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Financing Social and Community Enterprises : a demand side perspective

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Presentation to “Community Innovation and Social Enterprise” Conference

Shannon School of Business, Cape Breton University, Sydney, Nova Scotia, Canada

July 8-10, 2015

Introduction to Study: Financing of Social Enterprises

- ESRC Funded Research Project (IAA Scheme).
- Collaborative research project undertaken with a major social finance provider in the UK. It seeks to better understand the challenges of uptake of debt finance in the social enterprise sector from a demand perspective.
- Intended practical outcomes
  - **Development of a new model of engagement that addresses the challenges of social enterprises to take up social finance.**
  - **Development of a strategy that supports an increase in provision of social finance.**
  - **Development of a set of pre-investment relationship practices to overcome resistance to loan finance that can be disseminated to other social finance providers.**
  - **Identify a realistic conversion rate for social finance providers as benchmarked against commercial and philanthropic investment providers.**

Introduction and Context

- Finance is often seen as a key barrier to the development of the social enterprise sector (Social Enterprise UK, 2011)
- SEs are typically reliant on grants and public sector contracts
- Mainstream debt and equity products are unsuitable for SEs
- Limited development of sources of finance tailored to the needs of SEs.
- Geographical variations in the availability of such finance.
- Finance gap?

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- Evidence on the demand side (Sunley and Pinch, 2012 SEJ)
  - Majority of SEs have never had a loan – loan aversion
    - **No need**
    - **Caution/risk averse**
    - **Lack of assets for security**
  - No interest in equity finance
  - Limited commercial backgrounds of social entrepreneurs, social enterprise managers – a minority have private sector backgrounds
  - For the majority of SEs their main source of trading income is from public sector organisations

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- – Seek to live within their means – ‘bricolage’ approach (e.g. Recycled equipment, use of volunteers) – resourcefulness. Adapted to resource poor environment (Di Domenico et al, 2010).
- – A minority are making a financial surplus
- – Cautious attitude to growth – incremental
- – Only a minority adhere to market logics; most encounter tensions between social and market logics (Hudson, 2009; Hynes, 209, Dacin, 2011)

- All of this results in a <u>limited demand for social finance</u>

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- But the supply of social finance has been increasing:
  - Big Issue Invest, Triodos, Social Investment Scotland; CAF Venturesome; Big Society Capital
- Increasing prominence of intermediaries that seek to support the establishment and growth of SEs
  - Firstport
  - Just Enterprise
  - CEIS
  - Social Enterprise UK
- Some social finance providers report that it is hard to find investment opportunities (Lyon and Baldock, 2014)

Why does it matter?

- Research Question – will these new social finance organisations be able to get their money “out of the door”
- Is there evidence of demand?
- What are the constraints on demand?
- Implications for social finance providers
  - Can they grow their own demand? How?
  - How might they create more ‘investment ready’ propositions?
  - What does ‘investment readiness’ look like in a SE context?

Case Study Research Strategy

- Organisations which have taken up debt social finance.
- Organisations which have expressed an interest in social finance but have yet to take it up.
- SE’s unconnected to the Social Finance Provider (to broaden views on access to funding, funding needs and to deepen the contextual understanding of the social enterprise sector)
- Intermediaries who have a role to play in supporting social enterprises to become investment ready.
- Social Finance Providers and Commercial Banks.

Case Studies

- Community Transport Organisations
- Changing Lives through Art
- Contract Centres that support Advice centres
- Employment service, employability and training providers
- Childcare provider
- Community Media Business.
- Arts, Music and Café venue.

Key Findings from Phase 1:

- Lack of knowledge on social finance- lack of understanding of what it is and where it can be accessed.
- The Business Model Matters: Hybrid organisations fair better
- Precarious flow of income is a challenge (complicated by LA tendering process)
- Negative perceptions of High Street Banks
  - Unlikely to provide debt finance to SEs.
  - Mistrust of commercial banks by SEs

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- Risk Averse Boards: BIG hurdle to be navigated.
- Expressed need to develop Business Acumen in Social Enterprise
  - SEs want to develop their skills and expertise to be able to adapt their business models to be self-sustainable in the long term. They realise they have a skills and knowledge gap.
- The composition of social finance: part grant, part standard loan, part capital risk loan makes social finance an attractive option.

Lack of awareness of social finance

- Historic legacy of over reliance on grants, yet a realisation of being at the mercy of the government.

  " *We realised that we don't want to be in the situation of being in danger, we need to support ourselves…I didn't even know social finance existed at that point."*

- Confusing to know what funding is available. Too diverse and complicated for small SEs.
- Interaction with banks -the equivalent to being put through a ringer.

  "I was having a discussion with the bank about a loan and I felt every time I spoke to them, I felt like I was being put through a ringer."

  "Banks wouldn't look at us at all; commercial banks wouldn't even let us open a bank account"

Business Model Matters

- SEs with a hybrid business model are more favourable in accessing social finance.

  - Clear revenue generation streams- operate on commercial terms, profits directed to meet social outcomes through charity.
    - **Tree trunk and roots analogy**

- Have a positive perception of debt finance post first loan.
  - Prepared to take on more than one loan consecutively for business development (technology platform) or to purchase property (mortgage). Change in attitude towards risk of debt finance.

Precarious Flow of Income

- Reliance on project to project based funding/ commissioned projects means reaching financial sustainability challenging.
  - *"It is a bit hand to mouth and I think we keep talking about how do we change the business model so we can get out of that. We need longer term funding. Being funded year on year, and project y project and on different aspects of different projects is just really, really difficult".*
- Tendering process of Local Government: vulnerable income, councils want to show value for money. Increased tendering has added extra level of competition for the social sector.

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- Challenges of private sector tendering: competing with the big boys and operating as an ethical business- paying the living wage…
  - Does creating social value really matter in a commercial context?

Navigating the Hurdle of the Board

- The Board matters: governance, strategy, decision making: General risk aversion
  - Difficult journey
  - Time consuming: many conversations, required convincing
  - Requires a visionary Chairperson
  - You lose some along the way
  - Opportunities to reshape the Board and bring on commercial expertise.
  - Knowing the importance of being able to leverage the status of board members and gain credibility.

On the edge of a cliff

"It was hugely scary. At the time it was like being on the side of a cliff looking down and knowing I needed to get to the other cliff opposite me, not knowing how I was going to do it. There were a lot of sleepless nights, I knew that If I got it wrong the whole organisation could fall."

"We did lose a couple of board members who really couldn't take the risk, or couldn't understand the change from a nice small pink and fluffy charity, almost like a knitting club aspect and move to what was going to be a commercial business and the whole thought process that goes in there. So we did lose them".

Composition of Social Finance is positive

- Part grant, part standard loan and part capital risk loan in tranches.
  - Eases transition to debt finance
  - Immediate flow of capital and a medium term flow of capital
  - Standard loan repaid as per norm
  - Capital risk loan interest repayments tied to meeting social outcomes.

“The mixture of the grant/ loan gave us the security of having the grant which was useful, it gave us a chance to move into almost a cushioned way of the loan system with somebody holding my hand all the way through. It allowed us to get that growth that we wanted and needed and helped us understand the standard finance systems”

Strengthening Business Acumen

- To create a financially sustainable organisation it requires a strengthening of business acumen:

  “ We don’t have the commercial know how, if you want to generate a company you need to have the commercial know-how but it’s not really where our forte is because that’s not what we’ve been doing for really any of the time. Anything we have done hasn’t been that successful.”

  “ We need more models of ways of doing business”.