SOCIAL FINANCE

Financing New Employee Mutuals
May 2012

A TECHNICAL GUIDE TO FINANCING NEW EMPLOYEE MUTUALS

CONTENTS

MUTUALS SHOULD REMEMBER THAT DESPITE THE CHALLENGES OF RAISING FINANCE, THEY ALSO BRING SOMETHING POTENTIALLY EXCITING TO INVESTORS

PURPOSE

Public service mutuals represent a significant and very exciting opportunity for improving public service delivery. Usually structured as social enterprises that adhere to the values of employee-ownership, mutuals have a unique potential to combine the social ethos of public services with an organisational structure that enables them to embrace social challenges in more flexible and entrepreneurial ways.

However, should mutuals fail to adjust quickly to the new commercial environment which they face once they have 'spun-out' of the public sector, they may find that they lose contracts to public or private sector competitors – competitors who are often able to fund new developments or absorb losses for the sake of building market share. Spinning out of the public sector with few assets, external funding is therefore vital for most mutuals that are seeking to consolidate their role and develop their services.

The purpose of this paper therefore is to highlight the nature of the opportunities and challenges mutuals will face in securing the investment they require, regardless of their size or the stage of spinning-out at which they are at. It is designed to be an introductory resource for those with relatively little prior knowledge of raising external investment. Our aims are three-fold: firstly, to identify what the resource requirements of new mutuals are; secondly, to provide a high level introduction into how and from which sources these investment requirements might be met; and thirdly, to identify some of the implications of our analysis for potential and existing spin-outs.

In particular,this guide sets out the potential role that social investment has to play in supporting mutuals. As a growing market in which socially-motivated investors seek to support social sector organisations committed to delivering social outcomes, social investment could become an important source of funding for spin-outs. Social investment may better suit their needs and particular circumstances than traditional investment.

1 Introduction

How much money will we need to spin-out? Will we require external investment to grow? If so, how will we raise that investment? Should we be seeking to enter a partnership with investors, for example, or seeking a bank loan?

These are some of the common questions that we come across in supporting aspiring mutual organisations that are considering spinning out of the public sector.

So far, in our experience, many of the pioneering groups of staff who have spun out have navigated these financing issues fairly successfully. Prior to spin-out, the majority have received support from the Department of Health's Social Enterprise Investment Fund (SEIF) and/or have received financial support from their current employers, reflecting the focus of spin-outs in health and social care. Some have left with medium term initial contracts that pay in advance, eliminating the need for upfront working capital and providing a good base to grow organically by picking up other contracts.

Yet finance is set to become a more significant issue for many prospective and established mutuals. Grant funding to assist with spinning out is in short supply. The Mutuals Support Programme funding of up to £10 million for business support should help many organisations receive essential support and advice on issues such as business planning and staff transfer. But it will not provide for all the costs of establishing a new organisation. The future of the SEIF is uncertain. Other support is often limited and, if the Government's Right to Provide policy is successful, these programmes will be stretched.

Once independent, many spin-outs are finding that they need to compete with well-capitalised private sector providers or enter into new payment-by-results contracts that require providers to fund their services up-front and receive payment only if outcomes are achieved. Some are seeking to embed themselves in a local area by acquiring or refurbishing premises. These all require finance and many will not have the reserves to fund such investments themselves.

This brief paper seeks to summarise the funding requirements of spin-outs, and to identify potential sources of finance that might enable these requirements to be met.[1]

In section two, we explore the finance requirements of new mutuals at each stage of the spinning out process, from the initial options appraisal to the eventual expansion of an independent organisation. Each phase is analysed in terms of its specific resource needs at that stage and the funding that we anticipate could be involved for a medium-sized organisation.

In section three we assess the various types of debt and equity finance that spin-outs may wish to access, and describe the way in which spin-outs may be viewed by different kinds of investors. We describe the opportunities that funders will see in these new organisations, and the circumstances that might in some cases present a challenge to investment.

1 This initial analysis is based on discussions with around a dozen organisations providing business support and finance to new mutuals, a round table discussion organised by the Mutuals Taskforce in Autumn 2011 and a wider review of published material. We also interviewed around half a dozen potential mutuals and have drawn from our experience of providing social investment and support. It is therefore not in any way a comprehensive analysis, but we consider that it provides a good basis for discussion. We are very grateful to all those who contributed to the analysis and commented on drafts of the report.

In section four we describe more specifically some of the sources of funding that may be available to mutuals at the pre- and post-spin-out stages, and assess how viable an option each of these is. Here, we address the particular challenges that spin-outs may face when attempting to access these sources of finance, for example how particular organisational legal structures may necessitate specialist investment approaches. We also look at the scope for attracting investment from socially-motivated funders who are likely to be interested in the potential social impact that could be created by such social enterprises.

Finally, we summarise the implications of our analysis for mutuals in both the pre- and post-spin-out phases. This includes the key points that we believe potential and existing mutuals should consider around assessing their financing needs and engaging early with investors if they are likely to require external funding.

2 Finance required in the process of spinning out

Given the enormous breadth of new mutuals, ranging in size from two employees to well over a thousand and spanning a number of sectors, there are a wide variety of investment needs. However, most new mutuals will find that they require very different kinds of finance at the various stages of the process of spinning out. In this section, we provide analysis of the resource needs of new mutuals at five broad stages:

- Appraisal of the initial options to spin out;
- Business planning, initial contract negotiation and/or tendering;
- Set-up (or 'transition');
- Start-up and consolidation; and
- Expansion.

Appraisal of initial option to spin out

An options appraisal may include gauging initial staff and commissioner interest, exploring whether statutory services could leave the public sector, understanding the competitive landscape, determining what cost and benefits would arise from such a move and exploring how successful an independent business is likely to be.

Resource requirements

This work may involve little more than internal discussions. However, there may be legal and regulatory issues to be explored. For example, the creation of Social Work Practices, independent social worker-led organisations, required careful consideration of the statutory responsibilities of local authorities for vulnerable young people before the model could be developed. Similarly, for very large organisations that have been considered for mutualisation, such as British Waterways, the Post Office and Audit Commission, initial options appraisal has been a significant and time consuming effort.

Funding Requirement

Based on an organisation with 100 members of staff, we estimate resources of up to £10,000 are typically required at this stage, mainly in existing staff time. Often, this time can be carved out of two or three people's existing roles without incurring additional expenditure. However, costs could be much higher for a larger organisation, and may vary depending on whether this is a spin-out emerging into a new market, or where very little previous work to consider the options has been undertaken.

Business planning, initial contract negotiation and/or tendering

This stage involves a number of complex activities, such as developing a business plan, deciding on a legal form, considering staff transfer issues and negotiating an initial contract(s) with existing or new commissioners.

The work is typically quite significant even for a small group of staff. In our experience, business planning and initial contract negotiation typically takes six to 18 months, sometimes longer.

Some of the Community Health Right to Request organisations that have pioneered public sector mutualisations in recent years have had to confront issues such as staff pension transfers and payment terms from commissioners for the first time. Yet many of these groups benefited from working in the context of a national framework for spinning out led by the Department of Health, with central policies and guidelines. Further, many had the opportunity to secure an initial three to five year core contract. In other sectors where the route to mutualisation is less established, this business planning may be even more complex. Children's services teams hoping to mutualise and sell specialist services to Academies and Free Schools in their local areas, for example, will be operating in an uncertain commissioning environment. They may require significant market analysis in order to inform their business plan.

Resource Requirements

Almost all the successful teams we have seen have benefited from the existing public sector 'host' organisation allowing the manager(s) of the service considering spinning out to devote a significant period of time to leading the mutualisation process, whilst continuing to operate the business as usual. This may require funding someone external to 'backfill' some of their current role, particularly for clinicians. Potential spin-outs also typically need external support for a range of tasks, including:

- Writing a business and financial plan – usually employing someone to support business planning or releasing an in-house member of staff to work on the plan;
- Legal support on staff transfer issues, the governance of the new entity and the new responsibilities (e.g. statutory duties) of both the mutual and the commissioner;
- Market research in order to assess potential customers and competitors and the new business a spin-out might win;
- Dedicated HR support, particularly for large spin-outs where managing staff concerns will be integral to achieving a successful transition;
- A dedicated project manager; and
- Consideration of branding and communication.

Funding Requirement

The DH's SEIF has provided grants to cover this stage, which were typically between £20,000 and £200,00 for community health spin-outs. These organisations often received additional support, cash or in-kind from their 'host' Primary Care Trust (PCT). The Department for Education set aside between £80,000 and £120,000 to support each local authority in setting up the five initial Social Work Practices.[2]

For an organisation seeking to spin out with 100 members of staff we consider that it is prudent to assume costs of £60,000 to £120,000 at this stage. For larger organisations this figure would be greater, but is unlikely to exceed £400,000.

Set-up (or 'transition')

Once the decision to mutualise is taken, a further set of resource requirements are likely to arise in the process of setting up the new organisation, such as the costs of legal incorporation, putting in place new systems, structures and communications tools and potentially running the organisation in shadow form before it is officially established as an independent enterprise.

Resource Requirements

Some of these costs can be kept relatively low, particularly if the organisation is following a model that has already been used by a previous spin-out. However, this stage may also be quite protracted as contracts are finalised with the primary commissioner. The new company is often established some months prior to the full transfer of staff and business operations. Indeed this has been the case for all community health spin-outs, which have been required to operate in a 'shadow' form for up to six months or even more prior to becoming fully independent. During this shadow period, it may be necessary to maintain a project manager and cover the costs of recruitment and support for the new board.

Funding Requirement

We estimate that an organisation with 100 members of staff would require around £50,000 to £100,000 at this stage, although for larger organisations costs could reach up to £250,000. Again, some of this may be provided in-kind or in cash from the host organisation.

Start-up and consolidation

There are a range costs that will need to be met over the first few months to a year of independence, as a new organisation seeks to consolidate its position and avoid a situation whereby it is struggling to maintain cashflow. This phase involves forming the new organisation as an independent business: plugging any gaps in staff or expertise; starting to improve the way services are delivered; and ensuring that staff have a sense of ownership.

Resource Requirements

Needs at this stage can include:

- Working capital, to cover the costs of delivering the service prior to being paid;
- Finance for any immediate capital requirements such as new IT systems or asset refurbishment;

2 *Social Work Practices – Guide for Proposals*, Department for Education, 2011.

- Finance for services that are not covered by an initial contract but need to be sustained prior to winning contracts;
- New staff with skills that are particularly likely to be required, including business development and finance functions; and
- External support if the spin-outs lacks expertise in specialist areas such as marketing and legal advice.

Some new health and social care mutuals avoided some of these costs. Initial contracts often included relatively generous up-front payment terms, for example, reducing the need for working capital. Some negotiated for property to be leased at very low rents for the first few years, with maintenance costs continuing to be met by the PCT and with minor equipment and consumables purchased through the PCT.

Likewise, some very small mutuals – with three or four members of staff – reported to us that they envisage keeping the start-up costs low by working from home initially, pulling in favours from people they know and remaining employed on a part-time basis by their previous organisation.

However, even these early mutuals found expenditure can be incurred during this period and this needs to be planned. For example, the separation of IT systems from host and new provider can be complex. Those community health and social care services which merged into one new integrated organisation, for instance, had to work hard to bring staff together, in terms of culture, systems and structures.

Funding Requirement

Our analysis of the business plans of a sample of large community health spin-outs indicates that they often required finance to cover start-up and working capital costs over their first few months of trading in the range of £0.5 million to £1.7 million for organisations employing 1,000–2,000 members of staff. These have often been met through the achievement of efficiency savings over and above those agreed with the parent body and/or through payment-in-advance on block contracts. For an organisation with 100 members of staff, or a turnover of around £3 million and an up front contract, costs are likely to be much lower, perhaps closer to £100,000–£300,000.

For those that need to quickly build contracts with a wide range of customers, such as with individual clients through personal budgets, Academies or GPs, working capital requirements may be much higher than those that spin-out with a core contract that pays in advance. Such organisations typically look to have working capital equal to at least three months' of fixed costs: £0.5–£0.7 million for 100 members of staff.

Expansion

The final stage we identify is expansion. As with any organisation that has a single predominant contract, those that do not look to diversify and expand are taking a significant risk and therefore this is likely to be a priority for many mutuals.

We are seeing a number of expansion strategies planned or emerging:

- Spreading geographically. This was the main strategy of the Leisure Trusts that spun out of local authorities a few decades ago. For example, GLL (Greenwich Leisure Limited), which is staff-owned, now manages over 100 leisure centres on behalf of over 20 local authorities.

- Diversifying the service they offer across traditional public sector silos. For example, some of the community health services that have spun out of the NHS are very well placed to offer integrated health and social care services or packages of care for people with complex needs, spanning services such as health, employment support, housing and advice. In some community health services, we expect that groups of social services staff will join mutuals.[3]
- Private sector income generation. For example, leisure services social enterprises can offer 'for profit' gyms as well as local authority subsidised services. Providers of back office services, such as MyCivilServicePension or some of the public sector IT departments which are considering mutualising, have the potential to provide services to customers beyond the public sector.
- Offer contracts that are attractive to commissioners, and often potentially higher margins to the supplier, such as payment-by-results contracts. Commissioners are increasingly interested in contracts when some or all payment is only made once outcomes have been delivered. If staff form a spin-out from a Probation Trust, for example, they may find that they must wait for some payments from commissioners until they have reduced re-offending.[4] Likewise, one local authority is exploring a model in which family support staff mutualise under a contract in which payment is partly dependent on whether they reduce the costs of these families to other statutory services, such as the cost of taking young people into local authority care.[5] Some community health mutuals are considering offering commissioners packages of support to patients with long term health conditions, with payment partly dependent on whether these patients subsequently make less use of hospital provision.

A number of mutuals are also looking to acquire or improve assets in order to embed their local presence. Some social care mutuals are planning to build care homes, for example, whilst some training providers are planning to renovate or expand premises.

Funding requirement

It is important to note that not every spin-out will require capital to grow. Plenty have the scope to make surpluses and grow organically. But with increasing competition this can be risky. For those looking to expand fast, at scale, capital requirements could be considerable. For example:

- Simply bidding for new contracts may require organisations to have a certain level of reserves (large public sector tenders often include tests of financial strength). There has been speculation that one of the reasons that Central Surrey Health did not win a £500 million contract to deliver community services in south-west and north-west Surrey was that it was not able to meet the financial requirements from the commissioner. These requirements had initially included a £10 million 'performance bond', although that was subsequently dropped from the tender process.[6]

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3 Two health and social care mutuals were formed from the start under the Right to Request process, Sirona and SEQOL, with employees joining from the NHS and local authorities. In other areas, social care staff are considering joining community health staff who initially formed the mutual.

4 The Ministry of Justice is developing a number of payment-by-results pilots in which prison and community providers are paid all or a proportion of the contract value only if offending is reduced. This programme has not yet included any staff mutuals, but it is possible that spin-outs could be included as the programme develops.

5 This is being explored by the London Borough of Kensington and Chelsea as part of a Cabinet Office programme to develop Social Impact Bonds to improve the support provided to troubled families.

6 See http://www.parliament.uk/deposits/depositedpapers/2012/DEP2012-0460.pdf

- Payment-by-results contracts usually necessitate significant working capital requirements and involve some risk. Recent Department of Work and Pensions contracts to provide innovative services to reduce the risk of young people becoming Not in Education, Employment or Training, typically required providers to have £1–£2 million of working and risk capital. New payment-by-results programmes in Essex and Manchester to better support young people tackle behavioural problems are likely to require £2–£3 million of capital upfront, whilst the Peterborough Social Impact Bond to reduce re-offending required £5 million.[7] In employment support and health, contracts and capital requirements can be even higher. Our analysis of the costs of establishing integrated health and social care in a typical local authority area indicate that £5-£10 million of upfront investment may be required before significant savings are released in acute hospitals.
- Purchasing or refurbishing buildings out of which to operate significant services will typically require a partnership with a property developer and long term lease and facilities management contract or an upfront investment of several million pounds.

Many mutuals with whom we have worked have not spun out with the level of resources required to meet these demands, and with a limited ability to generate a surplus on their core contract, some will struggle to do so. For example, analysis of the first available community health spin-outs' accounts shows that despite having a around £80m of turnover, they only had around £800,000 of tangible assets.

Table 1: Summary of likely resource needs for a group of 100 staff forming a mutual

	Pre Spin-Out			Post Spin-Out	
Stages of development	**1. Appraisal of initial option to spin out**	**2. Business planning / initial contract**	**3. Set-up**	**4. Start-up**	**5. Expansion**
Resources required	Business support, back-filling staff time/costs, advice.	External advice, back-fill staff costs, staff and community engagement	One-off costs e.g. legal costs, staff development, new premises, insurance, branding	Working capital, business investment, IT, asset refurbishment and acquisition	Growth and development capital to diversify, invest in efficiencies and enter payment by results contracts
Typical value of resources required NB: some resources may be provided in kind by host organisation	Zero to £10k.	£60k–£120k	£50–£100k	£100k–£300k. Requirements could be larger if contracts paid following completion of work rather than in advance.	Zero to millions

7 *Social Impact Bonds. The One Service. One Year On*, Social Finance, 2011.

3 Types of finance available to new mutuals

Before considering the specific sources of investment that may be available to meet the resource requirements identified in the previous section, it is useful to provide an overview of the various kinds of finance that are available to an organisation. The range of financial products on offer to cover a new organisation's needs is wide. Table 2 below provides a summary.

Table 2: Overview of traditional types of finance

Type of Finance	Description
Grant Funding	
Grant	Non-repayable, often one-off, funding.
Repayable grant	A 'soft' loan e.g. permitting the borrower to take interest or capital repayment holidays in some instances, and /or with sub-market rate of interest.
Secured Debt Finance	
Working capital facility	Short-term finance to meet costs of everyday trading activities. Allows a borrower to meet short-term deficits and surpluses (like a tap that can be turned on and off as required).
Asset-based/ asset-backed lending	Debt facility in which the lender looks to the borrower's assets as a source of repayment, should the borrower's cash flows be insufficient to meet principal and interest payments. Examples include mortgages, equipment leases and receivables-based facilities.
Cash flow-based lending	Loans secured on general assets of the borrower.
Unsecured Debt Finance	
Unsecured loan	A loan that is not secured by charges over assets, but looks only to the borrower's cash flows as a source of repayment. In a distress situation (i.e. if the organisation enters administration), an unsecured creditor gets paid only after all claims of secured creditors are met. In order to compensate for this higher level of risk, unsecured debt tends to be more expensive than secured debt.
Equity Finance	
Traditional equity finance	A company issuing equity (shares) to outsiders raises finance in exchange for an ownership stake and a participation in the upside and downside risk of the company. While equity issuance can provide a new source of capital, consideration needs to be given over ownership 'dilution' or loss of control and the ability to safeguard an organisation's mission.
Quasi-equity or equity-like investment	This type of finance has similar characteristics to equity finance but is used where the organisation taking investment is unable to offer equity or shares. This is often due to the legal structure of the organisation. Repayment and returns are often linked to the performance of the organisation and therefore represent 'risk capital'.

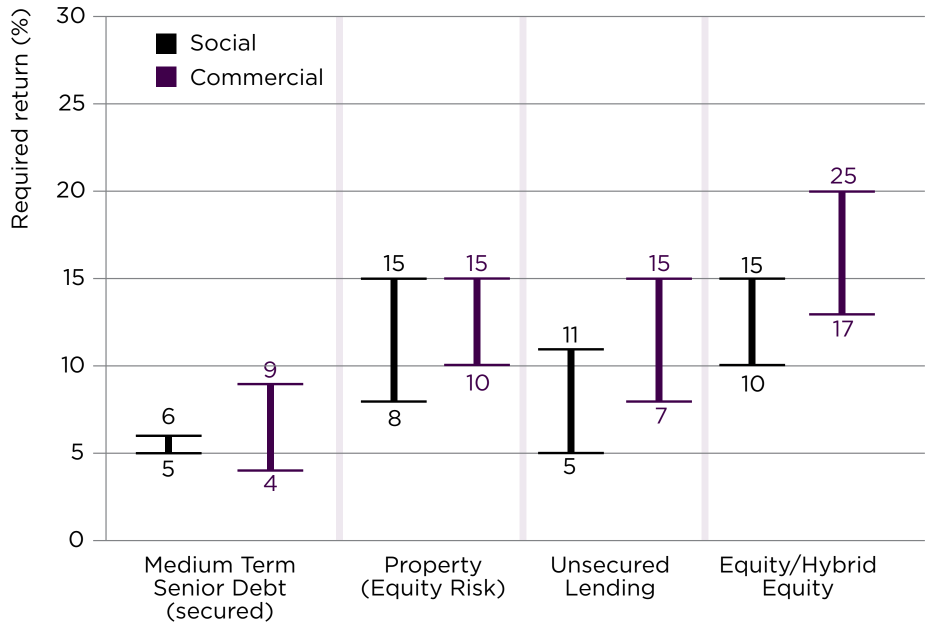
Social Investment

One type of investor which may be particularly interested in financing mutuals is a social investor. Social investors are those who seek a combination of a social impact and a financial return from their money. These may include, for example, Charitable Trusts and Foundations investing part of their endowment or affluent individual investors who have a strong social motivation. The Esmée Fairbairn Foundation, for instance, has set aside £21 million for investments that combine a social and financial return.[8] These may trade off higher risks or a lower financial return for ensuring that their money is generating social benefit.

The social investment market is still small – around £200 million per annum – but is a growing and potentially extremely important source of finance for social enterprises, including employee-owned mutuals with asset locks, such as Community Interest Companies.[9] There are now social investment products emerging across a variety of types of finance, which seek to better align social outcomes with financial returns: from secured debt to quasi-equity. A new social investment 'wholesaler', Big Society Capital, will be seeking to build the market further over the next few years by acting as a 'cornerstone' investor, deploying up to £600 million in a variety of social investment funds and social investment intermediaries. Given the small size of the market and the aim of investors to achieve social impact, social investment products may be created in bespoke forms, which can benefit recipient organisations with a product specifically structured to suit their needs. However, social investment can take longer to arrange than some types of commercial finance. Nor will social investors support any project blindly or take imprudent risks: they are still looking for a financial return and will apply a commercial level of rigor in assessing the robustness of investment proposals.

Graph 1 below compares the range of returns which commercial and social investors are often seeking.

Graph 1: Potential range of returns sought by commercial and social investors



8 http://esmeefairbairn.org.uk/what-we-fund/finance-fund/

9 *Growing the Social Investment Market: A Vision and Strategy*, Cabinet Office, 2011

4 Potential sources of funding

Having outlined the types of finance that could be available to a new organisation, in this section we assess the specific sources of funding that a spin-out might be able to access, and how easily this may be achieved. Consideration of the source of the finance is a crucial element of creating a successful mutual, so that capital is available when it is required. Additionally, understanding the social investment market, and how social investors may to be keen to work with mutuals in order to help them achieve increased social impact, could help many spin-outs access a valuable source of funding.

How easy will it be to raise external investment?

We consider that many new mutuals have good underlying propositions and as early entrants into new public service markets should be well placed to win other contracts. Spin-outs are often managed by some of the most entrepreneurial leaders in the public sector. They may hold initial multi-year contracts, have good relationships with commissioners and have the scope to make rapid productivity gains through improving staff motivation.

Many will, however, also face challenges. These will make them risky for investors. Challenges will include dealing with the transfer of liabilities, limited commercial experience, few assets and often a strong reliance on an initial contract (see table below).

Those we interviewed for this research often provided a similar message: mutuals have exciting potential service offers but gaps in business capabilities, market uncertainties and legal forms which may put off investors.

Table 3: Investment attractions and challenges for new mutuals

Attractions	Challenges
• Often led by some of the most entrepreneurial leaders in the public sector. • Often an initial 3-5 year contract and good relationships with commissioners. • An established core service, often with better trained staff than the social sector as a whole. • The scope for immediate productivity improvements arising from a change in culture. • The scope for winning contracts in other service and geographical areas – because they are more flexible in their remit and may have a 'first mover' advantage as public services are opened up. • Liabilities sometimes kept in public sector (pensions and redundancy). • Incentives for commissioner to see success of spin-out.	• Risk of losing re-tender of initial contract after three-five years or of failing to gain sufficient initial contracts if no guaranteed contract. • High pension costs and inflexible Terms and Conditions are transferred and make rapid business change difficult. • Relatively little commercial experience. • Initial management and financial information systems not fit for purpose in a more competitive environment. • Restrictions on the payment of dividends under some models. • Low capital base and usually no assets to borrow against. • Often operating in sectors in which overall government expenditure is declining and considerable uncertainty exists in the commissioning environment.

These strengths and weaknesses will vary by stage: those who have yet to spin-out will be very risky; those at start-up will continue to be risky but could be appealing in certain sectors; and those with a strong track record, good long term contracts or with assets to borrow against will carry much lower risks. In turn, these risks will influence the type of finance available and the levels of return sought by investors.

Aspiring and emerging mutuals will also need to consider the type of finance they may find most useful at each stage and for different purposes. For example, spin-outs may want to raise investment at an early stage through selling some equity rather than taking out a loan on which they will immediately need to start making interest payments at a time when profits are small.

Combining these two perspectives, we set out below some of the most promising sources of finance:

Pre-spin-out (Options appraisal, business planning, initial contract and set-up)

At this stage, finance will be difficult to come by for most groups of staff other than through grant funding, in-house support, or pro-bono support. We have found that commercial and social investors are unlikely to want to invest in an organisation before it has spun-out, and its lack of an autonomous legal structure might prevent this in any case.

Commercial investment

Getting a return on pre-spin-out funding would be extremely risky. Staff may never actually spin-out and even if they do may struggle to generate a return for the first few years. Commercial finance is therefore generally not possible.

The exception *may* be at the set-up phase, when the decision to spin-out has been made and the initial contract developed. If a stake in the new company is be taken to a commercial partner, it may be possible to draw on external support as soon as that partner is chosen. For example, such a model was developed for the mutualisation of MyCivilServicePension, whereby the new organisation will be 25% owned by staff and 40% by financial services firm Paymaster, with the Government retaining a 35% stake. These instances have been rare so far but may become more important in the future.[10]

Social investment

Funding at this stage will also be outside of the criteria of existing social investment funds. Like commercial investors, social investors will not practically be able to structure an investment prior to the new legal entity being established and will be put off by the uncertainty of whether staff will spin-out, lack of a final business plan and other risks.

Pro-bono support and grant funding

Groups of staff will therefore need to primarily look for in-house support from their current ‘host’ public sector organisation, support through the Government’s Mutuals

10 We have found a growing interest in involving investors once the decision to spin-out has been taken in principle. Some ‘host’ organisations, such as local authorities and NHS Trusts, consider that involving investors may not only bring in up-front finance, but can reassure commissioners that the new mutual will develop their financial capabilities more quickly. It has yet to be seen how such partnerships with investors will develop for smaller mutuals e.g. whether there will be a tender to find an investment partner or whether a less formal arrangement is established at the set-up phase with investors providing technical support on the business plan in return for an expectation that the mutual will take equity or quasi-equity once the new company has been established.

Support Programme (MSP) for business, HR, legal and financial advice, other sector specific government programmes such as the Social Enterprise Investment Fund and The Department for Communities and Local Government's Right to Challenge support programme, and pro-bono support from commercial sector organisations.

The £10 million MSP is the most important source of potential funding and should be an important boost to prospective mutuals over the coming two years. Other support may also be available for teachers looking to establish Free Schools, social workers looking to establish Social Work Practices and other sector support programmes.

It is worth exploring pro-bono support carefully. Prospective mutuals may be inundated with offers of a few hours advice from various business support organisations, but who will only help with the detailed process of writing a full business plan and drawing up new contracts for payment. These pro-bono 'taster sessions' are often little more than marketing exercises. However, we have also come across some much more substantial partnerships. For example, one group of health workers who established a new social enterprise a few years ago entered a long-term partnership agreement with an accountancy and consulting firm. Under this arrangement, significant administrative and management services were provided 'at risk' until initial contracts were won and the organisation was trading profitably, at which point payments were made.

The most significant resource gap that prospective mutuals will face prior to spinning out is flexible cash – to pay for services that are not covered under the MSP. Host organisations will generally need to pay for these services or the backfilling of staff released to work on the business plan. We are not aware of staff getting grants from non-governmental sources prior to spin-out, but as staff approach the point of start-up it may be possible to attract some grant funding for innovative, socially focused projects.

Post spin-out

After spinning out, a much wider range of financing may be available, although access to external investment should not be assumed. For organisations with attractive contracts or significant assets, commercial investment will be a realistic proposition. For those with strong social aims, a range of social investment products may be appropriate.

Commercial investment

Bank finance. Commercial banks offer overdraft facilities to provide working capital for larger mutuals with strong initial contracts. Smaller groups may find bank facilities more difficult. Banks will typically look for strong contracts and growing income to give confidence that interest payments will be covered. In addition, they will require some security for loans – normally in the form of assets and/or personal guarantees. This may prove challenging for spin-outs until they have proven that they are well-managed and have a track record of growth.

Equity/risk finance from commercial sources. Equity may prove to be more appropriate than a loan when the spin-out is relatively new, even if debt finance is available. At this stage, repaying loans could be difficult and the future is uncertain. In these circumstances, risk capital in the form of equity investment may be more appropriate to share risks and rewards with an investor.

For those mutuals that are likely to operate in service areas in which there are already established markets or in which the public sector may soon commence significant outsourcing, commercial service providers may be interested in forming partnerships at the start. For example A4E and Baxi Partnership offer to jointly invest in employee-owned organisations and become business partners. MITIE has established a £10 million fund specifically to invest in start-up mutuals, although the MITIE model expects that the mutual is eventually integrated into the MITIE group structure. Investment Funds are also interested in this area. For example, Odey Asset Management owns a 21% stake in Circle Healthcare, a health company part-owned by employees. This can be a good way of capitalising mutuals and, as mentioned previously, should be explored in the business planning and contracting stage or after spin-out.

However, such commercial investments may not always fit easily with the ownership structure and culture of some mutuals. There can be significant considerations for mutual and social enterprises in terms of their willingness and ability to cede ownership and pay dividends. Many new mutuals are taking legal forms that lock in their assets for a social purpose, such as through forming a Community Interest Company (CIC). There may be good reasons for embedding their social purpose in this way, but it can make investment more complex. CICs which are Companies Limited by Shares can in some cases allow equity investment. However even in these companies, staff have sometimes developed Articles of Association which stipulate that all shares must be owned by employees of the company. In these instances, it is simply not possible for investors to provide finance through buying equity. Furthermore, where it is possible to buy a proportion of the CIC Limited by Shares, the 'asset lock' may make it very difficult for investors to sell on their shares. Returns are also capped at 35% of profits. There may still be ways for social purpose organisations to raise equity investment for particular projects, but it is likely that they will need to form a separate organisation with investors, such as a joint venture, which does not have an asset lock.

Social investment

The constraints outlined above point to the potential role, and indeed a need, for social investment funds and intermediaries to support mutuals with a strong social purpose.[11]

We have found considerable interest from social investment funds and intermediaries in supporting new mutuals. Organisations such as Bridges Ventures, Big Issue Invest, the Social Investment Business and Social Finance have experience of structuring bespoke social investment products. Business support organisations such as Stepping Out, Mutual Ventures and The Co-operative Group also offer support in arranging finance.

As noted above, social investors may provide finance requiring lower financial returns if they are attracted by the potential of social returns. As importantly, they may simply be more used to assessing the risks and opportunities for social purpose organisations and understand the sector. Although some may still find it difficult or unappealing to invest in an organisation with an asset lock, other social investors are more comfortable structuring quasi-equity investments into organisations with these restrictions. Quasi-equity, for example, can take the form of an unsecured loan, mimicking the risk and return characteristics of an equity investment: the coupon (interest payment to investors) and capital repayment are dependent on the revenue earned by the mutual or the specific project which investors have financed. Social investors may also be interested in exploring the establishment of a Social Impact Bond type model for mutuals, whereby social investors fund interventions and receive returns from the commissioners if savings are made in public services.

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11 Not all mutuals will have such a social purpose and will therefore not be attractive to social investors, although may be more attractive to purely commercial investors.

Table 4 outlines some examples of sources of finance. Annex 1 provides more detail on social investment providers.

Table 4: Summary of potential sources of finance

	Pre Spin-Out			Post Spin-Out	
Stages of development	**1. Appraisal of initial option to spin out**	**2. Business planning / initial contract**	**3. Set-up**	**4. Start-up**	**5. Expansion**
Potential sources of funding/ investment	In house support	Grants from Social Enterprise Investment Fund (SEIF) if it continues Mutuals Support Programme (MSP) Sector focused national programmes e.g. Social Work Practice Pilot Programme DfE Free School support and potentially CLG 'Right to Challenge' funding[1] In-house support Pro-bono support in return for longer term relationship	MSP and other grant programmes Potentially equity partners Pro-bono support in return for longer term relationship	Commercial bank providing overdrafts or secured debt for those with long contracts, significant size and assets Potential interest by private investors or partners, particularly in back-office mutuals Potentially social investor interest, particularly where initial contracts in place and a strong social impact	Some interest by commercial Venture Capital funds once organisations have established track record e.g. Baxi and Capital for Colleagues Social Investment Funds and intermediaries have significant interest e.g. Bridges Social Enterprise Fund, Big Issue Invest, Social Finance, Finance South East Investment and Contract Readiness Fund. This £10m fund will provide grants to social sector organisations in order to help them prepare to bid for public contracts and take on investment

1 The financial support for those wishing to use the new 'Right to Challenge' elements of the Localism Act is likely to be focused towards smaller community groups, but details had not been published at the time of this paper.

5 Implications for mutuals

Financing public service mutuals presents a new but exciting challenge for investors and other funders. However, mutuals tend to have histories, legal structures and forms of ownership that are not seen as traditional by financiers.

Some have the potential to grow rapidly and could provide appealing service propositions to commissioners. Such growth should attract providers of finance in the right circumstances. It is the potential for improved delivery of social outcomes, together with the potential for a financial return, that will be of particular interest to social investors.

Nonetheless, mutuals should be wary of the fact that, initially at least, they may not find it easy to attract finance, due to a lack of assets and track record. Therefore, careful consideration should be given to how finance will be sourced during the entirety of the process of spinning out. We advise that groups of staff should consider the following issues when spinning out of the public sector.

Pre-start up

It will be difficult for mutuals to find external funding at this stage outside government grant programmes such as the Mutuals Support Programme. However there are a range of options available that can help to navigate this step, including securing a long-term relationship in return for pro-bono support, securing some funding from the parent body (e.g. a PCT), freeing up resources and developing expertise within the organisation in order to enable existing expertise to be channelled into the creation of the spin-out. It will be important to have a strategy for such partnerships from the start. Additionally, public sector staff considering spinning out may wish to consider how taking the following approaches could help them to secure funding once they are independent:

- Acquiring a legal form that would make investment easier. For example, adopting the form of a Community Interest Company (CIC) limited by shares, as opposed to a CIC limited by guarantee, and adopting a constitution whereby shares could be sold on to certain investors, could enable equity investment to be made.
- Agreeing certainty at this stage on contract length and quantifying pension liabilities, and long leases on assets, will make it easier to raise external investment should that be required.
- A partnership arrangement in which a commercial provider or investment fund takes a stake from the start could be attractive. Mutuals which are spinning out of the public sector with large, long-term fixed contracts, and which may offer an opportunity to some prospective private sector partners, are particularly well placed to consider such arrangements. However, in such an instance, independent corporate finance and legal advice should be sought. Investment may be cheaper once a track record has been established post spin-out.
- Informal relationships with investors or an intermediary may also be useful prior to spinning-out. These can help give an important perspective on whether the business plan is viable. Our analysis of community health spin-outs suggests that some are still relying on their former parent organisation to be a lender of last resort if a budget shortfall appears. However, there can be no guarantee that such assistance will be provided.

- If securing social investment is to form a part of a business plan, then spin-outs should consider how they will measure their social impact. Social investors will be excited by the prospect of the creation of new enterprises that are seeking to achieve social outcomes. However evidence of impact is often a precursor to securing their investment. For those organisations that have not been accustomed to publicly recording and reporting their impact, developing such performance management tools will be important.
- If external investment is to be sought, then staff expectations should be shaped such that it is understood that investors are likely to want a significant voice in how the organisation operates.

Post-start up

It is possible that a new spin-out may not require finance. The decision to seek it should always be taken as part of an overall business strategy, rather than being based on its availability. Ensuring initial contracts pay in advance, and hence reduce the need for working capital, can be a very helpful means of avoiding the need to seek finance as a way of overcoming a cashflow problem.

However, for most new mutuals, particularly those that have ambitious plans for growth and for the re-design or integration of services, access to finance will be a necessity. For these organisations, funding can be the catalyst that enables them to take advantage of their position at the forefront of a new model for public service delivery. Mutuals may wish to consider how taking the following approaches could help them to secure funding:

- It is important that mutuals give careful thought to choosing the right kind of finance to suit their needs and the risks and opportunities they face. They need to consider, for example, whether it is more appropriate to take on debt or dilute the ownership by staff. Social investment is a potentially good source of more patient capital, which may better be tailored to the individual needs of spin-outs; however investors will still expect a return.
- If an organisation determines that it will require finance, then it would be wise to engage with potential financiers early. This is particularly the case for social investment, which is a nascent market, and where social investors and investment intermediaries are likely to want to work closely with organisations to ensure that an appropriate financial structure is created to receive the funding. More broadly, mutuals should try to plan ahead in order to ensure that they do not seek finance at the point where it is running out: that is inevitably the more difficult and more expensive time at which to raise funds.
- Should investment be sought, then organisations should be prepared that investors are likely to seek to undertake a significant amount of due diligence and plan for such activities. This is will be very different from a public sector investment process or an application for a grant. Due diligence is likely to include detailed assessments of company accounts, contracts, future cashflows and assets, as well as the wider market they operate in. It is also likely to seek to test the capability of the senior team and governance structures. Like traditional investors, social investors will be seeking assurance of a return; however, because they are motivated by achieving social as well as financial outcomes, they will also want to see evidence that they are supporting an organisation that achieves social impact.

Finally, mutuals should remember that despite the challenges of raising finance, they also bring something potentially exciting to investors. In some markets, they are well placed to deliver strong social and financial returns and, with the right support and advice, should be able to attract interest from a range of potential investors. The task is to marry the interests of providers and investors as a partnership.

Annex: Summary of social investment products

Type of Finance	Description	Providers
Grant Funding		
Grant	Grants can be both non-repayable or repayable sources of funding.	**Social Enterprise Investment Fund (SEIF)** – Provides grant funding to social enterprises delivering health and social care services. Grants are typically in the region of £50k and support social enterprises in the start-up phase. The SEIF is currently closed and it is uncertain whether it will re-open. **Mutuals Support Programme (MSP)** – A £10m fund that will provide small grants to public sector spin-outs to procure professional services that will help them in the set-up and start-up phases. **Investment and Contract Readiness Fund –** A £10m fund to support civil society organisations to scale-up models that support social action and complement public services.
Debt-like investment		
Unsecured debt	Products are similar to those offered by commercial providers, however there are socially-motivated providers that specifically cater to the social investment market.	**Community Development Financial Institutions.** **Social banks.** e.g. Triodos Bank and Charity Bank. **Funds and intermediaries.** These can also facilitate the raising of finance, e.g. CAF Venturesome, Social Finance, Bridges Ventures.
Bespoke bonds	Social organisations can design and raise their own bonds on debt markets, in order to finance growth. As long as an organisation has a regular source of income with which it can repay bondholders, then this is a source of financing with potential.	Intermediaries and banks that facilitate the raising of the bond include Allia, Investing for Good and Triodos Bank.

Asset-backed debt	Asset-backed debt tends to be harder to structure for social organisations, because many are Community Interest Companies, Community Benefit Societies or charities, and are therefore subject to an asset lock. However an organisation may acquire assets which are not part of the asset lock, or may have additional assets against which products can be structured	**Social banks.** e.g. Triodos Bank and Charity Bank. **Funds and intermediaries.** e.g. CAF Venturesome, Social Finance, Bridges Ventures.

Type of Finance	Description	Providers
Equity-like investment		
Outcome-based financing	Payment-by-result contracts in which the investors are entitled to the revenues generated. For example social impact bonds, where investors provide the finance to fund interventions, and receive the revenue generated from the cost savings that result.	Intermediaries develop and arrange these contracts. E.g. Social Finance.
Equity partner	A commercial or social venture capital investor may seek to take an equity stake in an organisation, particularly if it spins out of the public sector with a long-term contract. There are also a few social venture funds seeking to provide this type of financing. Baxi Partnership offers this option to mutual organisations, combined with professional support.	Baxi Partnership, Bridges Ventures, Big Issue Invest, Finance South-East.
Quasi-equity	Because many social organisations do not offer share capital within their legal structures, they cannot accommodate equity investments. Therefore, quasi-equity alternatives, whereby a share of the increased profits achieved from the provision of a loan are passed to investors, are a growing market. Similarly, a quasi-equity investment may be made through the provision of a loan, which can be structured such that it repays interest in a similar way to that which share capital would pay dividends.	Bridges Ventures, Social Finance, Big Issue Invest, CAF Venturesome, The Co-operative Group.

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Ben Jupp is a Director at Social Finance. He leads work on developing Social Impact Bonds in health and other fields, investment in mutuals and larger social sector providers of public services and engagement with Government on aspects of social investment policy.

Prior to joining Social Finance at the start of 2011, on secondment from the civil service, Ben was Director of Public Services Strategy at the Cabinet Office. In that role Ben led work across Government to improve public services, such as through developing more personalised health and education services and shifting more transactional services on-line. In the civil service, he has also been Director of the Office of the Third Sector in the Cabinet Office, responsible for policy and support for the voluntary and community sector and social enterprises, and head of strategy at the Home Office.

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Dan has led the development of government policy on third sector access to finance, social investment and the role of the sector in service delivery at the Treasury and the Cabinet Office. He has also led several pioneering developments in practice, including agreeing a number of innovative performance-based investments in social enterprise; supporting business planning and development of around 50 Right to Request staff-led public sector 'spin-outs' through the DH's Social Enterprise Investment Fund at Local Partnerships; and helping agree c.£50 million worth of investments in third sector organisations delivering public services at Futurebuilders England.

He has worked on the practical challenges facing spin-outs with Mutual Ventures, the Baxi Partnership and Stepping Out. He is also part of a TSRC-funded academic team exploring the nature of innovation in public service spin-outs.

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