

The market for social investment has three sets of players: potential providers of capital and investors; financial intermediaries; and those seeking to raise finance. It is clear from our research that a growing number of financial intermediaries, social enterprises, charities and other social organisations are raising debt or other funds for investment and a range of new investors are being drawn into the market. However, our research also reveals insufficient overall capital and mismatches between the capital available and market demand. This nascent market also suffers from high transaction costs and a lack of investment-ready propositions.

Below we outline the issues and opportunities for different classes of investors, intermediaries and third sector organisations seeking capital.

Social investors

We believe substantial capital can be found for social investment from a wide-range of sources, but currently much of this supply is untapped or hard to access. We have analysed the issues and potential for different investor types below:

Very high net worth individuals

This group of people typically have their own trust or foundation and are participating actively as philanthropists and social investors. They are early adopters of social investment and, through conversation between like-minded individuals, more are becoming involved. The issues for this group include:

- High transaction costs due to the small deal size, the bespoke nature of many deals, and the lack of information to enable potential investors to compare investment propositions;
- Lack of authoritative market research and data to help with investment decisions, leading to quasi-philanthropic “heart rather than head” investments;
- Too small a group being asked on every possible deal, running the risk of people coming to feel over-committed.

The group of early investors needs to be broadened through peer networks, improving the available market information and increasing the buzz around social investment. This is a vital group from whom to garner support in the early stages of initiatives, when they are needed to help build the track record that will allow less sophisticated investors to engage in the market.

High net worth individuals’ agents (private bankers, etc.)

Private bankers and others are keen to show clients their green or socially conscious credentials by offering them suitable simple social investment products. However, those that look after high net worth individuals do not presently have the time or inclination to invest effort as well as money into the philanthropic or socially-oriented arena. For private bankers, the present market is frustrating because:

- There are few active social investment funds that diversify risk and present a simple investment proposition;

- Present propositions don't have the scale or liquidity to make them attractive to private bankers and are, typically, not regulated by the FSA;
- Social investment intermediaries struggle to market to private bankers and have little track record or understanding of potential return expectations due to the low volume of precedent transactions.

We believe there is considerable latent capital supply for simple, easy to understand, socially-oriented investment propositions that are of a sufficient scale to be offered to a broad range of high net worth clients by private bankers. These products should be tax efficient, regulated by the FSA and provide a low but reasonable rate of return in addition to the return of principle.

Grant-making trusts (GMTs)

On the face of it, GMTs should be significant social investors. There is precedent, particularly in the US, of GMTs making programme-related investments (loans, loan guarantees or share purchases to organisations that share their primary purpose). Such funding directly fulfils the mission of the trusts themselves. However, while some progress is being made in the UK, there is little scale of investment because:

- Trustees are conservative and nervous about whether social investment legally jeopardises their commitment to maximising the returns on the endowment;
- Social investments are often evaluated using the same criteria as purely financial investments, meaning that their social value is not given due consideration;
- Lack of codified processes means management is often confused about how to administer social investment and how to process it through their accounts;
- Trustees can also have concerns around supporting social enterprises such as whether the funding will be used for entirely charitable purposes or whether funded organisations might eventually be seen to be profiteering from such finance.

Significant capital could be released into the market if some grant-making trust capital were allocated to social investment. We sense a growing willingness to do programme-related investment with a few pilots already in progress.

Government

Around half of all third sector funding comes from local or national government. Government has capitalised a number of social investment organisations including the Adventure Capital Fund, Bridges Community Ventures, Futurebuilders and UnLtd. In addition, it seeks to encourage private capital into the sector through tax incentives such as community investment tax relief (CITR). Tax relief to support investment into small and medium sized enterprises such as the Enterprise Investment Scheme is also available to investors in social enterprises.

We have found that Government, like GMTs and others, are interested in social investment but are often uncertain as to the best way forward.

Retail banks

The retail banks are providing more lending into the sector following the precedents of Charity Bank, Triodos, Unity and others. They have a wide distribution network and are likely to be the first point of call for many social enterprises seeking finance. We are uncertain of the impact of reduced availability of credit and whether the banks will retrench. Issues include:

- A limited understanding of third sector legal forms and operating environment that makes it difficult for them to accurately assess investment risk;

- Security requirements for loans that may not be appropriate to third sector organisations.

The retail banks have tended to move into markets when others have demonstrated their profitability. If debt financed elements of the market can be supported to demonstrate a positive track record and a reasonable risk profile, the retail banks could bring significant capital to the market. In the mean time while precedent is being developed retail banks may constitute a rich source of referrals to social investment providers.

Capital markets

The capital markets have already been accessed internationally for socially oriented projects. For example, several micro-finance funded bond issues have already been put together. However, more needs to be done. Issues include the:

- Small scale of investment propositions presently precludes access to capital markets;
- High initial set-up costs for capital market vehicles such as a conduit or securitisation.

The international precedents have demonstrated that once a model has been created, the financing and set-up costs decline. In addition, the work around a social stock exchange could create an additional route to raising finance for social enterprises and businesses.

Social investment intermediaries

The majority of social investment intermediaries Social Finance has interviewed are interested in help in raising further capital or developing new financial products. These organisations divide into two groups: those that are primarily government-funded initiatives and those that are not.

Government initiatives (Futurebuilders, Adventure Capital Fund, UnLtd)

There are a range of issues for government-funded institutions. Their ability to invest is often hampered by additional constraints or requirements that can reduce their effectiveness. These might include:

- Additional criteria or limitations such as investees being individuals (UnLtd), or organisations that provide services to government (Futurebuilders);
- State aid concerns increase transaction costs as each transaction may have to be justified individually;
- A tendency to measure success on criteria such as speed of fund distribution and cost of fund administration, rather than investment success. In particular, the pressure to invest creates a tendency for conservative investments like secured loans, rather than softer development capital;
- A tendency to want to measure success too early, hampering organisations' ability to invest effectively; and
- The potential need to retender to deliver the service, with the potential for both management distraction and a focus on the wrong success criteria.

Community Development Finance Institutions (CDFIs)

There are a range of local, regional and national organisations with various business models that are categorised together as CDFIs. Most were set-up relatively recently using money from the now defunct Phoenix Fund. There appear to be some organisations building sustainable business models but the sector has been expected to become sustainable in a very short time

span. The majority are small in scale and are unlikely to become sustainable in the near future or at all.

Non-government funded social investment intermediaries

Non-governmental social investment intermediaries can typically be characterised as follows:

- Small and experimental, often without the desire or expertise to go to scale;
- Inexperienced at raising capital to enable them to achieve scale and sustainability;
- Tendency to make small, conservative investments to sustain small capital base.

The only exceptions to this are organisations that have a specifically commercial business model such as Bridges Community Ventures and Triodos Ventures Fund, or are at the conservative end of the financial spectrum, Charity Bank, Triodos Bank and Unity.

Almost all those we have talked to have been interested in scaling-up their current capacity through capital-raising. However, like most CDFIs, we believe many would have trouble providing a positive financial return to investors. Social Finance may therefore look to develop products that blend grant and investment capital to make social investment more attractive to private investors.

Third sector organisations

Third sector organisations have a range of issues identified in our research:

- Gaps in capital availability, particularly risk capital, constrains investment for innovation and growth;
- The inability to grow inhibits their ability to attract strong management and vice versa;
- Many organisations reliant on government contracts have short-term revenue streams that don't fully cover costs and are subject to change with political priorities;
- Poor access to independent financial advice, investment readiness support and corporate finance services; and
- Insufficient size or asset levels to be considered for repayable finance.

The role for Social Finance

We believe there is significant potential to increase both the capital available and the demand for capital by:

- Packaging investments to achieve scale;
- Blending funds from sources with different return expectations to better match capital requirements;
- Providing precedent transactions and developing a track record will increase transparency and reduce transaction costs.

By increasing and improving the flows of capital into social investment Social Finance will help the third sector to attract and retain talent and develop effective solutions to the problems faced by British society benefiting, in particular, marginalised communities.