

**Response by the Social Enterprise Coalition to the Office of the Third Sector's consultation on the risk capital fund for social enterprise**

**Author:** Kieran Larkin

**Contact:** Ceri Jones

**Telephone:** 020 7793 2320

**Email:** [ceri.jones@socialenterprise.org.uk](mailto:ceri.jones@socialenterprise.org.uk)

## **Consultation on the risk capital fund for social enterprise**

1. The Social Enterprise Coalition ('the Coalition') was established in 2002 as the national voice of social enterprise. Social enterprises are businesses with primarily social or environmental objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners. The Coalition represents a wide range of social enterprises, umbrella bodies and networks, with a combined membership reaching of over 10,500 social enterprises. These include co-operatives and mutuals, housing associations, leisure and football supporters' trusts and Social Firms. Social enterprises in the UK generate more than £27 billion in turnover, and contribute more £8 billion to GDP per year.
2. The response to this consultation has been prepared by the Coalition, reflecting the views of our members and key stakeholders. In producing this response the Coalition surveyed our members and held a working group, bringing together representatives of the social financiers.
3. Access to finance remains a key issue for the social enterprise movement, the 2003 Bank of England report<sup>1</sup> stated that 32% of social enterprise cite a lack of available external finance as the key barrier to expanding trade. The social enterprise movement will require a range of solutions to meet their finance needs depending on their stage in the growth cycle. Risk capital investment is a select, but important part of this spectrum.

### *Social enterprise and risk capital*

4. The Coalition welcomes the opportunity to respond to the Office of the Third Sector's (OTS) consultation on a risk capital investment fund for social enterprise. The Coalition supports the framework that has been produced by the OTS, and believes that it should greatly enhance the opportunity for a significant portion of the social enterprise movement to engage with the social investment and access equity finance.
5. The Coalition also believes that providing the fund is managed correctly and underwritten by some key requirements that it has the potential to grow the social investment market by developing relevant financial instruments for social enterprise. This could further demonstrate the viability of social enterprise as an investment area, and identify the terms by which investors are prepared to operate within.
6. The Coalition would however, state that we do not believe that the fund will be applicable to the whole of the social enterprise movement, because of a range of reasons discussed below. The Coalition believes that for these organisations, social investment still remains a viable undertaking, but not in the context of this framework.
7. In order for this fund to be a successful and replicable model and to make it an attractive proposition for an investor, the social enterprises that take part will need to provide both a financial and social return. Consequently the social enterprises that take

---

<sup>1</sup> Brown, H (2003) *The Financing of Social Enterprises* Bank of England.

part will need to a viable business proposition and to be financially capable, with the skills to manage this type of product. It is also important that the specification of the fund fully reflect its purpose of research and learning.

8. A number of barriers still stand in the way of social enterprises accessing risk capital. In order to further develop social investment, the Coalition recommends that in parallel to the risk capital investment fund the government enters a dialogue with relevant parties, such as the European Commission to work with issues like State Aid. This would help create a favourable environment and level playing field for the development of a wider form of social investment.

### *The equity gap*

**Do you agree that social enterprises face a similar equity gap as mainstream SMEs, i.e. that they fall into the gap between the finance available from informal investors and the failure of formal venture capital funds to invest into smaller deals?**

**If you agree, what evidence is there to support your belief?**

9. The Coalition feels that social enterprises do suffer from an 'equity gap', and that it is similar to the equity gap experienced by SMEs. It is anecdotally stated that viable, social enterprise, business propositions have been proposed that have been unable to attract the right sort or amount of investment. There are however, some differences to that of the mainstream market. The informal investors market for social enterprise, such as business angels, is less developed than that of mainstream business. Being a nascent market the networks that link social business angels do not yet exist.
10. Formal venture capital investors are also less likely to be interested in investing in social enterprises. As noted in the regular SME market formal venture capital investors are often put off by smaller deals because of the fixed costs. As social enterprises are unlikely to offer lucrative returns, given that 'principally profit is reinvested for the benefit of the community', these reduced returns are impacted disproportionately by the fixed costs.
11. A wider equity gap has also been identified for social enterprises that is larger than that of private businesses. This gap covers the area between provision of small grants for start up enterprises and those social enterprises generating substantial revenue and with a stable asset base that could provide security for a debt product.

**What size of social enterprise suffers from this market failure if it exists and at what point in its lifecycle is it most likely to suffer from it?**

12. The size of the social enterprises that suffer from this market failure is not the key factor. Social enterprises of a variety of sizes are victims of the equity gap. What is important is the point in the organisation's lifecycle. Social enterprises during the growth phase of the lifecycle are most likely to suffer from difficulties in accessing investment. Social enterprises during this stage which have stabilised their revenue often have

difficulties in accessing the amount of capital needed to start new ventures and grow their business.

13. However, not all social enterprises in the growth phase will be looking for, or suitable for this type of finance. Equity capital of the form suggested in this fund, is only likely to be suitable for 'high potential' social enterprise, that are both highly scalable and that are planning significant growth. This is similar to the SME market.

**From your experience, do you believe there are particular issues facing social enterprises in accessing equity financing? Are these issues specific to the social enterprise sector or are they the same generic issues that face all SMEs looking to source equity finance?**

14. Social enterprises suffer from many of the generic issue that all SMEs suffer in looking to access equity finance. However, the impact upon their ability to access finance is often greater, because of the specific social outputs that social enterprise are looking to achieve and the relatively recent success of the social enterprise model.
15. Social enterprises exist to deliver social aims, and principally reinvest their profits. Therefore the taking on of equity finance and paying a dividend presents a challenge to this goal. However social enterprises are businesses and recognize that the pursuit of social outputs must be balanced against the business need to remain profitable. Many social enterprises are not averse, and have in many cases designed their business model to distribute a portion of the business' profits, if that allows them to grow the social outputs in the long term. In order to secure these social aims, there are a number of terms that could be implemented such as capped dividends, a longer term fixed period for the investment, or a clause requiring the delivery of certain social goods, before the distribution of profits.
16. The dynamic of the social enterprise model also means that they will not seek to maximise a return on an investment. Although the social enterprises will be seeking to maximise its profit, through the generation of income by trading goods and services, the return of the investment is likely to be less compared to mainstream SMEs.
17. Like SMEs, social enterprises are often reticent to lose control of their business, the prerequisite for an equity structured investment. This is often more apparent in the social enterprise sector as the organisation's fear that outside control could cause the business to drift from its social mission. An exit strategy for the capital can also be difficult for social enterprise, much like those organisations seeking equity capital from mainstream investors. This lack of an exit strategy is compounded by the fact that at present no secondary market exists for social enterprises shares to be traded on. A number of social enterprises have managed to list on the alternative investment market (AIM), however this is not suitable for all organisations.
18. Some social enterprises are also limited in their ability to access equity because of the legal structure that they have chosen. Social enterprises take a variety of legal forms, and a number of these do not allow the organisation to issue shares. Many social enterprises have used the Company Limited by Guarantee (CLG) form, or the

Community Interest Company (CIC) Limited by Guarantee. Those social enterprises that have chosen the Industrial and Provident Society (IPS), such as co-operatives, only allow members to issue £20,000 worth of shares per member, however this is under review. Those organisations that have used the CIC model Limited by Shares (CLS) are able to issue shares, but this is subject to an asset lock. This would complicate the exit strategy of such social enterprises. They are also subject to a limit on the dividend they can issue, both per share and as a percentage of total profit.

19. Legal structures do present a complication for social enterprises. However, the Coalition would suggest that it is only a qualified barrier. Social enterprises are able to use the CLS company form to access equity, and guarantee their social aims within the memorandum and articles of association. Social enterprises that are faced by this barrier but need to access equity could potentially change their legal structure to suit external investment. However, this is not always a desirable solution as the legal structure is often chosen to reflect the aims of the social enterprise. This is particularly the case in the co-operative movement, in which its legal form shapes its commitment to the co-operative principles. There are examples of more complex solutions such as forming a separate legal entity, beneath the current company, specifically to access equity finance.
20. The Coalition would also put forward that a number of solutions have been suggested to us in considering the model and legal structure of the fund manager, which could provide a solution to this problem. Further information on this has been discussed under point 69.
21. There are also a number of sector based issues, for example Football Trusts, have found their ability to access equity finance has been damaged by the prior poor performance and the irresponsible behaviour of the private sector. This has led to this type of organisation perceived to be a poor investment and damaged supporters view of what accessing equity finance means for the business. There may be other markets in which similar perception issues are a barrier, to accessing equity finance.

**If you agree that an equity gap exists for social enterprises, do they encounter the same financial thresholds as mainstream SMEs? If not, where is the equity gap most acute for social enterprises?**

22. The Coalition believes that thresholds of the equity gap for social enterprises are slightly different to that of mainstream SMEs, given some of the differences in the social investment market.
23. The business angel's network for social enterprises is relatively underdeveloped. Social enterprises are also less likely to be able to make use of personal financial commitment, of the individual setting up the company, that often kick starts mainstream SMEs. As the owners will not be benefiting financially from the enterprise, it would be less appropriate for them to commit their own money, or for example use personal assets as collateral. As a result of these factors, the thresholds experienced by social enterprise will start from a lower level.

24. Based on the findings of sector research pieces, the products currently available and advice given to the Coalition on the demand from the social financier operating in this sector, the Coalition would suggest that this gap exists between £150,000 and £2m. These thresholds are broadly similar to the equity gap accepted by the European Commission.
25. Social enterprises currently rarely require access to more than £2m. Those that have need to have come up with more complex methods of raising these larger amounts of equity.

**When making a decision to invest in a social enterprise do, or will, investors encounter similar supply side constraints to those they would face when entering into an investment in a mainstream SME as described above?**

26. The supply side constraints faced by an investor, making a decision about their investment are likely to be the same as facing a regular SME though possibly more acute. There is a basic information asymmetry and increased transaction costs caused by the smaller size of many social enterprises, and the lack of understanding of the social enterprise model. As social investment is still developing, much of the information needs to be generated for every deal and is variable in its reliability. The risk capital investment fund will assist in creating reliable data, through the trialling of models, which investors can use to judge future decisions. Social enterprises using the IPS structure are also face greater transaction costs, by their requirement to audit all financial statements, meaning they are unable to provide the same data cost effectively.
27. An investor's perception of the risk involved in investing in a social enterprise is likely to be greater than that of an SME, due to both a common lack of understanding of the social enterprise model and the fact that the returns will in general be lower and are unlikely to produce a degree of lucrative payment, associated with traditional venture capital. Whilst research indicates that social enterprises, are in fact likely to be less risky than regular SME's, the steady returns that are produced may for the investor be outweighed by even a limited element of risk.
28. The Coalition recommends that the risk and reward could be balanced by creating a mixed portfolio of investments rather than making direct investments into a social enterprise. This would allow the higher risk younger investment to be offset by larger lower risk investments.
29. Like SMEs social enterprise also lack investor exit options, which can be even more complicated and potentially problematic than regular SMEs. As has previously been described CICs have an asset lock which means assets can only be transferred to another CIC. As of yet there is no secondary market for investors to trade in. This means all exits have to come through a matched bargain process, often incurring a longer lead in time, which negatively impacts on the liquidity of the investment. The Coalition recommends that the government gives more attention and carries out further research, as to how an exit options could be developed.

**Are there any other supply side constraints not mentioned above that investors might encounter when considering an investment in a social enterprise?**

30. The lack of understanding of the social enterprise model undercuts the supply side constraints, in addition to information asymmetries. There is lack of understanding from investors of the social enterprise model, and a lack reliable data on the performance of investments in social enterprise. This is likely to prove a barrier particularly to accessing foundation funds, which may be more conservative in their investment approach. The government and fund manager need to consider how they can educate and raise investors understanding of social enterprise.
31. This lack of understanding of the social enterprise model may also extend to the lack of an established model of social return of investment, which would provide a potential investor with empirical data to record the level of social return they are likely to expect. Whilst some investors are not interested in the social return, many that are seeking to make a social investment would expect to quantify their social impact.

**For those investors able to overcome their supply side constraints, are there a lack of quality investment opportunities to realise their investment intentions? If so, are you able to offer any insight as to why this may be the case?**

32. The Coalition understands that there is a latent supply of social enterprises that would offer a good investment opportunity. These are successful business that are succeeding in their market sector but have found it difficult to access the equity they need.
33. This may be down to insufficient or inappropriate equity products' providing satisfactory terms for both the social enterprise and the investors. It could also be a result of the lack of an established network which enables the investors offering capital to link up with the social enterprises that demand this type of finance.
34. The apparent lack of quality investment opportunities is also likely to be in part caused by the current lack of supply of capital. Many businesses may have the potential to be a quality investment opportunities but have not primed themselves in such a way, as there is currently a lack of incentive to do so. Supply and demand are interlinked, and as was seen in the mainstream market, the increased supply of venture capital significantly improved the demand for equity products. The Coalition believes that social enterprise as a high growth sector will exhibit a similar pattern. This again underlines the importance of this fund being part of a 'market making' exercise, to develop social investment.

**Do you agree that professional venture capital providers are not interested in pursuing smaller deals? If so, how does this lack of interest in pursuing smaller deals affect the social enterprise sector?**

35. Mainstream professional venture capital providers are unlikely to pursue smaller deals, if they are seen to be less profitable. As such given that social enterprises are often

smaller organisations, and will offer a less lucrative return, mainstream professional venture capital providers are unlikely to pursue these types of investments.

**Are venture capitalists focusing their interest on relatively established businesses resulting in the financing of smaller younger businesses being left behind? Do social enterprises tend to fall into this 'smaller younger business' sector and if so, how does this affect them?**

36. Social enterprises can be small younger businesses or larger more established businesses. However, as the social enterprise movement has only recently experienced sustained growth, there is likely to be proportionally a greater number of smaller younger businesses.
37. As social enterprises have had difficulties in accessing equity finance they have often found the growth curve to be longer than that of mainstream business. As such many social enterprises have found it difficult to finance their growth, and become a larger business.
38. This is a disincentive for venture capitalists to invest in smaller businesses, because of the size of the transaction cost, which is not proportional to the size of the deal. This may be further increased in the case of social enterprises given the additional complexity of the deal and lack of sector information.

**How does this barrier to entry for new fund managers seeking to enter the smaller end of the venture capital marketplace affect the equity finance available for social enterprises?**

39. If there is a limited flow of venture capital investment into the smaller end of the market as a result of the disincentive to invest in these deals, it seems justifiable to suggest that there will be a lack of venture capital entering the new social investment market, thus reducing the equity finance available to social enterprises.

**Are there any demand side constraints that are specifically found in the social enterprise arena or are the above mentioned deterrents found with both mainstream SMEs and social enterprises?**

40. The demand side restraints for social enterprise are complex, and differ partly depending on how you conceptualise equity as a financial product. Fundamentally the major barrier on the demand side for social enterprise accessing equity finance is the loss of control, also indicated as a barrier to SMEs. Social enterprises additionally do not wish to cede ownership that may threaten the pursuit of social and environmental aims.
41. Equity investment that would threaten the business commitment to social outputs would not be applicable for social enterprise. The fund manager is likely to need to balance the ownership of shares, with the control of the business. However, whilst this is an issue, the Coalition does not consider it to be an impassable barrier, as it can be navigated with options such as the use of non voting preferential shares, and the structuring of ownership with various classes of shares. This has been achieved by a number of social

enterprises such as Café Direct, Belu Water and the Ethical Property Company. The exact solution to these ownership issues, and terms of investment will require negotiation between the enterprise and fund manager. The best solution will be dependent on the nature and plans of the social enterprise seeking investment.

42. Social enterprises fear that the involvement of an investor, through an equity investment could impact on the day-to-day control, and lead to a short term pursuit of increased profitability. As a proportion of the profits are being distributed to the investor rather than reinvested within the business, it could alter the demands on the organisation. It may be necessary for the investor to agree a cap on the dividends distributed. Important to the success of this risk capital model will be the dialogue in framing the terms to agree the social and economic goals with the investor.
43. As previously described, attached to this issue of ownership is the legal structure of a social enterprise that can be a potential demand side constraint, given that it may prevent many social enterprises from accessing traditional equity products. The Coalition would suggest that although this will be a barrier, those social enterprises capable of using this form of equity should be able to achieve a solution. It would however, be beneficial for further work to investigate and develop equity instruments with the characteristics of subordinated debt. This would provide a product for another equity gap in the market.
44. The demand side may also be impacted by a lack of capacity within organisations to pursue these types of deals, and a lack of financial skills held within the social enterprise movement. The Coalition would recommend that the success of this fund will depend on the extent to which it can improve social enterprises financial skills set, whether through the involvement of the investors, mentoring, or linking to specialist support. Social enterprises will need impartial specialist support to ensure that equity is right for their business, and that they have the skills and processes in place to that such a strategy of growth requires. Consideration of the support needs will be vital for the funds success.

#### *Pari passu fund(s)*

**Are potential investors in the Fund(s) willing to invest on purely commercial terms? What other terms will investors be willing to enter into investments with the Fund(s)? What return are they likely to expect?**

45. The Coalition believes that investors are willing to invest on purely commercial terms; however social enterprises are unlikely to provide the most lucrative yields for potential investors. The social enterprises looking to access this product will be profit maximising organisations, but will be able to deliver a market return competitive within the social enterprise market.
46. Currently, in the mainstream, there exists a range of funds providing differing forecasted returns in exchange for varying levels of risk. Recently investors have shown a greater interest and demand for ethical funds. This demand would suggest that given an increased understanding of social enterprise and an appropriate instrument, it is likely the investment in social enterprise, with a 'commercial return' will grow.

47. The Coalition believe that as stated in Bridges Community Ventures *Equity-like capital for social ventures*<sup>2</sup> investments are likely to produce a maximum return of up to 10%, with an average return of 5-7%. This will need to be a longer term investment, committed for at least 5-7 years. The actual returns will be dependent on whether the fund is structured in a direct investment approach, or a mixed pot.
48. The attractiveness of the investment, and returns to investor will be maximised if it can be used in conjunction with an established tax relief mechanism, such as Community Investment Tax Relief (CITR). The Coalition would recommend that the government considers whether it is necessary for any alterations to be made to ensure that the fund manager(s) could use such an instrument, and generate a greater level of return for the investor.

**How will potential social enterprises respond to a Fund(s) that will offer investments products as described in point 40(vii)?**

49. The Coalition understands this question to be asking how social enterprises will respond to equity investment. In order to clarify this, the OTS needs to issue greater guidance on what it considers to constitute an equity product. The Coalition has made use of the EU definitions as set out in the *Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium-Sized Enterprises*, that state:
  - (a) **"equity"** means ownership interest in a company, represented by the shares issued to investors;
  - (c) **"quasi-equity investment instruments"** means instruments whose return for the holder (investor/lender) is predominantly based on the profits or losses of the underlying target company, are unsecured in the event of default. This definition is based on a substance over form approach;
50. The key issue in creating a product that is sufficiently 'equity-like' from these definitions is likely to be one of ownership. Having spoken to our membership the Coalition believes that on the whole there will be a positive reaction from social enterprises to the fund. Through our consultation process, the Coalition asked our members *'Is equity finance relevant to your business?'*, and the majority of the respondents replied positively, and a large majority of the social enterprises we consulted with also indicated that they would be interested in taking on equity finance.
51. The Coalition would strongly articulate that this fund will not be appropriate for all social enterprise, and that equity finance is only applicable to particular circumstances. In the private sector approximately 5-6% of SMEs will access venture capital funds, and the Coalition would expect a similar percentage in the social enterprise movement. Equity finance is applicable for high growth potential social enterprises that are both highly scalable and have plans for significant growth. The Coalition does not foresee any inherent difficulties with structuring the investment as equity or quasi-equity, in terms of generating a sufficient demand.

---

<sup>2</sup>Howard (2004) *'Equity-like capital for social ventures'* Bridges Community Ventures

**Is this a workable capital flow model for the Fund(s) to operate under? If not, what are the alternative models that the Government should consider?**

52. The Coalition believes that the capital flow model outlined seems reasonable given certain limitations imposed upon this fund. The Coalition would also suggest that any further developments or detail should be created on the basis of a dialogue between the tendering fund managers.
53. One recommendation the Coalition would make, however, is that consideration is given to allow the fund manager the opportunity to draw down the capital before necessarily agreeing the investments with the private sector. As long as there are acceptable requirements regarding the dispersal of the investment, this would provide the Fund manager with a source of finance from the interest accrued, which could potentially contribute to the management fees. However, the Coalition understands this may not be possible given the governments financing structure.

**What evidence is there that there are informal investors and professional venture capitalists willing to provide risk capital to social enterprises but lack the investment vehicle to do so?**

54. The Coalition believes there to be a latent supply of investors willing to provide social enterprise with risk capital. Through our consultation with numerous social lenders it has been indicated to us that both informal investors and professional venture capitalists exist, that are both willing and interested in providing risk capital to social enterprises.
55. The Coalition would point to work that has been carried out by Community Innovations, Triodos Bank, the share issue by Café Direct, Belu water and the Ethical Property Company, to indicate the supply to the market.
56. The Coalition would argue that the reason there has not been a greater degree of investments, indicates that a lack of appropriate investment vehicles remains a major barrier. The cases in which social enterprises have accessed risk finance so far have often required a complex process in both the issuing of shares and accessing of capital. If relevant, and tested models existed, that did not require the repeated reinvention of terms, the Coalition believes there would be much greater supply and demand for equity.

*Fund's objectives*

**From your experience do you feel that these four objectives are achievable considering the proposed structure of the fund outlined above?**

57. The Coalition believes that the four objectives set out are the correct ones for which the fund to function by. Nothing in the proposed outline of the fund would prevent these objectives from being achieved. We would however, state that these objective need to be considered as being achievable in their various time frames.

58. The current objectives, whilst correct, appear to represent a level of confused thinking particularly in concern to their order and hierarchy. The ultimate aim and policy goal of the fund must be to (ii) improve the access for social enterprises to equity finance. This will be achieved by demonstrating the viability of an investment within social enterprise (i), however this will only occur if a suitable instruments can be developed that can be utilised by fund managers (iv). Objective (iii) appears less relevant, as a meaningful market only means that the fund will run on a self sustaining basis. This will be realised as the result of achieving the other objectives. The Coalition recommends that further thought is given to interaction and relative importance of the objectives.
59. Whilst the Coalition believes that the fund as it stands will achieve the objectives that have been set out, we would like to insert the caveat that, although the fund will improve access to a portion of the social enterprise movement, there will remain further parts, which could use equity finance, but that might require a more sophisticated approach. This could be due to their legal structure, issues relating to the ownership of the business, or the ability to generate market returns. As a result of this the Coalition would strongly recommend that in addition to delivering this fund that the government create a dialogue with the relevant parties to address the barriers facing such enterprises.

#### *Requisite scale*

#### **What is the minimum fund size that allows the Fund(s) to operate on a commercially feasible scale and for the necessary conclusions to be drawn as to it successfully meeting its objectives?**

60. As is suggested within this consultation document, scale in financial organisations can offer a range of benefits. It allows a fund to create significant interest, whilst operating efficiently by reducing the transaction costs associated with due diligence. However, the fund will be operating in an imperfect environment where there is limited market penetration. The fund manager may need to develop its links with the sector and market its products under the restrictions of time.
61. Through consultation with a number of social financiers the Coalition has been advised that the minimum size for such a fund would be £5m. As a result the minimum size that the government's contribution should be is £2.5m.

#### **What are the advantages and disadvantages of the Government appointing one fund manager to run one large fund rather than several fund managers to run several smaller funds?**

62. One of this fund's objectives is to demonstrate the viability of social enterprise investments and providing information and research on the model. Given these objectives the Coalition would suggest that a large fund would be preferable.
63. In an ideal environment retaining a single fund would lead to the best results. A single fund would offer the fund a higher profile in the social enterprise sector and as the single point of contact, would produce a greater level of awareness in the financial

sectors. Its size would allow it to better attract private finance, and the skills of professional used to working with much larger amounts of capital. It would also reduce the proportional transactions costs of the manager's function.

64. However, the disadvantage of this and attraction of multiple funds is that it would provide the opportunity to test a range of investment models, such as a portfolio fund and direct investment approach. Also, should there be dramatic failure it would not impact on the whole research outcomes. Given that the fund manager is operating in an environment of limited market knowledge, faces issues of market penetration both spatial and sectoral, and has limited resources and time to connect and work with organisations, it may be attractive for the Fund to appoint multiple managers. Given these conflicting factors the Coalition would recommend, depending on the tenders, that the £10m is split, creating two funds each with a value of £10m once they have attracted private investment.

### *Legal structure*

#### **What would be a reasonable time span for the Fund(s) to run in order for its objectives to be properly evaluated by the Government?**

65. The Regional Venture Capital Funds (RVCF), which addresses the equity gap for mainstream business, suggests five years as the usual period for an investment. As social enterprises tend to require a longer investment period, it is likely that the terms would be in the region of 5-7 years. The RVCF Fund managers operate and manage funds that are governed for a ten to twelve year period. Based on this the Coalition would recommend that twelve years is the minimum period over which to evaluate the success of the fund objectives.
66. The Coalition would also recommend that, given the economic slow down in the UK financial market since the publication of the consultation document, that the fund managers be allowed an increased period of time to find suitable high growth social enterprises for investment.

#### **Are there any alterations to the traditional LP structure that the Office of the Third Sector should consider when forming the legal structure for the Fund(s) or are there alternative legal structures that might create a more suitable framework for the Fund(s) to operate within?**

67. The Coalition would suggest that initially the government investigate what possibilities are open to it in pursuing a legal structure for an investment fund. We would suggest that given the proven track record of the Limited Partnership structure, that it is likely to be the correct choice. The decision on which legal structure is used should come through a dialogue between government and the successful bidding fund manager(s). We would advise however, that in order to achieve a model that is economically efficient that the structure should be one that is tax transparent.
68. The Coalition believes that if the government decides to use the Limited Partnership model, additional adjustments may need to be made to ensure that it suited to social

investment. In order to ensure that the fund looks legitimate to the social enterprise sector, it would be beneficial that a proportion of the funds profits were reinvested. This would build the value of the fund, allowing it to make further equity investments, and would replicate the social enterprise model.

69. As previously outlined, some social enterprises have difficulty in accessing equity because of their inability to issue shares. A possible solution that has been suggested to the Coalition is that rather than have the investment pass through an LLP Fund Manager's structure, and part of the fund be used to capitalise CDFIs which are social enterprises. A CDFI could establish a separate wholly owned subsidiary as a Public Limited Share Company (plc). The investment could be made directly from government, *pari passu* with private investors into that company. The CDFI fund manager could then create a series of products that were quasi-equity to invest in social enterprises. The CDFI would then be able to offer dividend to the investor depending upon the success of the portfolio. This model would also allow the fund to make use of Community Investment Tax Relief (CITR) to provide the investor with a recognised "commercial" return. The Coalition would recommend that the product should remain sufficiently like equity, but may be subordinated debt. This may resolve the issue of a number of social enterprises being unable to access the fund due to their legal structure. The Coalition would suggest that the government considers using portion of the fund to pilot such a model, which would offer the opportunity to demonstrate one model of investment into social enterprise.
70. Further, the Coalition would strongly recommend that within the tender specification, it is clearly stated that these investments are of a longer term nature, and that social enterprises may to be given time to meet their performance targets. This is because social enterprises are likely to require longer to generate the same level of profits as a mainstream business.

#### *Definition of social enterprise*

#### **What level of demand does the market anticipate from social enterprises fitting the above definition?**

71. The Coalition, through its consultation with social financiers, anticipates that this fund, given its investment offer and high visibility will attract a reasonable level of demand from the social enterprise movement. This must be anticipated within the framework that this fund is only appropriate to social enterprises that have the potential for high growth. During our consultation a number of social enterprise respondents said that they would be interested in accessing a fund on similar terms.
72. We would suggest that, as with the SME market, 5-6% of social enterprises may look to access this fund. Government data and the 2005 Small Businesses Survey data suggest there are around 55,000 enterprises. It is likely that given the certain restrictions around legal structures that the actual demand is likely to be less than this. However, the Coalition would point to the 336 CIC's using the CLS structure, that would be able to access equity.

73. The Coalition would however, question the OTSs decision for using this document as the forum for looking at the definition of social enterprise. Whilst the Coalition recognises that OTS does not want to necessarily exclude any of the potential fund recipients, as this fund is designed for social enterprises, it would be unacceptable for organisations that are not be social enterprise to be in receipt of investments. The Coalition would recommend that the OTS works with the chosen fund manager(s), and issues them with guidance to ensure the fund is accessed by the correct recipients.

### *Performance targets*

#### **What is the best way to evaluate whether the Fund(s) has increased the flow of independent risk capital into the equity gap faced by social enterprises?**

74. This funds role is to develop the information and lead the way for social enterprises to access equity finance. As such it is very important that the fund is evaluated and that performance targets guide its path. The funds, objectives will, however, have various time scales.
75. There are two obvious mechanisms that the Coalition is recommending to evaluate the success of the fund. Firstly a number of indicators should be placed within the tender document that the Fund manager should be asked to report on, this will provide detailed evaluation of the actual funds impact. Secondly a piece of research should be carried out to evaluate the wider market. The Coalition recommends that an additional amount of money is made available to allow an independent institution to research the social investment market, and success of the fund. This should take place after a period has been allowed for the impact on the market to be felt. The Coalition would recommend that five years, toward the end of the initial investments would be sufficient.
76. Firstly the indicators should measure the amount of money committed by investors. In evaluating the flow of risk capital in to the equity gap faced by social enterprises, it is important that evaluation aims to look at how the fund has demonstrated the viability of investment into social enterprise. In order to achieve this, the targets should measure the wider understanding within the financial world of a social enterprise investment.
77. In improving the supply of equity capital to social enterprise, it is also important to evaluate how the success of the fund(s) has contributed to the risk and reward perception. This would look to evaluate how the returns matched the expectation of investors. An improvement should also be measured by the development of further specialised fund managers looking to supply equity capital or networks for linking up social enterprises with investors.
78. Finally, to increase flow it will be important to ensure a degree of liquidity is achievable within the investments, as the lack of an exit for capital will often be a barrier to supply. The Coalition would recommend the evaluation looks at how the number of investors able to exit their capital, changes over a longer period.

**How can we measure whether there has been an improvement in the ability of social enterprises to access the equity they need?**

79. The main measurement for improving the ability of social enterprises to access equity will be the number of social enterprises accessing equity, and the value of equity being accessed. Ideally this would include further funds established as a result of an improved landscape.
80. Improving the demand will also include a change in social enterprises perception of equity and an increased number of organisations considering and seeking out equity investment. This in part could be measured by the interest in the fund, particularly of social enterprises that are ready or 'almost ready' to access capital. This may also include a change in some parts of the sector around the ownership issue that equity presents, and an understanding of these being the terms by which an equity product functions.
81. It is also important that the relative transaction cost for social enterprises reduces so that it becomes increasingly available for a wider set of organisations. This should reduce as models for investment are developed. The Coalition recommends that one of the measurements is the average transaction cost for social enterprise looking to access finance.
82. Social enterprise ability to access equity, particularly those seeking to provide a blended return will be impacted on by the ability of those social enterprises to communicate to the investors their organisational social impact. The Coalition would recommend that the OTS consider that one measure of the improvement should be the extent to which there is the development of a robust framework for measuring social return on investment. Such a measure would be over a longer time period.

**What is the best way to quantify the number of investors interested in making a profit-maximising investment in the area of social enterprise? This should involve a calculation of investors that were willing to accept the return but might not have participated in the eventual investment of the Fund(s).**

83. The first step and relatively straight forward short term step would be to measure the number of social investors that have both committed capital to the fund, and the value of this capital. The Coalition would also recommend measuring the number of discussions entered into by the Fund manager(s) would provide a good indicator.
84. The Fund should also benefit the wider environment for investors in social enterprise, as the government leads the way and the market follows. It is important that the wider investor market learns about the option and terms of investing in a social enterprise. The Coalition would suggest that the research piece previously outlined would capture this wider picture.
85. Ultimately if the fund is successful and the number of investor interested in this market is satisfactory, measurement of their number becomes less important, as it would cease to be a significant barrier to finance.

**What are the key factors that should be considered when evaluating whether there has been a successful development of equity funding instruments for investing in social enterprises?**

86. It is very important to consider evaluation of the successful development of equity funding instruments for social enterprise. The appropriateness by which social enterprises are able to access equity will be critical in the success of improving access to risk capital investment. The key factors for to consider are:
- The number of social enterprises taking up equity;
  - The amount of money being taken up;
  - The terms of investment available;
  - The number of social enterprises still reporting they are unable to access equity;
  - And the success of the social enterprises which have accessed equity.
87. It is important to consider both the number and value of equity being taken up by social enterprises; these indicators have already been mentioned however they provide a basic but direct measure of whether the instruments developed have been a success.
88. It is also important that a successful development would allow a range of social enterprises to be able to take up equity. This will be achieved through a range of products with varying terms being available. Recognition of the number of products and range of social enterprises should be part of the evaluation. The evaluation should also look at the number of social enterprises still unable to access equity finance, particularly those who have shown a motivation to do so, as this could indicate that the products are failing to work for the whole movement.
89. Finally the Coalition would recommend that it is very important that in evaluating the successful development of funding instruments, the success of the social enterprises receiving funding is considered. This is not to suggest that social enterprise should not or will not fail, but, ultimately the reasonable development and appropriate instruments will be indicated by good success level of the businesses. It is important that the principles retain the concept, that this Fund is part of the wider policy to support the development and growth of social enterprise.

*Overhead Costs*

**Are fund managers currently working under such terms to cover their overhead costs/management fee and if not, would fund managers be open to doing so?**

90. The Coalition would strongly recommend against pursuing this model, as we believe it unfeasible for the proper operation of this fund. Given that this is a path-finding fund, it is vital to get individuals with the necessary skills involved that are able to make good investment decision.
91. The nature of investment within social enterprise, is likely to realise a reduced return on investment, over a longer investment period. It is therefore both unreasonable and

unworkable to ask to the fund manger to work for free for this period of this time. The reduced financial returns would also mean that management cost would have to be a proportionally bigger part of the deal. Consideration must also be given to the upfront costs of publicising the fund, to both social enterprises and investors. An obligation to take management fees from solely a percentage on the returns of the investment may produce an expensive form of finance for the sector which will not lead to the desired growth of social investment.

**Is there an existing model that the Government could rely on which would share the operating costs and management fee of a fund equally between the Government and the independent sector or would a new model have to be devised? If such a model exists, what are its characteristics?**

92. The Coalition would recommend that to ensure that the fund manager is of sufficient quality, and that they dedicate a sensible amount of time to the running of the fund and pursuit of investments, that a percentage management cost is taken after the commitment of each investment. This would allow for the payment of the management fee of the fund. The Coalition would expect that this would be at the rate of about 2-3%. The Coalition would then recommend that depending on the success of the fund, any further profit accrued be reinvested to make further equity investments in social enterprise.

*Remuneration of the fund manager*

**How is this remuneration best structured so as to create a strong incentive for the fund manager to maximise the financial performance of the Fund(s)?**

93. The fund manager is right to expect remuneration for strong performance and the success of the fund. However, the Coalition would recommend that for reasons previously outlined that a portion of any profits generated should be reinvested. If the fund manager is to receive the profits generated by the fund, it could very easily drive the pursuit of the most lucrative deals, and thus failing to provide the model for social enterprise risk capital investment to grow. To ensure against this the Coalition recommends further stipulations are included within the tender document.

**Looking outside the financial performance of the Fund(s) is it possible to compensate the fund manager for meeting the other objectives of the Fund(s) outlined in point 25 and if it is, how is this best achieved?**

94. The Coalition believes that it is vital that if the Fund is to effectively reach social enterprises that have a real commitment to delivering social and environmental outputs that a framework for measuring social output needs to be included within the fund. Although this is not a specific objective of the fund as specified under point 25, the Coalition would argue that it is vital to achieving all of the other objectives.
95. In order to demonstrate the viability of investment within social enterprise, it will be important that the social return is recorded as part of the investment return. Equally for objective two, increased access for social enterprises will be improved by being able to

deliver monetised social returns. The Coalition believes that objective three which includes testing the terms by which investors are willing to invest, will indicate that many investors will want to see some of the social returns offered by the social enterprises.

### **Recommendations**

- The government needs to be clear that equity capital and this fund will not be suitable for all social enterprises. That it is intended for social enterprises with high growth potential.
- To achieve a balance of coverage whilst maintaining a suitable size, two funds of £10m should be created.
- Due to recent financial conditions, the fund managers should be allowed an increased period of time to find suitable high growth social enterprises for investment
- As social enterprises will be looking to deliver a blended return, the fund should allow some of the management cost to assist in the reporting of the social return on investment. This should be stipulated within the tender specification.
- The government should open dialogues with relevant parties to pursue the further creation of an equity investment product, which is closer to subordinated debt.

**Social Enterprise Coalition Policy team  
November 2007**