RESEARCH REPORT

ClearlySo

BIG LOTTERY FUND

DOMINE DIRIGE NOS
CITY OF LONDON

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Executive Summary

Investor Perspectives on Social Enterprise Financing

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Executive Summary

This report, prepared by ClearlySo, was commissioned by the City of London Corporation, the City Bridge Trust and the Big Lottery Fund. The aim of the research is to understand more fully the perspectives of different types of institutional investors towards financing social enterprises; that is, social investment. The research asks, "What engages investors in social enterprise investment?" "What is the current level of interest?"; "What is deterring investors and what could improve and accelerate the take up?" and "what existing and potential vehicles might suit different types of investors?"

This timely report reflects the growth of attention in this sector. Investment into social enterprises in the UK last year amounted to just £190m[1]. Yet, this belies the increasing interest in businesses which create financial and social returns by tackling society's current and future needs. The Coalition government's Big Society Agenda, the increased interest in Socially Responsible Investment[2] and the role that social enterprises plan to play in the reconfiguration of public service delivery all exemplify this interest.

What engages investors in social enterprise investment?

This nascent sector offers a blend of financial and social returns, which benefits its customers, investors and society as a whole. The precise blend will vary according to the type of investment opportunity. Over time, the sector aims to provide investors with an increasing number of initiatives offering near market level financial returns alongside measurable social returns. The willingness to engage with the sector will grow as the social enterprises themselves offer nearer market rate returns.

Why are institutional investors important to the sector?

Institutional investors could be important to the sector's long term growth. The sector has been heavily dependent on government and philanthropy, and these need reinforcement. The global pools of capital which operate out of the City of London could provide exactly that. Additionally, the social investment sector is innovative and seeks to collaborate with the best minds in conventional corporate finance to produce highly successful enterprises and investment products. This would create a better fit between the enterprises' investment proposition and the investors' requirements.

Without adequate investment, there is a risk that the high expectations of the social enterprise sector to help meet society's needs will not materialise. To date, despite interest, there appears to be little engagement from the City and institutional investors to provide the financial backing required and very little actual activity. The social finance sector is self-contained. Currently, the top ten providers of social finance were responsible for 96%[3] of UK social investment in 2010. Government has spent over £350m[4]

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[1] *Of this, the majority is in the form of social banking – exact figures not available*
[2] *25% per annum till 2014 anticipated – Robeco, Booz & Co, 2008*
[3] *Growing Social Ventures, Young Foundation, 2011*
[4] *Growing Social Ventures, Young Foundation, 2011*

in support for this sector over the last eight years. High net worth individuals and charitable trusts have invested directly and through intermediaries into this sector. But institutional investment into social enterprise is either un-quantified (as in the case of retail bank lending to the sector) or negligible (as in the case of other investors).

What would make institutional investors engage in social enterprise investing?

Our research helps to understand and narrow the gap between what is desired by investors, and investment vehicles designed to fund social enterprises. Our research found that in general, investors are likely to engage if social investment can offer:

- An *expectation of* market or close to market returns
- Some guarantee or mitigation of risk while approaching market level returns; protection of the downside is more important than potentially high upside
- Liquidity if possible, which helps reduce perceived risk
- Robust measurement of the social returns generated by the investment
- Larger-sized investment opportunities e.g. through pooled funds
- Products and managers with a track record in which City institutions can develop confidence

The precise investment requirements vary from one investor to another. No one size or shape fits all. We found that charitable trusts had more tolerance for lower returns and smaller size propositions, but they emphasised the need for potential to scale and for clear exit strategies. Socially Responsible Investment (SRI) fund managers seek liquidity and market level returns, preferring listed share structures. Pension funds, for example, could invest in closed funds more easily than the SRI counterparts and they look to a strong track record of the fund originator as a key criterion. Retail banks avoid risky lending and compete to offer debt to the sector. Independent financial advisors and financial consultants, with a few notable exceptions, are broadly absent from the field of social investment, both through lack of information and a poor fit of business priorities.

Supply of suitable products to attract institutional investors

Existing products

Existing social investment products broadly meet their target audiences' requirements. But with a few exceptions, the target audience is not the institutional investor: it is the philanthropic and individual investor, who is prepared to accept sub-market financial returns blended with social returns. When we matched specific preferences of different institutional investor types against available products, we found certain gaps where there were no suitable UK social investment products on offer.

Existing investment products make effective use of 'tiered' structures in which donations and loans are layered into one vehicle. However, the less philanthropically focused products on offer do *not* generally make use of underwriting or guarantee to lift the returns or to mitigate the risk. Moreover, most of the social enterprise investment products are illiquid, making it hard for investors to exit an investment. This adds to the investor's perception of risk.

Some ethical shares and social bonds (loans) do offer near to market returns, but these are also relatively illiquid. Ethical shares are traded under a 'matched bargain system' often with limited trading histories and social bonds loans have little traditional market exposure. The latter are largely financed by the social finance sector.

These factors contribute to the low levels of engagement by institutional investors in the social enterprise sector. Encouragingly, the rapid and constant innovation in the sector suggests that these problems are being addressed in new product design. The list of products (given in the Annex of the report) that are currently available or under development, illustrates this point. As the sector develops, the number of organisations reaching nearer market level returns will grow.

Future product design

Future product design could take into account the commonly identified requirements of expected near to market rates of return, need for liquidity, risk mitigation, investment size and social impact measurement. Importantly, investors prioritised the protection of downside over the possibility of higher rates of return on the upside. Where investors perceive a deal as attractive but risky, the possibility for early stage underwriting, guarantee or different return structures across investors may provide a solution. In such structures, sources of capital with different social and financial objectives are "blended" in order to secure greater overall flows of funds. We see these deals being implemented on an international basis. Further use of pooled products could support public sector spin-outs, help to diversify the risk across the portfolio, raise the minimum investment size and provide some economies of scale.

Good product design will result from an interactive process between enterprise, intermediary and investor. Even though product design is less important than the underlying investment on offer, a well-constructed investment vehicle, designed with the target investor(s) in mind, can make it easier for an institution to engage in a social investment, *if* the proposition is attractive. The products under development are incorporating a number of these points and the most successful products will be developed in collaboration between investor, intermediary and investee.

The role of the Big Society Bank

The Big Society Bank, (BSB) will, if suitable terms are agreed with the four commercial banks, and the various regulatory hurdles are cleared, provide £600m of new capital for the social sector. Its creation can play a key role in developing the social investment marketplace. The BSB intends to develop new investment products, to be an early-adopter of social investment concepts, to support financial intermediaries, to co-ordinate social impact work and to act as a champion to lever in additional finance. Its role as an underwriter will be balanced against its ability to reserve capital for future years as the sector continues to develop. We are likely to see imaginative partnerships across social and traditional financiers with the BSB sharing risk and creating products which have a real chance of achieving scale and impact.

Key recommendations to accelerate social investment

Support intermediaries in building up the social investment market

Just as products need to be more flexible, so do the social enterprises themselves. Generally, the supply of "backable" propositions has been seen as inadequate by investors - a shortage which cannot be easily corrected through product engineering or packaging. However, there is evidence (from those involved in the process) that this supply is growing. Intermediaries have a substantial role to play in helping investor and investee meet common aims.

We suggest the following points would help to match requirements with opportunities:

- Intermediaries to help match target investors' requirements with investees' needs, through design and structure of suitable investment products
- Intermediaries to advise, inform and promote social finance opportunities to key players in the City, particularly to consultants, Independent Financial Advisors, fund managers and trustees
- Social private equity funds and social business angel networks to mentor and support immature social enterprises until they are ready for the more conventional markets in which City institutions are generally active

Development of infrastructure and products

- BSB to support the development of platforms, ensuring that these are developed in an integrated way that allows access to products for a wide range of investors to help build up liquidity over time
- Use the findings of this report as a basis for tailoring products to suit particular target investors
- Consider ways of supplying guarantees and underwriting (e.g. through UK's access to European Union budgets, through other institutional finances, through use of Big Society Bank resources, and / or others)
- Create pooled financial vehicles to build up economies of scale and diversify social investment portfolio, using structures which allow target investors to engage

Public policy recommendations

- Lobby for greater use of fiscal incentives to encourage investment into the sector
- Provide clarity over contracting arrangements for spin-outs and the role of impact in commissioning generally (this is vital to reassure investors in the business proposition)
- Consult on proposals to establish an appropriate finance regime for social and community finance, to provide the same exemptions to financial promotions across all legal forms of social enterprises

- Central government to assist local authority budget holders to identify potential savings across departments from public purse and base service contracts on this as well as on specific social benefit criteria

Impact measurement recommendations

- Hold investors' forums to understand the level and type of detail they seek to make and maintain a social investment; build this into a co-ordinated work strategy on social impact measurement
- Work with other networks internationally to exchange best practice and harmonise approaches as far as possible

Analyse the sector and champion its key successes

- Analyse key features of the UK social enterprise sector, for example, its loan default rate, average length of time to reach sustainability etc; use findings to promote its strengths as a sector to investors
- BSB with independent intermediaries to develop a bank of case studies, best practice examples from UK and beyond; encourage exchange of experience particularly amongst new social entrepreneurs
- Big Society Bank , intermediaries, enterprises to champion the sector to investors and to potential collaborators

Conclusion

The social investment sector has already made tremendous progress across the board in the last decade. It needs to continue to work through a wide range of clear, specific and detailed actions, whilst maintaining its dynamism to meet the broader aims of the sector. We see the Big Society Bank as having the potential to be a game-changer in providing focus for many of these issues. It is likely to have the funding, expertise and weight required to champion the cause of social investment and to bring the City and its institutions more fully into play. This report discusses practical ways to attract investors into the sector and to seize larger scale new investment opportunities, such as those generated by financing needs of the public sector spin-outs.

There is much benefit to be gained by the many innovative social intermediaries and entrepreneurs working closely with interested institutional investors. Over time, the sector could then meet its dual aims of increasing the level of actual transactions and of integrating social and financial considerations within the business agenda. We believe that the findings of this report can help to frame such collaboration.

CITY OF LONDON

DOMINE DIRIGE NOS

City of London Corporation
PO Box 270
Guildhall
London
EC2P 2EJ

Tel: +44 (0)20 7606 3030
Email: economic.research@cityoflondon.gov.uk
www.cityoflondon.gov.uk

The City Bridge Trust
City of London
PO Box 270
Guildhall
London
EC2P 2EJ

Tel: +44 (0)20 7332 3710
Email: citybridgetrust@cityoflondon.gov.uk
www.citybridgetrust.org.uk

Big Lottery Fund
1 Plough Place
London
EC4A 1DE

Tel: +44 (0)20 7211 1800 or +44 (0)300 500 5050
Email: general.enquiries@biglotteryfund.org.uk
www.biglotteryfund.org.uk

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