development Investment Capital: Three Steps to Establishing an Asset Class for Investing in Underserved Markets.
For a copy of the paper, contact bsirull@pcvmail.org
To read a review of the paper, visit www.socialfunds.com/news/article.cgi/2008.html.

[13] Howard, L. and Giddens, M. (editor) (2004), Equity-like Capital for Social Ventures, Bridges Community Ventures, London.

[14] Interestingly, if market rate returns are attained, a PRI designation may still apply. It is a matter of intent, not outcome. In the US a PRI is a designation by the IRS that allows a foundation to relax its fiduciary or "prudent man" rules of investment, and to count an investment towards its grants payout requirement.

[15] Howard, L. and Giddens, M. (editor) (2004), Equity-like Capital for Social Ventures, Bridges Community Ventures, London.

[16] The FB Heron Foundation focuses on promoting five wealth creation strategies: home ownership, business development, childcare, community development and access to capital.

[17] FB Heron Foundation website www.fbheron.org

grant funding to social enterprises in emerging markets but to also raise awareness about the work of these enterprises in order to generate interest from the international investing community. It is the IFC's hope that "Capturing Value," whose judges include representatives from the United Nations and the World Resources Institute, will catalyse investment in emerging markets, where social entrepreneurs also struggle to secure funding.[18]

## DEBT/LOANS

Debt, defined as money loaned at a stated interest rate for a fixed term of years, is available in social enterprise capital markets in a variety of forms. Like most capital instruments, debt structuring is based on the classic risk/return equation. That is, the higher the risk assumed by the debt issuer, the higher the corresponding interest rate charged to the debtor. While interest rates are an important component of the debt calculation, they must be considered in relation to other aspects of the debt capital, including the type of debt (eg subordinated debt), the structure of the payments (eg is there a balloon payment?), the life term of the loan, and the points associated with closing the loan. Because debt capital creates liabilities on the balance sheets of enterprises, it needs equity or net assets to be leveraged. Many types of debt financing are currently available to social entrepreneurs – here are a few examples.

### TRADITIONAL BANKING INSTITUTIONS

Traditional banking institutions in the US provide debt capital to social enterprises in two forms: business loans and loans that qualify for Community Reinvestment Act (CRA) credits. It is – theoretically – possible for a social entrepreneur to qualify for the same traditional business loan used by for-profit entities. However, while this sort of debt capital is more readily accessed by for-profit social enterprises than nonprofit ones, it is not easily accessed by either, owing to the inherent risks involved in financing an entity that puts equal emphasis on financial return and social mission. Debt capital is also available to US social enterprises thanks to the Community Reinvestment Act. Enacted in 1977, the CRA obliges depository institutions to invest in the communities they serve by financing projects that address community needs. To that end, US banks offer a limited number of low or zero-interest loans to nonprofit social enterprises to meet their Federal obligations. Unfortunately, the availability of debt capital in the form of CRA loans has decreased recently due to changes in the regulations.

### FOUNDATION PRI DEBT

In addition to traditional grants, foundations may offer loans to social enterprises. Many major US foundations have made such programme-related investments, but, in total, less than 1% of US foundations by number have made PRIs, and just one-tenth of 1% of total assets of foundations are in such mission-based investments.[19]

An example of a PRI loan facility is the Esmée Fairbairn programme. Launched in 2003, it offers both secured and unsecured loans of between £10,000 and £250,000 to the UK voluntary sector at interest rates from 0% to 7%, for terms of up to five years. The programme is a pilot to help extend the foundation's support beyond grants, and to learn more about the demand for loan finance. It is run in co-operation with Charity Bank, which provides due diligence and loan administration services, as well as acting as a collection agency.

### BONDS, INVESTMENT NOTES AND NONTRADITIONAL LENDING INSTITUTIONS

An increasing number of innovative structures and facilities have cropped up in recent years to provide fixed-income investment instruments to fund social purposes:

Citylife has issued six zero coupon bonds to investors who are prepared to forgo capital growth and interest income on their money, but who are guaranteed it back after five years. The bonds invest the interest in social enterprises and local communities to regenerate social, economic and intellectual capital. The bond is held under trust and investors have a bank-guaranteed return on their investment. Citylife structures five-year fixed-term loans with compound interest.[20]

Compartamos is Latin America's biggest provider of microfinance – small loans aimed at budding entrepreneurs in areas of severe poverty. In order to access finance to grow to reach one million clients, it offered a US$45m bond – the first of its kind for the microfinance sector – underwritten by Banamex, the Mexican subsidiary of Citigroup.[21]

BIGinvest is an organisation that lends and provides capacity support directly to social enterprises and community development finance institutions (CDFIs) in the UK. It has accessed £3.5m of loan funding and is accredited for Community Investment Tax Relief (see below) and as

[18] See discussion at www.environmental-finance.com/onlinews/2809ifc.htm.

[19] Source: Foundation Center's Bi-Annual PRI Report.

[20] Citylife is an independent UK charitable organisation, incorporated as an Industrial and Provident Society. Zero coupon bonds are issued at below face value, and then, rather than paying interest, slowly grow to their full face value at maturity.

[21] Accion International website: www.accion.org

a wholesale CDFI. It fills a market gap in financing social enterprises and CDFIs, working in partnership with CDFIs and banks to build underwriting capacity and demonstrating that deals can be underwritten successfully. It is an initiative of The Big Issue, ShoreBank, Bank of Scotland and the Phoenix Fund.

Calvert Foundation has long offered its registered Community Investment Notes – through which investors can channel capital into disadvantaged communities – to retail investors in the US as an open-ended investment note programme. Its current footprint is approximately US$100m, sourced from 2,500 investors, placed into almost 200 entities globally. In January 2005, the Calvert Foundation announced the "wiring" of its Community Investment Notes – the first time that such community investment instruments have been available electronically for both individual and institutional investors, through brokers across the US. This capital is then structured for a broad range of nonprofit and for-profit borrowers, including an increasing number of social enterprises (including a recent US$10m social enterprise commitment catalysed by support from the Case and Skoll Foundations). Traditionally, however, capital has been used to finance affordable housing, microfinance and other asset-based strategies.

The Community Investment Tax Credit (CITR), introduced in the UK in 2003, was developed in an effort to increase the availability of funds for social enterprises and small businesses located in disadvantaged areas. A form of economically targeted investing, CITR accounts offered a tax credit of 5% of their deposit a year for five years, as well as interest on their deposits.

But Charity Bank, one of the main providers of CITR funding, stopped accepting deposits under the scheme last August, and Triodos Bank took deposits for less than a month last year and is no longer offering CITR accounts. Both are working with policy makers to address some of the scheme's practical difficulties.[22]

In the US, in particular, there is an increasing number of revolving loan funds, such as Nonprofit Finance Fund, which provide analysis and flexible, frequently unsecured, financing that nonprofits typically can't get from other sources. Across the USA, NFF works with over 170 funders, including financial institutions, foundations and government agencies, to develop new ways of meeting the capital growth needs of the nonprofit sector.

Several innovations were sparked through the creation of loan guarantee funds which have altered the risk profile for investors in social enterprises. In Hungary, the IFC's Hungary Energy Efficiency Co-financing Program structured guarantees and technical assistance to catalyse US$5.7m in lending for energy efficiency by local financial institutions. Homeless International's Community-Led Finance Facility has nearly £11m in funding which provides loans and technical assistance for community-based organisations implementing slum redevelopment projects in India and Kenya. The guarantee portions of this facility allowed debt providers such as Citibank to commit capital to projects in these poor communities where they never before would have invested. Furthermore, Tembeka Social Investment Company in South Africa was originally created in 1996 as a guarantee fund to leverage funds from local banks to social ventures such as microfinance institutions. As a result of a technical market study in 2002, it decided to become more of a wholesale financial services provider through soft loans and equity to NGOs, trusts, credit unions, community organisations and development companies serving disadvantaged communities.

The Global Exchange for Social Investment (GEXSI), has also worked to create incentives, risk limitations, and development investment services. In partnership with VantagePoint, GEXSI has brought together insurers, bankers, social entrepreneurs, and development aid agencies to create a global Social Investment-Re-insurance Facility (SIRIF).[23] The SIRIF proposal is to apply development aid funds to guarantee and insure market-oriented private sector development investment relevant to the realisation of the UN Millennium Development Goals.

## EQUITY-LIKE CAPITAL

Equity-like capital avoids problems that social enterprises have historically had with issuing equity.[24] It typically takes the form of a deeply subordinated long-term loan (junior to all other debt). If structured appropriately it can serve as patient capital similar to preferred stock. This differs from the equity described above in that investors using equity-like instruments tend to be more focused on keeping social value creation a priority over financial value creation. Current providers of equity-like finance in the UK (Venturesome, Aston Reinvestment Trust and Local Investment Fund) have all had very different experiences with the model. In the US, a codified example of this sort of capital is the Equity Equivalent Investment

[22] Connon, H., Brown's social banking scheme fails to catch on, The Observer, 2 April 2006.

[23] See download of report at www.gexsi.org/downloads.htm

[24] Howard, L. and Giddens, M. (editor) (2004), Equity-like Capital for Social Ventures, Bridges Community Ventures, London. www.bridgesventures.com/downloads/social_venture_fund.pdf

(EQ2) – loans that function somewhat like equity for nonprofits and count towards Community Reinvestment Act fulfilment for bank investors.[25]

Bridges Community Ventures defines "equity-like" capital as high risk, relatively high return, patient, and uncollateralised, looking instead to future cash flows to provide repayment. These are indeed many of the characteristics that must necessarily be included in any risk capital structure. In general, we find that the UK market has begun to accelerate its experimentation on developing capital that meets this profile.[26]

Further research and development in this area of capital finance is being undertaken by organisations such as the Calvert Foundation and Good Capital in the US, and Social Investment Scotland, Triodos Bank and Bridges Community Ventures in Europe.

## GRANTS

Nonprofit social enterprises have traditionally accessed donations from individuals and through grants from government, foundations and corporations.[27] Of course, these resources require no financial repayment. Grants from private sources,

[25] Federal Reserve Bank of SF: www.frbsf.org/community/investments/eq2.html

[26] It should be noted that Bridges Community Ventures is not in the business of supplying equity-like capital to nonprofits, but rather equity to for-profits. www.bridgesventures.com

## FEATURES OF DIFFERENT FUNDING INSTRUMENTS

HIGH RISK ←→ LOW RISK

| | Grants | Patient capital | Pure equity | Equity-like | Loans |
|---|---|---|---|---|---|
| EXPECTED LOSS % | 100% | 20-50% | 10-20% | 10-20% | 1-8% |
| FINANCIAL RETURN ON AN INVESTMENT | 0 | -50% – c.10% | No limit | Variable up to 30% | Fixed 5-18% |
| TERM OF INVESTMENT | Often short periods | Repayment holidays | Undefined Depends on success | 5-7 years Depends on success | Fixed term |
| INVOLVEMENT IN BUSINESS | Low (except venture philanthropy) | Some (through partners) | High (through board) | High (through board) | Low |
| EXIT OF INVESTMENT | n/a | Repayment | IPO, sale, layout | Royalty, repayment or APO | Repayment |
| LIQUIDATION RIGHTS | None | None/subordinate | Residual | Subordinate | First priority |
| VOTING RIGHTS | No | No | Through ownership | Structured in loan agreement | No |

*Source: BCV Interviews, Home Office report on Patient Capital, Social Enterprise in the Balance, CAF (2004)*

such as foundations, are typically short-term, project-based commitments of relatively small amounts of capital. Though sometimes renewed annually, these are often one-time injections of capital that may be paid out over one to three years.

Despite claims that grants represent the equity of the nonprofit sector, in truth they usually lack the characteristics of mainstream equity investments. Although, in a technical sense, grants can certainly serve the purpose of "equity" capital for nonprofit social enterprises, they present significant challenges:

- small amounts of capital committed over a short time period restrict major growth
- restrictions on the use of funds results in limited resources targeted for general operations/ development and may provide incentives for activities not well aligned with the strategy for achieving its social mission and professional management due to the incredible attraction of "free money"
- application process is often bureaucratic and drawn out, and the hidden costs of fundraising and reporting cause inefficiencies[28]
- social enterprises that do not hold charitable tax status usually cannot receive grants.

Because of the third-party payer structure of a significant portion of the nonprofit sector, much social good gets funded by grants. However, grants more accurately represent consumption of capital, not investment. And, if a funder sees social good as a commodity, then their interest is in funding the lowest-cost provider of the commodity. Commodity purchasers are generally disinterested in funding innovation or value-added services. Instead they reward suppliers that eliminate "frills" such as research, additional administrative infrastructure aimed at improving organisational efficiencies, or employee education and development.

Of course, social entrepreneurs want to create the most efficient and effective means of delivering a social outcome. But the risk capital to expand a successful enterprise usually doesn't come directly from its customers: most enterprises would be heavily constrained if they could only tap expansion capital from their profit margins. In the for-profit sector, venture and other expansion capital fill these needs.

In contrast to investing in a product or service, the mantra in venture investing is that the three most important things in an expanding enterprise are the management team, the management team and the management team. That's because venture capitalists are investing in people they believe can create huge value. The effect of this is to direct funds not simply to the delivery of a service or product, but to build an organisation capable of taking an idea, innovation or service/product to its next level of development and thereby create greater long-term capacity for the organisation to deliver quality and value to any given market or community. This venture capital approach is focused on building organisations and management capacity upon the base of demonstrated success or innovation. When applied to investing philanthropic capital, this translates to high levels of engagement and the adoption of business-based practices – essentially grant capital invested in an ambitious plan to create or expand an enterprise that will have results that far exceed what would have happened if those same funds were spent on consumption of social good.

Therefore, if grants are to function more like equity for the sector, some innovations in deploying or structuring grant capital might need to be:

- establishing longer, larger relationships to lower fundraising costs and measure impact more closely, including multi-year grants
- designing donor syndicates around standardised offerings
- high engagement management and capacity support from donors.

In the final analysis, the current landscape of capital for social enterprise is somewhat ill formed. There is increasing activity and interest, but very little activity squarely focused on the risk-taking expansion capital needs of social enterprises, whether for nonprofits or for-profits. The most compelling opportunity for the field is to institutionalise new facilities for capital and engagement structures. A number of interesting experiments will likely be initiated in the near to intermediate future.

[27] The US had US$241bn in philanthropic funds in 2002, provided by 37 million individual donors, 60,000 foundations, 400,000 corporate investors and bequests. Government grants totalled over US$65m. Meehan, W., Kilmer, D. and O'Flanagan, M., Investing in society, Stanford Social Innovation Review, Spring 2004, pp34-43.

[28] For-profit capital market: US$2-4 spent per US$100 raised for legal, marketing, admin. Not-for-profit capital market: US$10-24 per US$100 raised for buying donor lists, direct mail/telephone calls, and CEOs spend 30-60% of time on fund-raising. Meehan, W., Kilmer, D. and O'Flanagan, M., Investing in society, Stanford Social Innovation Review, Spring 2004, pp34-43.

CHAPTER 4

# SOLUTIONS

Central to any solution must be the intention to create a relationship between providers and users of capital wherein the investor becomes a risk partner in the endeavour and the social entrepreneur contracts to move appropriate and manageable value back to the investor over time. Upon this foundation a new kind of risk-taking expansion capital can be imagined, sourced either through a new kind of investor profile, through blending more traditional philanthropic and commercial capital, or both.

## SOLUTION 1: CHANGE THE TERMS OF ENGAGEMENT AND RULES OF THE GAME

The most audacious option in terms of sourcing capital is to recast some of the rules we've taken for granted. Investor engagement needs to complement the development of true risk-taking expansion capital. We need a new "contract" – a re-evaluation of the relationship between investor and enterprise.

Investors have to be apprised of the cost of doing good through these deals, in the same way that social enterprises need to face the friction that exists in their business model between mission and profitability. Both parties have to figure out the central expectations around the often-challenging intersection of risk, return and social value creation: which metrics matter to whom and why the business and social impact is best intertwined.

Enterprise managers have to dig deeper and supply a rationale that is both compelling and distilled

to a utilitarian core that is accepted by numerous stakeholders. The investor then needs to internalise this value to create a new expectation of return – that is essentially a process of valuing external societal benefits within the returns of the deal.

Philanthropy is catalytic and critical; it has a fundamental role to play. Investing in commercial activity for market returns, yet with a concern for people and planet, is well-established and creating positive impacts in the world. But new hybrid models in the middle – social enterprises – require something of both these worlds. And though there is no hierarchy of virtue between the left, right or middle of the spectrum, there is beauty and utility in a well-balanced business, creating real social impact without the need for separate ill-integrated service programmes running in parallel.

### SOLUTION 2: BY ALL MEANS, USE PHILANTHROPY TO UNLOCK MARKET-BASED CAPITAL IF THAT IS EXPEDIENT

It's time to be pragmatic. If investors won't embrace new values, subsidy has to be brought in (and both the early adoption of the new, and the blending of the old, can coexist). In an ideal world, perhaps, all investors would be able to accept a homogeneous proposition with regards to these considerations. Then no donor or philanthropic investor would be construed as subsidising another more market-rate investor.

Then again, mainstream capital markets are rife with all manner of cross-subsidisation. Tax credits, guarantees and low-interest loans from various government and quasi-government agencies (or even private foundations) course through deals in many sectors of the economy. At the same time, we must realise that getting investors to understand a more balanced return goes against much of the conventional wisdom of the market. So, while we might advocate a more balanced expectation, a good argument can be made for not pushing boulders up hills – using "softer" capital to leverage and support more conventional market rate capital is often the most expedient path.

So the answer is "both": encourage investors to offer capital and use strategies that blend grants and soft money to unlock more market-rate capital. We should nurture a new set of expectations among an ever-widening investor base – one that respects blended value – while simultaneously mixing grant or concessionary investment capital into deals with more market rate capital.

Over time, hopefully, investors will become increasingly comfortable with new ways of thinking about the goals of their investment. But for now, whether the new capital shows up in the exact form required, or in components that can be blended into the form required, is academic except for the transaction costs to the social enterprise.

### SOLUTION 3: INSTITUTIONALISE A NEW KIND OF CAPITAL

Regardless of the manner in which the capital comes to the table, we must then turn to the specifics of the risk-taking expansion capital to be deployed.

For social enterprises within a for-profit structure, private equity fits the bill, at least structurally. The challenge for these enterprises is not one of which instrument to use, but rather how to attract unconventional investors and then negotiate expectations with them. The next task is to build understanding and acceptance of corporate purpose, to design approaches that insure against mission drift, and to set clear expectations around unconventional (read "below-market") risk/return models.

However, advancing specific answers to the challenge of the lack of risk-taking capital to fill the expansion gap for nonprofit social enterprises is a little more complicated. Let us examine a number of concepts, culled from social enterprise practitioners and pioneering work being done to develop new social finance instruments.[29] It is our contention that a number of these will need to be adopted, adapted, and deployed by investors in social enterprises over the coming years.

What might the characteristics look like of ideal risk-taking expansion capital for the nonprofit social enterprise? The assembled capital has to understand the costs and benefits of doing good. Most of the solutions that have been either proposed or tested draw from the following characteristics:

- links to success – repayment and/or yield dependent upon outcomes or revenues
- minimised debt service – non-amortising principal and/or capitalising interest
- deep subordination – ability to support other debt
- patience – Long terms, even unspecified and rolled forward, or determined by revenue
- flexibility – the ability to use prepayment or demand for repayment to course correct
- exit – a strategy for how investors and enterprises can end the relationship.

[29] In addition to input from our readers and contributors, the authors wish to acknowledge a focus group discussion that was conducted at www.xigi.net in June 2006, during which numerous practitioners commented upon and proposed a number of these models and instruments.

Let's explore a few models that could prove attractive:

One might be modelled on a vehicle from the conventional capital markets, a "Zero Coupon Bond." Though technically a liability, this structure may be designed with expectations around risk, for instance, to be deeply subordinate to all other liabilities. The zero coupon aspect removes debt service and compounds exposure to the investor. In one scenario, the social enterprise would raise US$1m. Assuming an 8% compound yield, the note would then slowly appreciate over a five-year period to a maturity value of US$1.47m. (Note that the deferred interest is still treated as interest for taxable investors in most cases. A variation of this instrument is the Social Value Note, a zero coupon bond tied to index options in order to enhance the potential for a financial upside to be offered to investors.[30]) In this manner, minimised debt service and deep subordination are combined to create a manageable construct. The interest is, in effect, capitalised during the relationship, allowing all cash flows to grow the business. The exit is firmly established in timing. And, if the business is successful, then the enterprise would probably be able to refinance the debt at a lower rate from a PRI or other friendly source once the earlier stage risk was taken out of the equation.

To the above model could be added the flexibility of the option to "call" the note back from investors, essentially repaying it early at the will of the enterprise after a certain time period, say three years. Alternatively, the investors could "put" the note back to the enterprise (demand repayment) if certain benchmarks of mission or financial management were not met.

Another example could be a "Preferred Share" model. This combines the patience of a long rolling term with minimised debt service, flexibility, links to success and deep subordination. A base coupon is stipulated, but only to be paid upon successfully reaching benchmark X, though it is capitalised regardless. Thereafter, when Y happens investors get another structured payment of a premium of interest. And, if in any year threshold Z is met, a portion of principal value is returned. That said, there is no maturity stipulated, debt service is not necessarily in play, links to business events drive carefully structured yield and there is a stipulated flexibility in repayment built into the model. But, again, this is still technically a liability on the balance sheet of the nonprofit social enterprise.[31]

A relatively straightforward model is simply to construct what has on occasion been called a "grant with a put". In this scenario a funder simply makes a technically but only loosely recoverable grant to a social enterprise. It stipulates that it will have no recourse to the assets of the enterprise. But, a success threshold on a core programme and business metric is identified, above which the grant begins to be repaid. This extends through to a ceiling upon which the total grant plus a premium has been repaid to the funder. This can be a relatively elegant and simple model that meets many of the characteristics deemed attractive in this type of capital.

Those seeking a work-around to the inability to own a nonprofit outright might consider a "Revenue Rights" structure. For example, investors provide a social enterprise with US$1m today, then, over time, receive a certain percentage of its revenue above a certain threshold, or number of units sold, or whatever the appropriate benchmark might be. Though an interesting model, it raises the challenge of truly understanding margins and being appropriate to a given business model. How would this affect the financial statements? Would social enterprises and their boards consider such a contract? Much groundwork would need to be done to consider such a structure, but in certain circumstances it could be quite attractive, and perhaps escape being considered a liability at all (or at least one with a set value). This is obviously the most radical of the examples in meeting some of the characteristics sought after.

Little use has been made of these models to date. And, unfortunately for nonprofits, they generally show up as liabilities (with the possible exception of the revenue rights model). In the case of a liability, no matter how carefully structured the expectations, and well matched the terms, a nonprofit enterprise that shows debt on its balance sheet will encounter difficulties when arranging its finances and seeking further capital.

So, by combining the characteristics of linking to success, minimised debt service, deep subordination, patience, flexibility, and a plausible exit strategy, and adding a shared contract between investor and entrepreneur on understood value and the cost of doing good, a structure approaching equity-like expansion capital can be fashioned.

[30] Emerson, J. (2001). Please see the article by that same name at www.blendedvalue.org.

[31] The Calvert Foundation is working to get legal and accounting approval that would actually let this sit on the nonprofit balance sheet as a net asset. These models have also been referred to as "Grants with Puts".

CHAPTER 5

# CAPITAL CONCLUSIONS

It becomes clear there is a rich landscape of actors and strategies in the capital markets serving social enterprise, yet a significant gap remains in the availability of risk-taking capital to fund the expansion of promising organisations. The outcome? Much of the opportunity represented by these maturing social enterprises remains blocked or is channelled into overly slow, organic growth. Attainment of an optimal capital structure remains out of reach.

Perversely, start-up social entrepreneurs are often able to absorb grant capital (or "friends and family equity") to get the ball rolling, while later-stage enterprises stall due to the massive gap between start-up capital and later-stage mission-oriented debt financing. Regardless of the enterprises' for-profit or nonprofit status, if their risk/return model isn't "strong enough" in conventional terms, they tend to stall in the expansion phases before lower-risk debt capital becomes available.

What then happens is the root of much frustration for investor and nonprofit social enterprise alike, as the enterprise is left to fit debt capital and grant capital into an equity capital gap. And for-profit enterprises struggle with equity investors that are seeking conventional returns, when their hybrid social purpose business just does not support this. Regardless, investors and entrepreneurs experience the pains of the mismatched expectations that follow.

What is clear is that many new investment opportunities and instruments will be created – because the gap in the market will demand it. Investors are looking for ways to structure their capital in more effective terms and social entrepreneurs require new forms of capital to complement the next stage of their development.

With that in mind, it must also be understood that with these new approaches and investment initiatives there will also be a level of failure. High-risk capital – by its very definition – carries greater exposure for both investor and investee. Where there is innovation there will be failure. However, that failure may be hedged if those involved take care to leverage the existing knowledge and draw upon the talent present in the business and nonprofit sectors which may best be applied to this challenging task.

In undertaking what is in some ways a capital experiment that will take us into new terrain, it is imperative that adequate attention be paid to clarifying the specific terms and expectations of those engaged in each investment. Traditional term sheets and understanding of returns may well not be enough to get the deal done. Regardless of balance sheet and deal term considerations, if the expectations between stakeholder and enterprise are carefully and honestly defined, and the terms structured to match the needs of the enterprise as discussed in this paper, it is possible to envision the evolution of a host of successful risk-taking expansion capital instruments which may meet the needs of not only those specifically involved in the deal, but also an array of stakeholders, from community residents to programme participants to low-income individuals seeking new stairs upon which to climb towards real economic development and not simple reliance on grants and relief.

Importantly, though perhaps a broader issue, is the reality that in the absence of significant, shared understanding and experience with regard to these instruments, the high transaction costs of executing every deal as a new cutting-edge negotiation are going to be prohibitive, limiting the number of such investments and thus the amount of capital capable of moving into these emerging markets. In order to build a viable capital market in this area, those creating the financial innovations of the future must take adequate care to document their work, terms and practices in order to popularise investment models, engage in syndication opportunities and, through shared or commonly endorsed due diligence practices, decrease the transaction costs of individual investments and the market as a whole.

Finally, at its core, this work requires a rethinking of capital investing and enterprise development. This includes the need for us to advance a broader understanding of the full, blended value created by capital and brought to market by ventures of all types – nonprofit and for-profit. The financial landscape and instruments presented in this paper in many ways represent the missing links between mainstream investing and traditional philanthropy. And this capital gap will continue to shrink as increasing numbers of people transcend the artificial value barrier between "doing well and doing good."

# RESOURCES

## SELECTED ONLINE RESOURCES

Accion International
www.accion.org

BIGinvest
www.biginvest.co.uk

Blended Value (resources on "blended value" and "blended value investing")
www.blendedvalue.org
www.blendedblog.org

Calvert Foundation (information on community development, microenterprise and social enterprise investments)
www.calvertfoundation.org

CDVCA (Community Development Venture Capital Alliance)
www.cdvca.org

Citylife
www.citylifeltd.org

Community Investing Center
www.communityinvest.org

Esmée Fairbairn Foundation
www.esmeefairbairn.org.uk/loans.html

FB Heron Foundation
www.fbheron.org

GEXSI (The Global Exchange for Social Investment)
www.gexsi.org

Good Capital
www.goodcap.net

Nonprofit Finance Fund
www.nffusa.org

Partners for the Common Good
http://pcgloanfund.org

RSF
www.rsfoundation.org

Social Edge (an online social entrepreneurship community)
www.socialedge.org

Social Enterprise Alliance (a social enterprise member association)
www.se-alliance.org

Xigi.net (database, blog and mapping of the social capital market)
www.xigi.net

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