

Discussion Paper

Promoting social enterprise financing

Presentation and discussion of three models bringing together government, foundations and private investors to mobilise financing for social enterprises



About this report

This discussion paper has been produced as part of the Social Innovation Europe project (SIE). SIE was established in 2011 as the first pilot action on social innovation under the Innovation Union. Funded by DG Growth, the SIE platform has become a community of over 3000 people across Europe, a go to place to understand the context of social innovation in different countries, and a database of organisations and events across Europe. The magazine hosts the SIE interview series, with actors across Europe talking about key issues, from Digital Social innovation to Stories of Impact.

For the purpose of this report 2 interviews have been conducted which have been published separately.

This report also builds on research undertaken within the project 'Building a Social Finance Market in Denmark' commissioned by the National Centre for Social Enterprises and carried out by the Danish Technological Institute in 2014/2015. Through mapping of international practices, investigation and evaluation of existing financing schemes as well as five interviews and two workshops with key experts, commercial investors, social investors, policy-makers and foundations, the project investigates ways to promote the creation of a market for social enterprise financing in Denmark.

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Introduction

Both social innovation and social enterprises are on the rise. Businesses are becoming concerned with solving social problems rather than simply making a profit. Policy makers are looking beyond GDP and considering to include social value measurements in firm-level or national bottom lines. However, what is the difference between a Social Entrepreneur and a Social Innovator? Kayla Kurin argues that “while a social entrepreneur is focused on solving a problem through business, a social innovator could be looking to solve the problem through a number of different mediums. A social innovator may be an employee in a company, part of a government organisation, or a participant in a hack-a-thon. Further, social innovators tend to use the structure of open innovation”¹.

Social enterprises stand behind some of the most fascinating social innovations in Europe in recent years. Many compelling cases from all over the continent have demonstrated how social innovators running social enterprises are managing to address some of the most pressing social challenges, while at the same time running a business. Such cases have bred high expectations from the side of policy-makers at all levels. At EU-level, social enterprises are seen as an almost perfect example of what the EU’s vision of smart, inclusive and sustainable growth could look like in real life. At member state level, social enterprises are seen as new and promising actors that can support the public sector in addressing social challenges while at the same time creating jobs and growth. Whether realistic or not, these expectations have put the European social enterprises front and centre in fundamental discussions around how we as societies address social challenges and how we define growth.

Although social enterprises by definition operate in a space between the public and private sectors, public sector institutions at all levels play a key role in shaping the ecosystem surrounding them. A recent study concludes that a solid and well-functioning ecosystem is essential for the future growth of the enterprises and the sector as a whole (ICF-GHK, 2014). The study identifies the following six select features of the social enterprise ecosystem:

- Networks and mutual support mechanisms
- Business development services and support schemes specifically designed for social enterprises
- Marks, labels and certification schemes
- National legal frameworks for social enterprise
- Impact measurement and reporting systems
- Social (impact) investment markets

This discussion paper discusses how we in Europe can strengthen the last of the six components: the creation of social investment markets for social enterprises. We start off by providing an insight into the current demand for capital among European social enterprise. We then identify the primary financing gap and discuss how a broad and steady supply of social finance can help bridge it. Next, we provide an insight into specific social finance products, before finally giving an overview of three distinct models and discussing their strengths and weaknesses.

It is important to note, that this article does not focus on how to improve the enterprises’ opportuni-

¹ <https://www.wethinq.com/en/blog/2014/09/07/social-innovation-vs-social-enterprise.html>

ties for selling products and services in the market (e.g. through public procurement). Nor does it focus on the role of non-financial support and how it can be strengthened.

A substantial need for capital

Many social enterprises regard lack of financing opportunities as a significant barrier to start-up and growth. A recent British survey shows that 40% of social enterprises regard lack of access to finance a significant barrier to start-up and 39% regard it as a significant barrier to sustainability and growth (Social Enterprise UK, 2013). At least part of the explanation for their difficulties in attracting capital can be found in the term ‘the double cost’, which an Australian study found a majority of social enterprises facing (Burkett, 2010). Social enterprises must not only cover ordinary SME expenditures like wages, administration, marketing, rent and office equipment. They also face so-called ‘social impact costs’ which include costs associated with lower productivity rates, demonstrating both social and financial impact, liaising with public employment services, conversations and care with disadvantaged employees and building social capacity. Thus, social enterprises often have difficulties paying the same interest rates or meeting other financial requirements under the same conditions as ordinary for-profit SMEs (ICF-GHK, 2014).

In the current landscape, social enterprises tend to rely either on grant capital in the form of e.g. grants, donations or project funding, or commercial financing products such as bank loans (Burkett, 2010; Glänzel et. al., 2013; Social Enterprise UK, 2013). Ironically, many social enterprises at the same time report of significant drawbacks related to each of these two forms of financing. Many social enterprises are for instance reluctant to make use of traditional commercial finance products, fearing that they – due to the double-cost issue described above – might not be able to pay back the loans (Burkett, 2010). In addition, a significant number of social enterprise leaders report, that relying too much on grant funding can be a risky strategy since individual grants are time limited and are not reliable in the long term. Grant funding can also lower the incentive for leaders and employees to professionalize the business aspects, thus leading to unhealthy business behaviour (see e.g. Social Enterprise UK, 2013). In other words, there seems to be a substantial need among social enterprises for alternatives to the traditional forms of financing.

A further issue is that like all SMEs the vast majority of social enterprises are at least micro² and often hyper micro businesses. They are not large enough to have a departmental structure and struggle to achieve a state of ‘investment readiness’ that would make them credible to a mainstream lender. They also lack collateral against which most small business loans are secured. For the same reason they often struggle to compete for larger contracts from public sector agencies. Capacity building is needed for both management and contract acquisition especially because many founders start not as entrepreneurs but as people wishing to achieve some level of social change.

Finally, while grant funding exists and is still accessible, it can act as a barrier to social enterprises wishing to grow, because funders are frequently less demanding about future prospects than a lender. Although grant funding is often important at the early stages it can therefore act as a brake on growth once some critical mass is reached. This might imply that a wider spectrum of financing is

² Defined by the EU as having less than 10 employees.

needed that sits between a traditional grant and a classic bank loan.

Start-up and growth capital in particular demand

The demand for capital seems particularly high in the start-up and growth phase of the business cycle. In the start-up phase, many social entrepreneurs chose to invest their own savings or receive favourable (often interest-free) loans from family and friends. However, this is not an option for all social entrepreneurs, who might not have the rich friends or the personal savings to do so. Banks and other private investors also tend to be reluctant to provide high-risk capital to social enterprises, where success is generally measured in social and not monetary value. The start-up phase is mentioned by a couple of recent studies to be the phase in which the unmet demand for external finance is highest. One survey from the UK concludes that *'access to finance is (...) the principal barrier to start-up'* (Social Enterprise UK, 2013). Another study from Australia found that the start-up phase *'involved the greatest level of struggle to obtain capital – in any form'* (Burkett, 2010).

In terms of growth, hiring a new batch of key employees who can take the company to the next level, purchasing new facilities or opening up a branch in another city often requires capital. Social enterprises typically have significant difficulties building enough equity to pay the needed amounts out of their own pockets, or to ensure convince potential external investors that their business is a safe financial investment. This again refers back to the double cost issue referred to at the beginning of the article. At the same time, many social enterprises have difficulties living up to the conditions built into commercial loan products (Burkett, 2010; GIZ, 2014).

The financial dead zone

The demand for financing depends highly on the type of social enterprise in question. When placing the enterprises on a continuum ranging from 'primarily social' to 'primarily commercial', it quickly becomes clear that the ones positioned on or near the outer positions of the spectrum have the fewest problems identifying and making use of suitable finance products. To many 'mainly social' enterprises such as charities with smaller sales activities, grant funding might be fully adequate to meet their needs. For enterprises at the opposite 'mainly commercial' end of the spectrum, traditional commercial finance products such as bank loans or credit lines might be fully suitable.

It is at the middle of the spectrum that the major finance gap for social enterprises seems to exist. Enterprises who want to balance their social and commercial goals evenly (or close to evenly), currently have very few options for attracting capital. They are too commercial for foundations and philanthropic organisations, and too social for traditional private investors. This might be one of the key reasons why social enterprises across Europe tend to be either grant-based or pursue a commercial income strategy with only few choosing to combine the two (Glänzel et. al., 2013).

This financial dead zone at the middle of the spectrum has two significant implications:

1. In the current landscape it is hard for a mainly commercial enterprise to become increasingly social without hurting their chances of obtaining finance. In contrast (and perhaps more importantly), the 'mainly social' enterprises might risk losing their financial foundation if they

opt to pursue a more commercial strategy. In other words, the lack of social financing contributes to upholding an either-social-or-commercial divide among European social enterprises.

2. Moreover, 'changing lanes' midway through the process is a difficult exercise often involving a complete rebranding and reorganisation of the enterprise and substantial cultural change at all levels (Burkett, 2010).

The answer: Social financing

What it takes to fertilize the financial dead zone is the emergence of a stable and widespread supply of social financing. Social financing combines elements of grant financing and commercial financing, and is provided with expectations of a combination of both financial and social returns.

Three categories of financing for social enterprises

- **Grant financing** is typically provided by foundations, philanthropic organisations or public sector programmes in the form of for example donations or project funding. Only social outcomes are expected in return
- **Commercial financing** is capital provided in the form of for example, loans or shares in exchange for a financial return in the form of either interest (debt), partial ownership of the company (equity) or a combination of both
- **Social financing** combines elements of grant financing and commercial financing, and is provided with expectations of a combination of both financial and social returns

It would be a mistake to conclude that social financing is the answer to all of the financial troubles of the European social enterprises. In fact, multiple studies have showed that there is no right mix of financing suitable for all social enterprises (Burkett, 2010). What is required is instead a broad range of financing products across the full spectrum, allowing the individual enterprise to pursue the combination of instruments best suitable for their particular business-model, type of enterprise and development stage. Work is also needed on the demand side to ensure that social enterprises are investment ready.

It should also be remembered that many social enterprises do not currently experience problems attracting suitable capital, and that many do not even pursue additional capital, focusing instead on other elements that can improve their sustainability and growth (e.g. non-financial capital, increasing sales, etc.). However, among those enterprises which face an unmet demand for external capital, social capital is certainly the one most urgently needed (ICF-GHK, 2014; Glänzel et. al., 2013).

What are social enterprises looking for?

According to Ingrid Burkett (2010), social enterprises need:

- The right type of capital (grant, loan, equity, etc.)
- At the right time (suitable for the lifecycle phase where the social enterprise currently is)
- For the right purpose (e.g. not keeping a bad business afloat through donations)
- For the right impact (ensuring that the capital provided is the most suitable for promoting the desired social and/or financial impact)
- For the right returns (ensuring that the returns are not so high that they choke the ability of the enterprise to generate social impact, and not so low that they do not instil incentives)

If social enterprises were given sufficient access to a broader range of social finance products, the either/or dichotomy of the current social enterprise landscape would be softened, and business-models combining social and commercial purposes would become increasingly attractive for social entrepreneurs to embrace. Also, fluctuations on the ‘mainly social’ – ‘mainly commercial’ spectrum would become possible, thus no longer confining the enterprises to stay on the same path throughout the lifetime of the company.

Type of capital	Instrument	Scheme description	Read more
Grant capital	Repayable grants	Grants that include clauses for repayment of some or the whole grant in case the social enterprise achieves certain financial thresholds or milestones.	Burkett, 2010, s. 47
	Matched grants	Grants that match the surplus or equity generated by the social enterprise over a specified period of time. This incentivises the social enterprise to maximise its income generated by commercial activities.	Burkett, 2010, s. 47
Debt capital	Social enterprise lending	Ordinary loans, but with special conditions applying to social enterprises, such as low interest rates, no interest rates, interest-free periods, longer repayment periods, etc. Typically provided by social banks or through foundation or government supported schemes.	Burkett, 2010, s. 48
	Program Related Investment Loans (PRI)	Mainly used by foundations as a supplement to grant funding. Their investment in social enterprises can typically motivate other funders to get involved, while receiving a low return on investment years later (interest rate of 1-4%).	Ford Foundation, 2014
	Subordinated debt	Debt providers have a subordinate status in relationship to the normal debt. It has a lower credit rating and therefore, a higher yield. However, it has a lower priority than other debt in case of liquidation during bankruptcy.	GIZ, 2014
Equity capital	Social angel investments	Individuals (angels) or networks of angels who invest in promising social enterprises in return for equity, decision-making power and a social return. Typically accompanied by non-financial support i.e. sparring, access to networks, etc.	clearlysocial angels.com
	Social impact investment	Impact investors typically finance either social enterprises or for-profit companies that have social impact potential. In return, they typically take on partial ownership through which they gain decision-making power.	NVCA, 2014; Sal-tuk, et. al., 2011
Mezzanine capital	Convertible loan / mezzanine financing	Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time or in full. Typically used to finance expansion and growth.	GIZ, 2014; OECD, 2013; Investopedia, 2014
Hybrid capital	Recoverable grant	A regular loan that must be repaid if the project reaches certain predefined goals. If the goals are not reached, the loan is converted into a grant.	TUM & Schwab Foundation, 2011
	Forgivable loan	A loan that is converted into a grant if certain predefined milestones are reached. In a way, it is the opposite of a recoverable grant.	TUM & Schwab Foundation, 2011
	Quasi-equity	Typically a loan where the financial returns are calculated as a percentage of the future revenue of the company. Attractive to social enterprises that, due to their legal structures, often cannot attract share capital.	Venturesome, 2008a
	Social impact bonds	Social enterprises and other non-profit service providers (with support from intermediaries) are contracted to deliver a specific social impact. Impact investors and philanthropic organisations fund it. The government only pays if the programme succeeds.	Social Finance, 2012
	Royalty financ-	The investor provides funding for the social enter-	TUM & Schwab

	ing/revenue share agreements	prise for a guaranteed percentage of future revenues. Upside: Paying back in down months not a problem, no giving up control to equity investors. Downside: Usually high interest rates.	Foundation, 2011
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Source: Lauritzen, 2015 (unpublished) (adapted)

Social financing products for social enterprises

We argue above, that ensuring a broad and steady supply of social finance products would significantly improve the ecosystem surrounding social enterprises in Europe. But what do we mean by 'social finance products' and what do they look like in real life?

The table below contains an overview of some of the most common social financing products who are out there, but who are not broadly available:

The role of national governments in promoting social financing

As the above table demonstrates, social financing primarily comes from non-public sources such as foundations, pension funds and banks. Although the public sector can act as a small supplier, the main role of governments is to set up schemes and framework conditions that makes it attractive for private investors to get involved³. A number of such schemes are in place in select countries round the world, but none of them are widespread. Below, we present a number of these schemes and explain their pros and cons:

- **The capital fund model** - In the capital fund model, a capital fund is set up, which allows one or more private investors or foundations to place larger long-term investment in the country's social enterprises. These are divided into smaller portions and invested in promising social enterprise. The investments are typically accompanied by education, mentoring, networking activities and other forms of non-financial support. The role of national governments in this scheme is typically to organise the setting-up of the foundation, to liaise with the investors involved, to sponsor the non-financial support initiatives and to finance security mechanisms for private investors. One major advantage of the social capital model is that it is recognizable to private investors who often know it from other SME support schemes. The model often requires the installing of risk-mitigation mechanism to be sufficiently attractive for private investors. The Social Capital Fund in Denmark is a real-life example of such a scheme.
- **Social stock exchanges** - Although their activities are currently limited, social stock exchanges are currently opening all over the world under high expectations. They have different setups, but the basic principle is the same. Social enterprises who live up to certain set criteria can register and will (after undergoing a due diligence check) appear on an online social stock exchange platform. Here, private investors (including private citizens) can browse through the registered

³ On top of that, public sector institutions play a key role in a number of other areas which are of crucial importance to the start-up and growth of social enterprises such as e.g. procurement and supply of non-financial support. Although these matters are not treated in this article, they are still recognised as highly important.

companies who are categorized based on e.g. social purpose and location. They can also dive into their annual reports and other background material to ultimately identify the company or companies they want to invest in. Typically, the social stock exchanges are driven by third sector organisations, but might just as well be government-run. A clear advantage to this scheme is that it gives investors an easy overview of the social enterprises they could potentially invest in, and that a due diligence check has already been conducted before engaging with them. On the other side, the scheme has a relatively short history, and has, to this point, produced limited results in terms of attracting large-scale private investments. Social stock exchanges specifically reserved for social enterprises can be found in Canada, the UK, Singapore, Kenya, Brazil and South Africa (Chhichhia, 2015).

- **Social impact bonds** - The social impact bonds scheme might be the most famous and at the same time least implemented of them all. As in the capital fund scheme, private investors make a long-term investment in an intermediary organisation, who in turn places individual investments in social enterprises. An independent institution measures and monetizes the social impact (e.g. improved health, social inclusion or prevented incarcerations) generated by the social enterprises, and the government then pays the investors for the social impact generated (which it saves on its own budgets). To make the scheme attractive to private investors, a foundation is often needed to take on eventual losses in case the social enterprise does not deliver. Outside paying for the social impact generated, national governments can play an important role in setting up the scheme and getting the different stakeholders involved. A clear advantage of the scheme is that social impact is rewarded, but measuring and monetizing this impact is at the same time the main insecurity of the scheme, which might scare off private investors. Currently, around 40 social impact bonds have been launched around the globe with the majority in the UK followed by USA (8), Netherlands and Australia (2), with one each in Canada, Belgium, Germany and Portugal. Although not necessarily targeted for social enterprises the majority of delivery partners for social impact bonds have been either social enterprises or commercial arms of charities. (Social Finance, 2014 and Ramsden 2016).
- **Match funding** - Another option for national governments is to provide or orchestrate funds matching investments made by private investors in social enterprises. This way, one Euro invested by private investors in a social enterprise turns into two once it reaches the enterprise, thus boosting the impact of the investment. Match funding usually comes from the public sector, foundations or other philanthropic organisations and typically is subordinated to the private sector capital so that in the event of a default the public or foundation money is most at risk. One clear advantage is that the scheme is simple to the borrower, easily understandable and relatively light in terms of administration. However, installing risk-minimizing mechanisms such as loan guarantees and first loss arrangements might be necessary to make the scheme sufficiently attractive to private investors – at least until a solid track record of successful investments is built.
- **Tax incentives for social enterprise investors** - The last scheme we will mention in this article, are tax incentives for social enterprise investors. In different ways, national governments can relieve the tax burden of private investors (including even private citizens) investing in social en-

terprises. Reliefs can be given on the amount invested or on interests or dividends earned through the investments. (UK National Advisory Board to the Social Impact Investment Taskforce, 2014). However, tax incentives can be difficult to control and target and may lead to unintended consequences. In particular, in countries like the USA which have a long tradition of tax incentives the main beneficiaries tend to be cultural facilities and religious organisations rather than initiatives focused on social need.

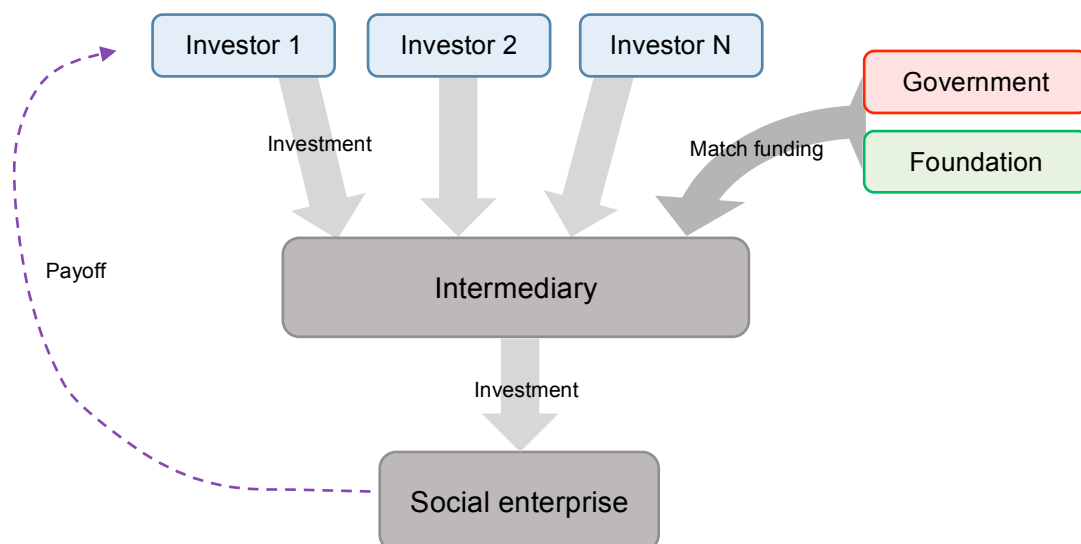
Emerging funding models for social enterprises

Financing of social enterprises requires different actors and products, hence it is unsurprising that different models have emerged globally. In the following section we present three models: the match-funding model, the capital fund model and the model that utilised social impact bonds. These models are not necessarily pure models and hence variations are discussed. For each model strengths and weaknesses are listed.

Model I - The match-funding model

In the match-funding model, government or private foundations match investments made by private investors (pension funds, banks, mutual funds, etc.) with taxpayer money or philanthropic donations. Private investments typically go through an intermediary organisation (e.g. investment fund or NGO) with particular expertise and insight into social enterprises and the market in which they operate. Typically, the private investments are matched one-to-one by the involved foundations or government sources. The payoff (interest, share on profit, etc.) can flow back either directly to the investors as illustrated in the model below, or can be paid to the intermediary organisation, which in turn distributes it among the involved investors.

The figure illustrates the model including the involved actors and capital flow:



The model is attractive to private investors who, compared to non-matched areas, can potentially create a larger impact for the same investment. This increases the likelihood of a solid payoff and thus raises the attractiveness of the investment. As regards governments and foundations, the match-funding model presents a way to ensure that the funds invested in the social enterprise sector are supplemented by private sector funding. In addition, any potential payoffs are reinvested in other social enterprises. Thus, the model is often a favourable and more sustainable alternative compared to purely government- or foundation-sponsored one-off investments. The social enterprises benefit from larger investments and the fact that it becomes easier to persuade private investors to invest in their enterprises. At the same time, the investments put pressure on the social enterprise to reach certain performance criteria and pay back the investment (plus returns).

Different arrangements are often made in terms of how the payoff is divided between the private investors and the involved foundations or government institutions. For instance, the payoff may be divided based on the share of the total investment made, or subordination agreements can be made, where, for instance, investments made by private investors are subordinate to those of the foundations or government institutions.

Variations

The above figure outlines the textbook use of the model, but in real life, variations are often applied. Some of the most common variations are described in the following.

- The figure shows the matching of funds occurring before the collective investment is made to the social enterprise. However, the matching of funds can also happen in the link between the intermediary and the social enterprise, so that it is the investment of the intermediary that is matched instead of the investments of the private investors.
- The intermediary organisation can be circumvented by making a government body (e.g. an agency) directly responsible for deciding which investments to match and which ones to leave untouched. For the government body, this arrangement requires a high level of specialised competences in the field.
- Foundations and governments might not directly be looking for a share of the pay-off (sometimes they are not allowed to do so due to charters or legislative barriers, etc.). However, it might be an advantage to have a share of the payoff go back to the intermediary organisation to be used for matching new future investments. Different arrangements can be made in terms of dividing the potential payoffs between the private investors and the intermediary organisation – both in terms of shares of the total payoff and payback priority. This, however, depends on the type of investment made in the social enterprise (loan, quasi-equity, etc.), the actors involved, and the structure of the scheme.
- The match-funding model can be combined with the capital fund approach, where the intermediary organisation functions as a social capital fund. In this combination, the government not only matches outside funding, but also provides its own funding independently of other investors, finances the operation of the fund (intermediary) or finances the provision of non-financial support to social enterprises.

Implementation of model

The following table outlines a few specific examples of where and how the model has been implemented in countries around the world:

Scheme name	Country	Short description	More info
The Australian Government's Social Enterprise Development and Investment Funds	AUS	Australia's first investment fund providing late-stage seed and growth capital for social enterprises. Private investments are matched by funds from the Australian government.	https://employment.gov.au/social-enterprise-development-and-investment-funds p. 8
Bridges Ventures	UK	Community development venture fund established in 2002 with £20 million in private sector investments matched with £20 million	http://www.socialimpactinvestment.org/reports/UK%20Advisory%20Board%20to%20the%20Social%20Investment%20Taskforce%20Report%20September%202014.pdf , p. 14

Scheme name	Country	Short description	More info
		<p>from the UK government. Today, the fund manages over £460 million due to its success in attracting additional private investments.</p>	
UnLtd	UK	<p>Government-sponsored non-profit organisation that promotes social entrepreneurship in the UK. Provides match funding of up to up to £100,000 for private investors willing to invest</p>	<p>https://unltd.org.uk/</p>

Scheme name	Country	Short description	More info
		in social enterprises.	

Strengths and weaknesses

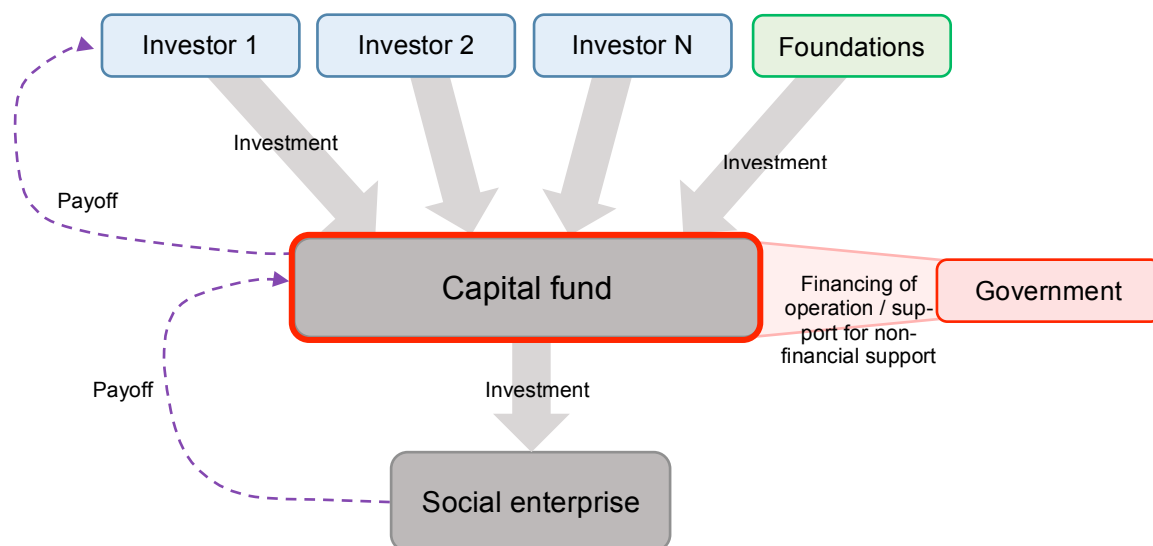
The model has different strengths and weaknesses compared to other approaches. The following table outlines some of the strengths and weaknesses mentioned most often:

Strengths	Weaknesses
<ul style="list-style-type: none"> • Significantly limits investors' concerns associated with investing in social enterprises since they pay less for the same potential payoff. • Provides significant incentives for social enterprises to work to attract private investments (since it will be doubled if they succeed). • Easy to communicate to potential investors and the greater public - particularly if the one-to-one principle is applied. 	<ul style="list-style-type: none"> • Although the match funding significantly heightens the chances of a solid payoff and, in turn, lowers the risk of bankruptcy or inability to pay back the investment, the investor is not guaranteed a minimum return. • National and EU State Aid laws may constrain the usage of the model • Often little money goes back into the system to be used for matching future investments. Often structured as a one-off venture on the part of the government or the involved foundations. • Some foundations might be reluctant to support private investors seeking to make a profit. • Many investments will be made in relatively safe collateralised enterprises (e.g. for property)

Model II - The capital fund model

In the capital fund model, one or more private investors or foundations place long-term investments in a capital fund, which in turn places individual investments in social enterprises. Typically, the social enterprises need to live up to certain criteria and go through an application process, where they are being carefully vetted through various due diligence processes. Investments placed in social enterprises are typically accompanied by non-financial support in the form of mentoring, sparring, education or access to networks. The capital fund might even demand a seat on the company board as a condition for the investment. Government institutions can play a number of different roles in this scheme, but in most cases, they finance the daily operations and administration of the capital fund, or they finance the non-financial support provided to the social enterprises. The investments made in social enterprises are typically favourable loans with low interests and long repayment periods compared to ordinary bank-loans. They typically pay back the capital fund, which in turn pays back the private investors.

The below figure illustrates the model – including the involved actors and capital flow:



To private investors the capital fund model is a familiar scheme. To them, the attractiveness of the scheme primarily hinges on two factors:

- 1) The sector-insight, professionalism and trustworthiness of the capital fund, which they depend on for securing a solid return.
- 2) The applied security or support mechanisms, which minimizes the risks involved and mitigates the costs associated with the favourable conditions under which the social enterprise investments are provided.

Foundations typically also play the role as investors, but often under different conditions than private investors. In some cases, their investment are subordinate to the private investors, meaning that they are the last ones to receive their share of any financial return – i.e. they are the ones suffering hardest in case of default. In other cases, the image is reversed, with the private investors being the ones bearing the primary risk. This depends on the preferences and strategies of the parties involved

and the security mechanisms that are part of the setup in question. Foundations that do not provide social investments (e.g. because their charters do not allow for financial returns) can make a donation to the capital fund, which can be used to finance loan guarantees or cover the costs associated with the low interest rates and long repayment periods.

Government institutions do not necessarily have to be part of this model, and in many setups around the world, they are not. When they are involved, they typically contribute fixed annual amounts to cover non-financial support or operational costs of the intermediary. The non-financial support creates value for the social enterprises regardless of the success of the investment and can also be expanded to cover social enterprises that did not achieve an investment. To governments, getting involved in this scheme is thus often regarded as a low risk venture, which does not distort competition by favouring one or a few enterprises over others.

To social enterprises, the model presents a way of obtaining a loan under favourable conditions accompanied by different forms of non-financial support. The only disadvantage to the model seen from their perspective may be the loss of autonomy in cases where part of the decision-making power is given up as a condition for obtaining the investment.

Variations

The figure above outlines the textbook use of the model, but in real life, variations are often applied. Some of the most common variations are described below.

- In the model described and illustrated above, the foundation plays the role of an investor alongside the other private investors. However, foundations can also (or instead) sponsor the operations of the capital fund or the non-financial support provided to the social investors, i.e. the role which the government plays in the model outlined above.
- Instead of favourable loans, the investments provided to the social enterprises might also take other forms. Quasi-equity loans where the financial returns are calculated as a percentage of the future revenue of the company are gaining popularity in other countries, and classical equity investments can be provided to social enterprises registered as share- or stockholder companies.
- The capital fund model can be combined with other models. The capital fund can alongside its role as a capital fund e.g. also be an issuer of social impact bonds. Also, investments made in the capital fund can be matched by government or foundation funding, hereby combining the scheme with the match-funding model.

Implementation of model

The following table outlines a few specific examples of where and how the model has been implemented in countries around the world:

Scheme name:	Country:	Short description:	More info
Big Society Capital Fund	UK	Established by the UK Government. Size: potentially EUR 840m over five years. Funding comes from dormant bank accounts and the four main UK high	http://www.bigsocietycapital.com/what-we-do

Scheme name:	Country:	Short description:	More info
		street banks.	
The Social Capital Fund	DK	Sponsored by the Tryg Foundation, the fund invests in social enterprises with growth potential. Size: EUR 10m over seven years. Also provides non-financial support to social enterprises (government and foundation funded).	http://www.densocialekapitalfond.dk/
RBC Generator Fund	USA	Invests in for-profit enterprises creating a financial as well as a social impact in areas such as youth employment or employment for disadvantaged groups. Size: EUR 9m.	http://www.rbc.com/community-sustainability/rbc-social-finance-initiative/

Strengths and weaknesses

The model has different strengths and weaknesses compared to other approaches. The following table outlines some of the strengths and weaknesses mentioned most often:

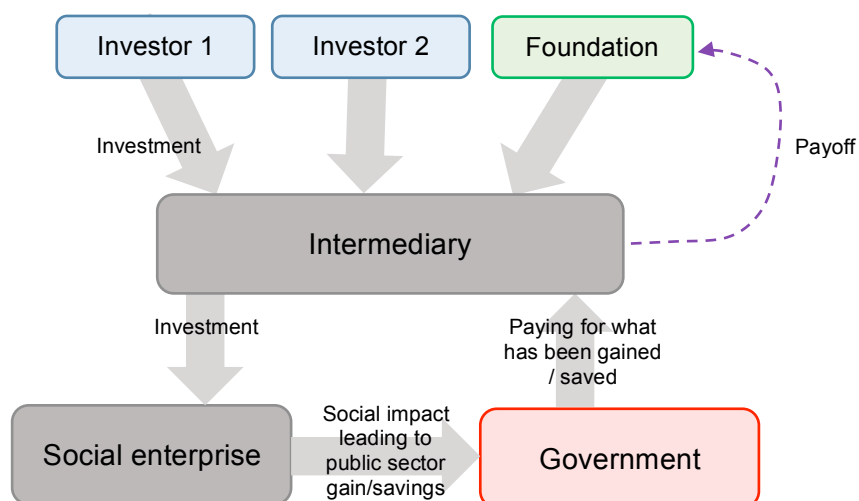
Strengths	Weaknesses
<ul style="list-style-type: none"> The combination of financial and non-financial support is attractive to all parties involved and has proven efficient in terms of creating both financial and social impact. The model is well-known to private investors. Enables low-risk and uncontroversial involvement by government institutions. The scheme has a long and solid track record on the traditional finance market and a solid one on the social finance market compared to other schemes. 	<ul style="list-style-type: none"> In some cases involves loss of autonomy for the social enterprises Long implementation period. May take time for new capital funds to demonstrate results and build up trust among potential investors Primarily suitable for large and well-established social enterprises. Often requires setting up security mechanisms to make the model attractive for private investors. These mechanisms may be financed by foundations or government institutions, etc. Requires high-level specialised competences and a deep insight into the world of social enterprises by the capital fund and its staff. The investments are often in relatively safe enterprises with collateral (e.g. property)

Model III - Social impact bonds

The Social Impact Bonds scheme (or Pay for Success/Payment-by-results scheme) unites the resources of government, private investors and social enterprises around supporting the realisation of innovative solutions to social problems. A social impact bond is a particular variant on a payment by results contract in which there is a financial loop that enables finance to be raised at the outset

whereas results payments are made either at the end or at milestones during the contract. In this model, private investors make a long-term investment in an independent intermediary, which in turn places individual investments in social enterprises that provide well-documented and efficient solutions to social challenges. The social effects generated by the activities of the individual social enterprise result in specific gains or savings for the government institutions involved in the form of employment (reduced unemployment benefits), improved health (lower costs of treatment and care) or improved social status (fewer costs associated with social programmes), etc. The value generated is then carefully calculated, resulting in a specific amount, which is then paid back to the intermediary by the government institution. If the value added by the social enterprises involved in the scheme is higher than what was originally invested in them, the principal as well as a return on investment is paid back to the private investors.

The following figure illustrates the model – including the involved actors and capital flow:



The model is particularly interesting to government institutions for which it is often a difficult exercise to evaluate the potential success of local social initiatives before they have started up. This is often both a highly complex and expensive exercise. Moreover, anti-trust laws often prohibit governments from supplying direct funding to social enterprises⁴. In the social impact bonds scheme, the involved government institution is held risk-free, only paying for the results that have in fact been achieved, while at the same time providing a legal way of supporting social enterprises. However, the public sector may retain the need to deliver a service should the social impact bond fail.

To private impact investors, the scheme presents an attractive way of financing social impact while at the same time receiving a financial return. In its pure form, the scheme might scare off some potential investors, given that they – together with the involved foundations - are the ones carrying the full risk. In the early bonds, the investors would receive no payment if the results targets were not achieved. This can, however, be mitigated by using different security mechanisms such as minimum return guarantees, risk sharing or investment matching (see separate brief on match-funding model). The deal can also be structured to mix some payment for service with some payment by results.

⁴ In Denmark, the so-called 'social activities' of the social enterprises can legally be supported by the government, whereas supporting their 'commercial activities' is considered a violation of anti-competition laws. In reality, this is often an impossible distinction to make.

Such mechanisms would require the creation of a dedicated fund of, e.g., government and/or foundation money. Another way to enhance the attractiveness of the scheme for private investors is to apply a fixed interest rate (typically 5-9%), which the government institution must pay back to the investors (through the intermediary) on top of the calculated added value.

Foundations are often attracted to the scheme because it mobilises a full selection of different actors (and their capital) around addressing the same social issue. The financial return, which can afterwards be reinvested in new social impact bonds, also makes the contributions made by the foundation last longer than traditional grants and donations. In most of the UK and US schemes foundations have played a key role either as main funders or as subordinated lenders which take higher levels of risk than private sector investors.

To social enterprises, the scheme presents a clear alternative to other models in that the investment can be paid back as added social value instead of only hard cash. This is particularly attractive to enterprises in the 'social' end of the 'mainly social-mainly business' continuum that otherwise often find it difficult to attract financing other than donations or project funding. However, many of the deficiencies for social enterprises could be solved by creating better structured contracts and longer term security of funding.

There are different variants on social impact bonds. In the so-called 'managed SIB' the intermediary is independent of the three other actors (private investors, social enterprise and government). It approaches potential investors and collects their investments, it makes and tracks the investments made in the social enterprises, it measures the social effects generated by the social enterprise, and calculates its value to allow the government to appropriately pay back the intermediary and, in turn, the private investors.

Variations

The figure above outlines the textbook use of the model, but in real life, variations are often applied. Some of the most common variations are described in the following:

- In the managed SIB model described and illustrated above, the foundation plays the role as an investor. However, foundations can also play other roles in the scheme, e.g. as 1) sponsors of a fund dedicated to alleviating risks for private investors through different mechanisms (see previous section), 2) donors of funds to intermediary, 3) match funders of private investments, or 4) funders of the intermediary and its operations.
- Issuing social impact bonds might be only one of multiple services provided by the intermediary to social enterprises. The intermediary may also function as a capital fund offering traditional investments and non-financial support alongside the bonds.

Implementation of model

The following table outlines a few specific examples of where and how the model has been implemented in countries around the world:

Scheme name:	Country:	Short description:	More info
Social Impact Bond Fund	UK	Operated by bridge ventures, the specific focus of the fund is to make social impact bond investments in NGO's and social enterprises. The	http://bridgesventures.com/social-sector-funds/social-impact-bond-fund/

Scheme name:	Country:	Short description:	More info
		size of the fund is currently £25m.	
State of Ontario, Social Impact Bonds	CAN	The government of Ontario are currently receiving applications for social impact bond investments, which are expected to be granted at the end of 2015. Issued to social enterprises and NGO's providing prevention-oriented solutions to 1) housing, 2) youth-at-risk, 3) improving employment opportunities for persons facing barriers.	https://www.ontario.ca/page/social-impact-bonds
Rikers Island, New York City	USA	Single investor (Goldman Sachs) invested \$9.6m in a non-profit organisation running intervention programme for young inmates to prevent reentry. A foundation (Bloomberg Philanthropies) guarantees part of the investor loan and pays operating costs of intermediary. City of New York finances evaluation. Rikers Island was the first SIB to fail. Goldman Sachs lost \$1.2m and Bloomberg Philanthropies lost \$6million [check figures]	http://www.mdrc.org/key-partners-nycs-social-impact-bond

Strengths and weaknesses

The model has different strengths and weaknesses compared to other approaches. The following table outlines some of the strengths and weaknesses mentioned most often:

Strengths	Weaknesses
<ul style="list-style-type: none"> • Social enterprises receive money for running their operations up front. • Social enterprises can pay back the investment by creating social impact – no need to leverage financial return. • Social enterprises are forced to measure 	<ul style="list-style-type: none"> • Only works in areas where outcomes are clear, measurable and can be monetised. • Relies heavily on effective measurement instruments such as SROI, and randomised control groups which have often been criticised. How can social effects be measured,

<p>and communicate the value they create.</p> <ul style="list-style-type: none"> • Government money is not spent until goal has been achieved, which is attractive in times of shrinking public sector budgets. • Private sector money are being mobilised (at least in the short run) to create societal impact. 	<p>and how do we know whether the social enterprise created the impact or if it was another intervention?</p> <ul style="list-style-type: none"> • With the first bond being issued in 2010 in the UK and currently only 25 being issued in total across seven countries, the track record of this scheme must be considered very thin. • Private investors carry all the risk, which might either scare away potential investors or necessitate subordinate foundation co-funding or various government funded security-mechanisms. • Might end up costing more for the involved government institution. On top of the value created, the government often pays the operating costs of the intermediary and a fixed interest to the investors. • High set up costs and associated complexity. Goldman reported 1200 hours of time in Massachusetts fund. • Might create an incentive to invest in easy-to-measure short-term issues instead of long-term and more complex ones.
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Conclusions

Social enterprises are increasingly seeing the potential of investments and have increased their efforts to achieve them (Glänzel et. al., 2013; Social Enterprise UK, 2013). Grant funding still appears to be the preferred form, but social finance instruments are also viewed as attractive and are expected to be embraced by an increasing number of social enterprises as they find their way into the market. On the supply side, a clear trend is seen towards development of an increasing number of new and innovative financial products targeted at the specific needs of social enterprises. These are mainly found in the social finance category where focus is mainly on developing and testing equity-like schemes for social enterprises that are not formally registered as enterprises (GIZ, 2014; O’ Sullivan, 2012; TUM & Schwab Foundation, 2011). Moreover, numerous EU and national initiatives to support the development of social financing markets have been launched, some of which dedicate funds to creating financial incentives for future social enterprise investors. It is thus likely that social enterprise investments, although currently in an infant stage, will be a growing and heavily supported in the years to come.

However, the problems are not all on the supply side of the equation. Social enterprises themselves need to become more sophisticated users of finance and more investment ready. Capacity building will be required to enable more social enterprises to take on non-grant funding.

But if we want a self-sustaining ecosystem, relying entirely on funding from programmes that could be cut a few years down the line, is risky. What is needed is a system that makes it easy, possible and attractive for private investors to support social enterprises. Foundations need to embrace social investments – providing grant funding to the wrong social enterprises might hurt them in the long

run and banks, pension funds and other private investors need to become increasingly aware of the potentials involved in investing in social enterprises.

Social entrepreneurs often work on bigger problems that require capacity building to reach the scale at which profits become possible. The ultimate impact buying opportunity is actually to strategically partner with unique social entrepreneurs whose models are globally scalable and can solve global challenges sustainably. This could lead to global disruptive social change.

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