

# **BEST TO INVEST?**

A funders' guide to social investment

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# EXECUTIVE SUMMARY

Social investment offers the opportunity for socially minded investors to increase the impact of their money. It's early days, but the concept has attracted much interest from funders and has the potential to help charities and social enterprises access long-term, affordable finance. This report aims to help funders think through the benefits and risks of social investment, and how to decide if it is for them.

## What is social investment?

Social investment is the provision of repayable finance to charities and other social enterprises with the aim of creating social impact, and sometimes generating a financial return. It is also known as impact investing or social finance. Social impact is generally understood as the difference an organisation or project makes to the social problem it seeks to solve. It is the progress made towards achieving a goal—whether that is to reduce homelessness, eradicate malaria or improve educational attainment.

The UK social investment market is growing fast: from the creation of Big Society Capital to the proliferation of social impact bonds, including the high-profile example at Peterborough prison. Demand for social investment is driven by a number of factors. The government has been the biggest source of finance so far. Its vision of a thriving social investment market where social ventures can access capital to grow reflects its policies to open up public service delivery to independent providers. It also reflects a shift away from reliance on direct grants and donations and the charitable sector's increasing desire to improve sustainability by diversifying income streams.

## The UK social investment market

The social investment market is now valued at over £200m, and expected to reach £1bn by 2016. A recent report claims 765 deals were carried out in 2012/2013.<sup>1</sup> Much of this investment is driven by social banks, with secured loans accounting for 90% of the total market (by value). But the market remains small compared to grant spending: the charity sector received £14.7bn in voluntary donations in 2010/11. Investors currently consist of a small group of grant-making trusts, with very few individuals involved. But the number of deals are increasing, attracting money in the form of loans, equity and quasi-equity, as the investor base continues to expand.

The market is structured around three main players: **investors**, which include government, trusts and foundations, individuals and corporates; **intermediaries**, for example Big Issue Invest, Social Finance and Charity Bank; and **investees**—mainly charities and social enterprises. Investors supply capital to investees either directly or via intermediaries. The investment may take a different form depending on the needs of the investee, the preferences of the investor and the products on offer by the intermediaries.

## Is social investment right for me?

Funders considering social investment should focus on how it could help them achieve their mission. An understanding of the advantages, disadvantages and risks are crucial when thinking through the options.

## For funders

Social investment promotes greater alignment between funders' social mission and investment portfolio, and creates the potential to achieve greater social impact through the recycling of funds. It can also free up valuable

<sup>1</sup> *Growing the social investment market: the landscape and economic impact* (2013) Prepared for City of London, Big Society Capital and Her Majesty's Government by ICF GHK in association with BMG Research.

grant funding and put in place better accountability measures for the investees due to the long-term nature of the investment.

However, social investment has a steep learning curve and is likely to require additional resources. The market is new and developing all the time, so in addition to the complexity of instruments and the unclear or untested legal and regulatory environment, funders will need to contend with a high level of uncertainty. Endowed foundations must consider the need to maintain a good financial return to continue their grant-making activities. The largest risks are that the potential expected returns—both social and financial—are not delivered.

## For investees

Social investment can support charities and social enterprises to expand their operations, develop new goods or services, and fund working capital. As well as providing vital access to finance, it can help organisations acquire a reliable income stream and become more sustainable over time. Proponents of social investment have also suggested it brings a new discipline and rigour to investees.

There is a danger that social investment may cause delay or reduce social impact, as resources that an organisation could otherwise use for its own purposes will need to go towards repayment. The investee's readiness for social investment, and the culture change it might require, may pose additional problems. The main risk is not being able to repay the investment.

## Should I make a grant or a social investment?

Social investment is a tool that can be used alongside traditional grant-making. In some cases, social investment will be the best option; in others, a grant will be more appropriate. There are four key questions to consider:

1. **Is there an income stream to repay an investment?** The investee needs a reliable source of income to be able to pay back the funder.
2. **Does the sector have a track record of social investment?** Some sectors are more suited to taking on social investment than others, often related to the potential to earn income from goods or services delivered by organisations in that field.
3. **Does the organisation have a track record of repaying social investment?** Many potential investees do not have a track record, so the funder will need to carefully assess financial systems and capabilities of staff.
4. **Is the organisation at the optimum stage of development?** Organisations at different stages of development will be more or less suited to repaying a social investment.

If all these conditions are in place, the funder will then need to balance financial and social considerations. This report includes several scenarios to illustrate a rule of thumb that will help with this process: if a funder is willing to make a grant equivalent to the size of the financial loss in return for the additional social impact gained from making the social investment, then that funder should make the social investment.

## How do I get started with social investment?

Funders need to develop a plan: this will require a degree of flexibility when it comes to implementation, but is key to navigating the market. Every funder's plan is unique and will depend on their personal motivations, the mission and aim of the organisation, the trade-off between financial and social return, the appetite for risk, and the resources required to carry it out. Once a plan is in place, funders need to find social investments that meet their requirements. In this report, we categorise how funders currently source deals as reactive, proactive and collaborative. For newcomers, collaboration is important: peer networks and knowledge sharing can help them to find out more about potential investment opportunities, co-invest, and reduce costs.

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# INTRODUCTION

Social investment has attracted huge attention in the past few years. From the creation of Big Society Capital to the proliferation of social impact bonds, including the high-profile example at Peterborough prison, social investment is now a buzz word in the non-profit sector.

As funders of social change and the charity sector, individuals and grant-making trusts and foundations have naturally shown a great deal of interest in social investment. This interest has grown as funders face increased pressures on their own resources.

In a time of spending cuts and austerity, many funders are seeing growing demand for their funding to pay for services previously supported by government contracts or public donations. At the same time, many trusts and foundations have seen the returns on their investments dwindle, making it harder to sustain their grant making.

In this context, social investment is an attractive prospect for funders who want to do more to support charities and social enterprises, in a way that has the potential to make both more sustainable in the long term.

Some foundations and individuals (including many we interviewed for this research) are already involved with social investment. These early adopters are helping the social investment market to develop and grow. Yet, at NPC, we know of other grant-makers and individuals who are interested in the field but unsure whether it is right for them. The relatively new social investment market can appear complex and difficult to navigate.

## The purpose of this report

We have written this report for UK-based funders—both grant-making foundations and individuals—who are interested in using social investment to increase their social impact, but are not sure if it right for them. This report provides funders with more information about social investment, helps them think through its benefits and risks, and provides some ideas for taking first steps. It is an introductory guide and so is likely to be less relevant to funders already experienced in social investment or those looking for comprehensive, detailed guidance on how to set up social investment processes.

Further resources can be found in the appendices, including definitions of some of the terms used in this report (Appendix A) and references to other reports (Appendix B).

## About this report

This report is divided into four main sections:

- Section 1 provides an overview of social investment: what it is, how it works and what the regulatory background looks like.
- Section 2 looks at when social investment is appropriate, including the advantages, disadvantages and risks of social investment from the point of view of both the investor and the investee.
- Section 3 considers how funders can work out whether a grant or a social investment is a better route to achieving social impact.

- Section 4 helps funders take their first steps in social investment, including developing a social investment plan and considering the issues of appraising a social investment opportunity.

Throughout the report, legal issues are introduced and discussed by Bates Wells Braithwaite.

**Box 1: Bates Wells Braithwaite: Navigating the legal and regulatory environment**

The social investment space is developing quickly, with new enterprises, products and opportunities entering the market all the time. However, the law in relation to charities and trustee investment duties is mostly over 20 years old. This means it is not always easy to interpret and apply the law to new social investment opportunities.

Bates Wells Braithwaite has kindly contributed summaries of some of the key legal and regulatory issues relevant to charities wishing to engage in social investment. These summaries do not constitute advice. Trustees should always consider whether independent advice is needed before investing.

# 1. ABOUT SOCIAL INVESTMENT

This first section provides an introduction to social investment. It covers:

- NPC's definitions of social investment and social impact;
- the social investment market and what funders are doing;
- the types of social investments and how they are repaid; and
- the regulatory background.

## What is social investment?

**Social investment is the provision of repayable finance to charities and social enterprises with the aim of creating social impact (see Box 2) and sometimes generating financial returns.**

This definition is not used universally, and there are overlaps with other terms such as 'impact investing' and 'social finance'. Like many emerging fields, definitions and terminology vary a great deal depending on who you speak to, and they shift as the field develops. We define social investment this way because we think it reflects the most common understanding of the term among UK funders and charities at the moment.

Our definition of social investment constitutes just one part of a broader field that includes 'positive screening'—strategies to integrate environmental and social considerations into mainstream investment decisions—and 'negative screening'—designed to exclude investments seen to do harm (in arms or tobacco, for instance) from a commercial investment portfolio. However, neither positive nor negative screening techniques are considered in this report.

### Box 2: What do we mean by social impact?

Social impact is the difference that you are making to the social problem that you are trying to solve. Whether you are trying to reduce homelessness, eradicate malaria or improve educational attainment, your social impact is the progress you make towards achieving that goal.

It is generally more straightforward to measure the social impact of charities and social enterprises than to measure the social impact of funders. With funders, social impact is achieved indirectly, through the grants they give or investments they make in charities and social enterprises.

The social investment market is still in the early stages of being able to articulate the social impact of investments, with the focus so far being on developing tools and metrics that investees can use to demonstrate their impact. This is certainly an important part of the picture, and funders may want to think about how they can support their investees to put impact measurement systems in place.

Even so, such impact measurement systems cannot fully describe the impact that a funder has had, because the investee's achievements do not depend solely on the funder's investment. Other resources and capabilities (including other funders) are likely to be contributing to this social impact.

Another way of thinking about the impact of social investments is to look at their effect on the investee. For example, it might be that the investment improves the governance or financial management of the investee, or increases its resilience or financial stability. This is something that CAF Venturesome looks at to judge the success of its investments.

Measuring the social impact of funders is an emerging field and research is underway to increase understanding of this complex area. For the purposes of this report, we consider social impact for funders to be:

- the social impact achieved by the investee that the funder has invested in; and
- improvements in the effectiveness of the investee to deliver social impact.

For further resources in this area (including *The little blue book*<sup>2</sup>, NPC's guide to analysing charities), please refer to Appendix B.

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<sup>2</sup> Vernon, B. and Copps, J. (2010) *The little blue book: NPC's guide to analysing charities, for charities and funders.*

## About the UK social investment market

The UK social investment market is currently worth around £200m, and looks set to grow to £1bn by 2016.<sup>3,4</sup> In 2012/2013, 765 social investment deals were carried out.<sup>5</sup> Much of this investment is driven by social banks, with secured loans accounting for 90% of the total market (by value).<sup>6</sup>

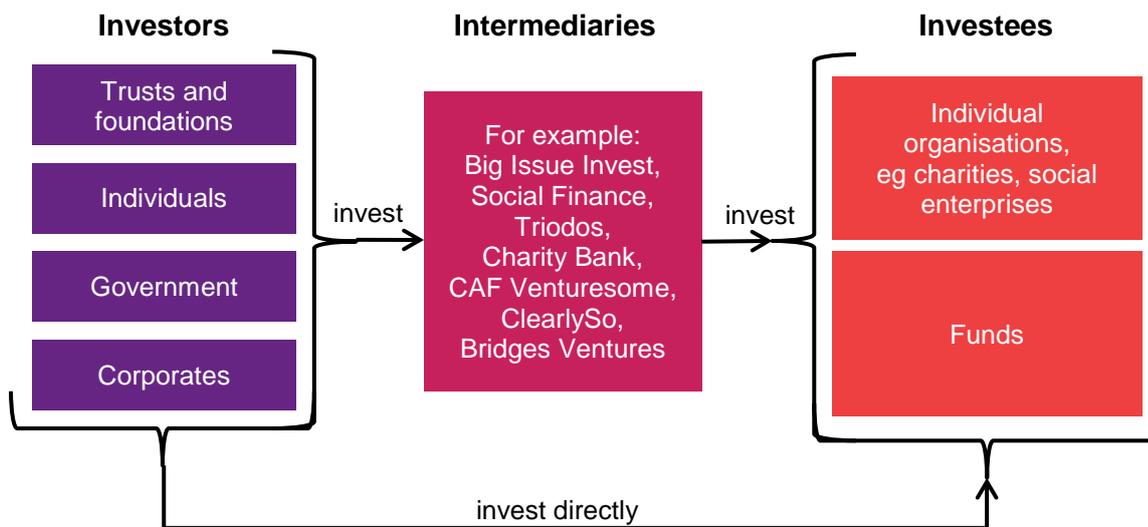
Nevertheless, social investment is still extremely small compared to grant spending: £14.7bn was given in voluntary donations to the charity sector in 2010/2011<sup>7</sup>.

### Key players

The social investment market is structured around three main players: investors, intermediaries and investees (see Figure 1).

Investors supply capital to investees, either directly or via intermediaries. The investment may take different forms depending on the needs of the investee, the preferences of the investor and the products on offer by the intermediaries.

**Figure 1: The structure of the social investment market**



### Government

The government has played an important role in supporting the growth of the social investment market and published its social investment strategy in February 2011.<sup>8</sup>

<sup>3</sup> *Growing the social investment market: the landscape and economic impact* (2013) Prepared for City of London, Big Society Capital and Her Majesty's Government by ICF GHK in association with BMG Research.

<sup>4</sup> Brown, A. and Swersky A. (2012) *The first billion: A forecast of social investment demand*. Boston Consulting Group and Big Society Capital.

<sup>5</sup> *Growing the social investment market: the landscape and economic impact* (2013) Prepared for City of London, Big Society Capital and Her Majesty's Government by ICF GHK in association with BMG Research.

<sup>6</sup> *Ibid.*

<sup>7</sup> <http://data.ncvo-vol.org.uk/a/almanac13/about-the-almanac/fast-facts-2/>

<sup>8</sup> Cabinet Office (2011) *Growing the social investment market: A vision and strategy*.

Most significantly, the government established Big Society Capital in 2011, a social investment bank with £600m from dormant UK bank accounts and investments from major UK banks.<sup>9</sup> The aim of Big Society Capital is to support the growth of the social investment market by investing in intermediaries. It made its first investments in September 2012, providing a total of £37m to 12 intermediaries.<sup>10</sup>

The new Finance Bill (2014) will bring in tax relief for investments in social enterprise following a consultation launched in June 2013.<sup>11</sup>

## Intermediaries

A plethora of social investment intermediaries has emerged in the last few years, with the aim of connecting potential social investors with potential investees. They may do this in several ways, including:

- raising capital among investors;
- providing advice and support to investors on social investment strategy and/or products;
- designing and issuing social investment products;
- managing social investment funds (made up of several social investments);
- supporting charities and other potential investees to get ready to take on investment; and
- researching and publishing information about the social investment market.

Social investment intermediaries include social banks (such as Charity Bank and Triodos) and specialist social investment organisations (such as Big Issue Invest, Bridges Ventures, CAF Venturesome and, ClearlySo) that do a combination of raising capital, brokering relationships between investors and investees, providing advice to investors, developing and managing social investments and funds, and providing support to investees. Organisations like Nesta, NPC and the Young Foundation undertake research and provide information about the social investment market.

Big Society Capital has created a searchable directory of social investment intermediaries on its website<sup>12</sup>, and some of the main intermediaries are listed in Appendix C.

## Investees

Social investments are generally made in organisations that have a social mission. These include:

- **Charities:** Organisations that are registered with one of the three regulators in the UK: the Charity Commission in England and Wales, the Office of the Scottish Charity Regulator, or the Charity Commission Northern Ireland. Charities may take on the investment themselves or through a trading subsidiary.
- **Community interest companies (CICs):** Mid-way between a charity and private company, the social mission of CICs is regulated by the CIC regulator, and there are restrictions on how CICs can distribute their profits and assets.
- **Industrial and provident societies:** Co-operatives and community benefit societies that are '*democratically controlled by [their] members in order to ensure their involvement in the decisions of the business*'.<sup>13</sup>

<sup>9</sup> <http://www.bbc.co.uk/news/business-17602323>

<sup>10</sup> <http://www.bbc.co.uk/news/business-19589982>

<sup>11</sup> HM Government (2013) *Growing the social investment market: 2013 progress update*.

<sup>12</sup> <http://www.bigsocietycapital.com/finding-the-right-investment/>

- **Companies limited by guarantee or shares**, which have a declared social mission: According to Social Enterprise UK, *'to ensure a standard company is a true social enterprise it will need to ensure it has a social mission written into its Memorandum and Articles of Association and is clear about reinvesting its profits.'*<sup>14</sup>

In this report, we use the term 'charities and social enterprises' to cover potential investees in all these different legal forms.

## What are funders doing in social investment?

Little data is available about the numbers and practices of grant-making trusts, and we know even less about the habits of high net worth individuals. Research by ClearlySo has shed some light on a range of potential social investors<sup>15</sup>, but even so, we only have a partial understanding of the role of funders in social investment.

Based on conversations with funders and intermediaries, our understanding is that only a small minority of grant-making trusts and foundations are involved in social investment in a sizeable way. These tend to be the larger UK grant-makers with professional staff and enough resources to be innovators in the sector.

These pioneering foundations are usually interested in testing and growing the social investment market as an objective in itself, as well as trying to achieve specific programmatic aims, such as reducing homelessness. In some cases, the foundation's interest in social investment as a form of social innovation means that it is willing to consider investment opportunities that are less aligned with its programmatic objectives (although still within its legal objects).

*'Funders also see social investment as an additional tool which may be a better tool than a grant in certain contexts. So interest is around understanding this tool, its potential application and value as a complementary or alternative tool to grants for addressing certain social problems and funding certain social innovations.'*

James Perry, Chief Executive of Panahpur

Despite some instances of well-established grant-makers making social investments, relatively few foundations are following in their wake. Although the reasons for this are unclear, we have identified four barriers:

- **The social investment market is not yet mature:** This means that the costs of getting involved are high and there are relatively few opportunities for foundations to make investments, especially using lower-risk, relatively straightforward investments.
- **There is a need to ensure a good financial return on endowment assets** in order to keep up levels of grant-making and/or to ensure objectives for the endowment are met, particularly where the foundation exists in perpetuity.
- **Compared to grants, social investments are often (although not always) complex**, which can be off-putting to funders that do not have professional staff or in-house skills. It can be challenging to value accurately social investments in terms of the likely social and financial risk and return; the legal structures involved are complex (and often bespoke for each investment); and it can be difficult to obtain investment advice (which is regulated). In addition, investment decisions tend to be outsourced to professionals who are not comfortable or familiar with the blending of the financial goals of investment with the social goals of grant-making.

<sup>13</sup> <http://www.socialenterprise.org.uk/about/about-social-enterprise#legal>

<sup>14</sup> <http://www.socialenterprise.org.uk/about/about-social-enterprise#legal>

<sup>15</sup> ClearlySo (2011) *Investor Perspectives on Social Enterprise Financing*.

- **The regulatory and legal environment is unclear.** As the summaries provided by Bates Wells Braithwaite make clear, the legal and regulatory systems that deal with trustees' fiduciary duties and the provision of investment advice have not yet fully adapted to accommodate social investment. So, while social investment is perfectly possible, some funders may find this lack of clarity off-putting.

We believe that this situation is changing and that more foundations are becoming interested in social investment.

Funders who would like to find out more about grant-makers' involvement in social investment should look out for research by the Association of Charitable Foundations (ACF) due to be published later in 2013, which will include findings from a survey of ACF's members about their involvement with social investment.

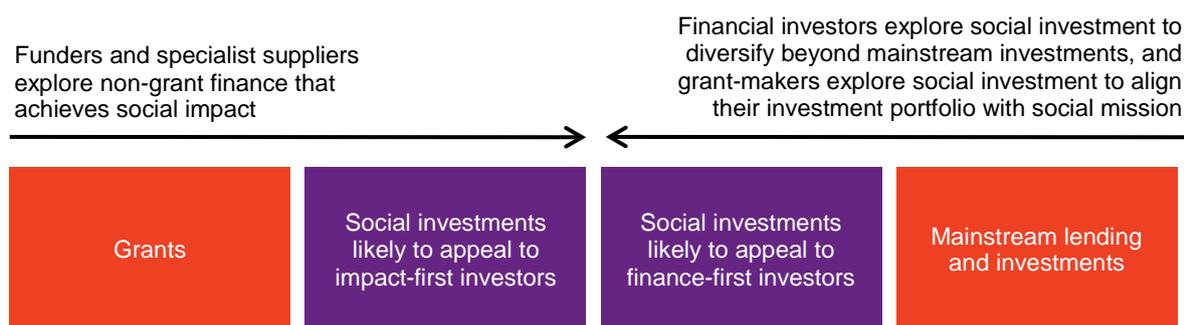
## Two approaches to social investment

Social investors often approach social investment from two different perspectives, depending on their motivations:

- **Finance-first investors** prioritise making a financial return on a social investment, and are often only interested in investments that offer a rate of return that is near to or competitive with mainstream, commercial investments. Finance-first investors often approach social investment with a view to diversifying beyond mainstream investments or aligning their portfolio with their value and/or social mission. Being a finance-first social investor does not necessarily mean sacrificing social impact, but it can narrow the number of opportunities.
- **Impact-first investors** prioritise investments that generate a high social impact. While impact-first investors may receive high financial returns from their social investments, they are usually prepared to accept lower or even no financial return if the social impact created is high enough. Some impact-first investors are even willing to sacrifice their financial returns so that more attractive rates can be offered to other investors demanding higher returns.

These two approaches are summarised in Figure 2. This report is relevant to social investors taking either approach, although it is primarily aimed at impact-first investors who are interested in social investment as a way to increase the social impact of their funding.<sup>16</sup>

**Figure 2: Spectrum of approaches to social investment**



<sup>16</sup> Finance-first investors may also want to read Cambridge Associates (2012) *The UK social investment market: The current landscape and framework for investor decision making*.

## Types of social investment

Despite the wide range of social investment products and structures available, most fall within one of three main categories:

- **Debt:** The most common type of social investment to date, where an investor lends money to a charity or social enterprise, which then repays it over an agreed term, sometimes with interest. Common forms of debt include loans, mortgages, working capital and bonds.
- **Equity:** The investor owns a stake of the investee organisation, most commonly in the form of shares. Relatively few equity investments have been made to date in the UK, as charities are unable to issue shares or dividends.
- **Quasi-equity:** An equity-style structure for investees, such as charities, that cannot issue shares. Quasi-equity investments are often fairly complex, with investors sometimes receiving a portion of revenue generated or similar success-based rewards.

Funders can either make social investments directly into an investee, or indirectly via social investment funds, which will most often be managed by a social investment intermediary.

### Box 3: Social impact bonds

Social impact bonds (SIBs) are one of the most high-profile forms of social investment. Developed by Social Finance, a UK social investment intermediary, SIBs are essentially contracts where the public sector commits to paying for improved social outcomes.

Social investors provide the capital to deliver a set of interventions and, if the improved social outcomes are achieved, the public sector pays investors back and provides them with a financial return. If social outcomes do not improve, investors make a loss. For SIBs to work, improved social outcomes must also create significant savings to the public purse; it is from these savings that investors are theoretically repaid.

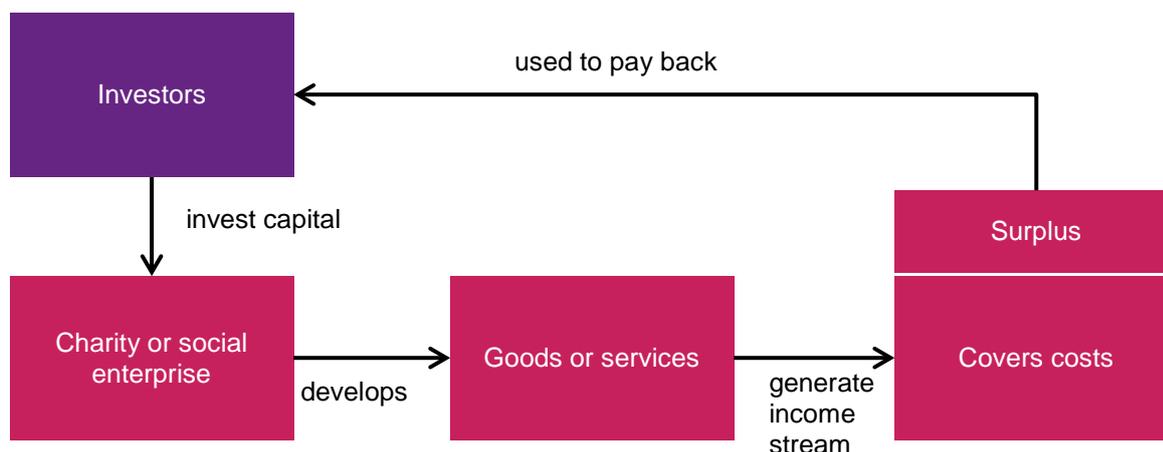
There are 13 SIBs currently up and running in the UK.<sup>17</sup>

<sup>17</sup> HM Government (2013) *Growing the social investment market: 2013 progress update*.

## How are social investments repaid?

At its simplest, social investment works by investors investing capital into a charity or social enterprise. The investee then uses this investment to expand its operations, to develop new goods or services, or to fund working capital. Crucially, these goods and services must have an attached income stream that is sufficient to cover the operating costs and to repay the investor, often with interest. This is summarised in Figure 3.

**Figure 3: Repayment structure of social investment**



## The regulatory environment for grant-making trusts

Grant-making trusts and foundations in England and Wales are regulated by the Charity Commission and so must make social investments in accordance with its guidance, *CC14: Charities and investment matters*.<sup>18</sup> This defines three types of investment that grant-makers might make: financial investments, mixed motive investments, and programme related investments. The primary intention of the investment governs how it is classified, although the other factor that is taken into consideration is the expected financial return of the investment. This information is summarised in Table 1 and more fully described by Bates Wells Braithwaite in Box 4.

**Table 1: Summary of CC14: Charities and investment matters**

	Primary intention	Financial return
Financial investment	Generate return <i>in order to</i> further the charitable objects	Expected financial return and risk profile justify it as an investment
Mixed motive investment	Generate return <i>and</i> further the foundation's aims	Expected financial return and contribution to charity's aims mean that it is not wholly justified as financial investment or PRI
Programme related investment (PRI)	Further aims of charity and generate return	Some financial return
Grant	Directly further charitable objects	No financial return

<sup>18</sup> <http://www.charitycommission.gov.uk/publications/cc14.aspx>

#### Box 4: Bates Wells Braithwaite: Charity Commission guidance

The Charity Commission has issued guidance for charities on investment: *Charities and Investment Matters: A Guide for Trustees*, commonly known as CC14. This guidance identifies three principal types of charity investment: financial investment, programme related investment (PRI) and mixed motive investment.

- **Financial investment** is investment that is justified solely on the basis of risk-adjusted financial returns. Most traditional investment activity by charities is financial investment in this sense, as the object is generally to find the best available returns in the market, considering all the relevant risks associated with any particular investment opportunity.
- **Programme related investment (PRI)** is investment that is justified solely on the basis that the investment is wholly in advancement of the objects of the charity. Examples might be a charity with an advancement of education object investing in a school or an educational product, or a charity with a protection of the environment object investing in renewable energy. Often, there will be a question about whether a particular investment opportunity is wholly in furtherance of a charity's objects, which may be a matter of interpretation and may involve fine judgements of fact and degree. In simple terms, an investment is a PRI investment if the charity could equally make a grant for the same purpose. Where a charity makes a PRI investment, there is no obligation or expectation that the charity will seek the maximum risk-adjusted financial returns. A charity may therefore make PRI investments that involve higher investment risks or lower financial returns than other investments available in the market at large.
- **Mixed motive investment:** In the most recent version of CC14, published in October 2011, the Charity Commission recognised this new type of investment. A mixed motive investment is an investment that cannot be justified by reference to either (a) the expected financial return or (b) the extent to which the investment supports the charity's purposes. It is an investment that can only be justified by the sum of these elements—in essence, by a dual financial and social return.

The practical consequence of the revised CC14 guidance is that, as far as the Charity Commission is concerned, it is now clear that charities will often be able to accept a discounted financial return on their investments in exchange for greater social impact, where that social impact is related to the objects of the charity. The guidance helps charities wishing to invest in social enterprises or social investment products.

In practice, given the state of development of the social investment market, many or most of the social investments made by charities will be mixed motive investments in this sense, involving greater risks or lower expected returns than other investments.

Section K of CC14 sets out in detail the practical questions and issues that the Charity Commission believes trustees should consider before deciding to engage in mixed motive investment. However, CC14 only represents the Charity Commission's view of the law.

## Summary

- The social investment market in the UK is small but rapidly developing, with the support of the government and the charitable sector. The momentum behind investing to create social impact is strong.
- Investors currently consist of a small group of foundations and grant-making trusts, with very few individuals involved at this stage, although the investor base is expanding.
- Funders are being put off by various barriers, including the high costs of involvement, relatively few available opportunities, the complexity of instruments, the lack of in-house skills, difficulty in obtaining investment advice, the unclear legal and regulatory environment, and the need for endowed foundations to maintain a good financial return to continue their grant-making activities.
- The number of intermediaries and deals is increasing (from a low base). The social banks are providing the bulk of finance, and a bond market is emerging.
- The regulatory environment is also moving in the right direction and the government has committed to a tax relief for social investment.

## 2. IS SOCIAL INVESTMENT RIGHT FOR ME?

Funders interested in social investment should first think of their mission, what they are trying to achieve and whether social investment can help in this.

Social investment is not always appropriate, so funders should also think about the circumstances in which they make a social investment.

An understanding of the advantages, disadvantages and risks of social investment can inform funders in this process. This section considers these from both the funders' and the investees' perspective.

### What are the advantages, disadvantages and risks?

Funders need to consider the advantages, disadvantages and risks of social investment for themselves and for their potential investees. As social investment is still a new field, there is not a lot of information or evidence here. Table 2 highlights some of the main risks, explored in more detail below.

**Table 2: Advantages, disadvantages and risks of social investment**

	Funders	Investees
Advantages	<ul style="list-style-type: none"> <li>Leads to closer alignment between investment portfolio and grant-making</li> <li>Can achieve financial return</li> <li>Has the potential to increase social impact</li> <li>Increases efficiency by recycling funds</li> <li>Potentially frees up valuable grant-funding</li> <li>Increases accountability for investee</li> </ul>	<ul style="list-style-type: none"> <li>Allows (accelerated) growth or investment in crucial assets</li> <li>Improves access to finance</li> <li>Conserves cash, especially unrestricted, needed elsewhere</li> <li>Has the potential to increase sustainability</li> <li>Opens up a new source of funding/ new audience and diversifies income</li> <li>Provides new financial discipline and rigour</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>Entails a steep learning curve</li> <li>Requires additional resources and skills</li> <li>Has little track record</li> <li>Is an immature market</li> </ul>	<ul style="list-style-type: none"> <li>May need a lot of work to get investment ready</li> <li>May require culture change</li> <li>Requires repayment</li> </ul>
Risks	<ul style="list-style-type: none"> <li>Financial returns are sub-market or capital is not returned at all</li> <li>Social impact is not delivered</li> <li>Reputational risk</li> <li>Legal and regulatory risk</li> </ul>	<ul style="list-style-type: none"> <li>Unable to repay investors</li> <li>Social impact is not delivered</li> <li>May cannabalise existing grant funding</li> <li>May cause mission drift</li> </ul>

## What type of funder are you?

The advantages, disadvantages and risks presented above do not apply equally to all types of funders. Depending on the nature and circumstances of the funder, some of the advantages will be more or less compelling and some of the disadvantages more or less of a constraint. For example, an individual investor interested in making a social impact with an appetite for risk may be less concerned about getting his or her capital returned. The investor may worry more about the resources needed to make social investments.

For endowed trusts and foundations, a key consideration is the status of their endowment. The Association of Charitable Foundations classifies endowments into four types:

1. permanent endowments, which are required by law to operate in perpetuity;
2. expendable endowments, which are not technically obliged to exist in perpetuity but which may aim to preserve the value of the endowment for future generations;
3. endowments that are spending out within a specific time frame; and
4. foundations that take an open-ended approach to longevity, spending what seems appropriate in terms of mission without making preservation of the endowment a goal.<sup>19</sup>

For example, foundations with a permanent endowment (see Box 5) or with a strategic decision to exist in perpetuity may find that the need to retain the value of their endowment for future generations is a particular constraint.

Where possible, we have highlighted how different types of funder might be affected by these different considerations. However, it is important for funders thinking of making social investments to identify the legal or governance structures that apply to them and think through how the following advantages, risks and benefits might apply to them.

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<sup>19</sup> Jenkins, R. and Rogers, K. (2013) *For good and not for keeps. How long term charity investors approach spending on their charitable aims*. Association of Charitable Foundations.

**Box 5: Bates Wells Braithwaite: Permanent endowments**

Charities with investment permanent endowment (ie, in which the capital of the endowment cannot be spent and must be invested to generate an income return that must be used for particular purposes) are under an obligation not to spend but to invest their endowment. The courts have generally interpreted this to mean that these charities have an obligation to seek the best risk-adjusted financial returns available in the marketplace.

Nevertheless, charities with permanent endowment may pursue a variety of approaches to social investment. Such charities may, for example, socially invest on the basis of risk-adjusted financial returns only, where the investment is an attractive one with a low level of risk. This may involve seeking social investments with relatively low returns but relatively low levels of risk, as part of a diversification strategy. At current interest rates, charity bonds, for example, may be more attractive than money market funds and may provide a source of low-risk income in a diversified investment portfolio.

Charities with permanent endowment may alternatively use the income generated by their invested endowment for social investment purposes, if this furthers the purposes of the endowment.

This may be carried out as part of a 'total return' approach to investment of permanent endowment. This approach allows charities to invest permanent endowment more flexibly with a view to maximising the overall return, whether capital gain or income. A total return approach to investment also allows the trustees of a charity to spend capital gain by enabling them to allocate a proportion of the capital gains on its endowment to income that can be spent.

Prior to the Trusts (Capital and Investment) Act 2013 it has usually been necessary to apply to the Charity Commission for an Order to permit trustees to take a total return approach to investment of permanent endowment.

In certain circumstances, it will soon be possible for charities to decide to take a total return approach to investment of permanent endowment without a Charity Commission Order under s104(4) of the Trusts (Capital and Investment) Act 2013, once the relevant provisions come into force and the Charity Commission has produced the requisite regulations on which it is currently consulting. This may facilitate additional social investment.

## For funders

### Advantages

#### **Leads to alignment between investment portfolio and grant-making**

All funders have a social mission at the heart of what they do, and for many, their social mission is achieved solely through their grant-making. For foundations with endowments, the grants given often come from the return earned on their investments. These foundations are likely to invest their capital in commercial investments in order to maximise their returns and, therefore, their grant-making.

Social investment, on the other hand, promotes greater alignment between funders' social mission and how their capital is invested. It allows their social mission to be achieved via their investments as well as their grant-making.

### **Has the potential to increase funders' social impact**

Funders that incorporate their social mission into both their grant-making and their investments have more resources with which to achieve their mission. This gives them the potential to achieve more social impact. We discuss this idea in more detail later in this section.

### **Increases efficiency by recycling funds**

Whereas grants are a one-time transaction, social investment is returned. This means it can be recycled and used again to support a new investee, so the same money can potentially make a social impact several times over.

### **Frees up valuable grant funding**

Grant funding is a precious and finite resource. Social investment provides an alternative way of financing projects that can repay an investor. The result is that funding previously used to support such projects could be used to support initiatives where social investment is not a possibility.

### **Increases accountability for investees**

After a grant is given, it can be difficult for the recipient to remain accountable to the funder. Social investment and repayable finance increase the accountability required of the investee. James Perry of Panahpur views this as a key differentiating factor that can also offer the funder the opportunity to support that charity in a number of additional ways, because the nature of an investment relationship is ongoing, whereas grants are often one-off transactions.

## **Disadvantages**

### **The learning curve is steep**

Social investment can be a steep learning curve for those involved. Grant-makers may be unfamiliar with the terminology, structures and processes of making investments. For those with a financial background, the complex world of social change may seem remote from the more clear-cut environment of financial investing.

### **Additional resources are needed to make investments**

The process of making a social investment is likely to require additional resources. Funders wanting to support particular organisations or sectors may need to work hard to source investments, and may need to provide support to potential investees to help them get ready for taking on investment. Many grant-makers do not have all the necessary in-house capacity to source, appraise and execute social investments, and may need to rely on external advice. (See Appendix C for a list of intermediaries who can help.) Funders are likely to incur fees for legal and professional social investment advice, as well as for undertaking due diligence.

### **The social investment market is immature and has little track record**

This immaturity means that, like with all emerging fields, things constantly change as the market is developing, and funders may also have to contend with a great deal of uncertainty. For example, there is currently no well-developed way to value social investments, partly because there are not very many of them yet and because few of them have actually matured with investors successfully being repaid. Funders will need to be comfortable with that uncertainty if they are to find making social investments a satisfying experience.

## **Risks**

### **Financial returns may be sub-market or capital may not be returned at all**

As with any investment, there is a risk that the investee is unable to pay back the investment, and so the funder loses its capital. Even where the investee successfully repays, many (but not all) social investments

available today provide a sub-market financial return—ie, below what one would expect in the commercial investment world given the same level of risk and limited options for trading investments.

This is not necessarily problematic in itself: individuals may be prepared to take some loss in return for the social impact created. Similarly, foundations that are legally or strategically able to spend down their endowment over time or that make social investments from their grant-spend may be willing to accept losses.

However, this can be a thorny issue for grant-making trusts and foundations that are making social investments from their endowment and that need to preserve the real value of their assets. This is often the case for foundations that have permanent endowments (ie, with a legal obligation to exist in perpetuity) and for foundations that have expendable endowments but where a strategic decision has been made to maintain the value of the endowment for future generations.

Instead of reducing the endowment by taking a loss on investment, funders can absorb the loss by reducing the level of grants made. Some grant-makers have specifically designated a pot within their grant spending to absorb losses. However, this may not be attractive to funders who have pledged to maintain their grant spending and who see social investment as a means opening up the amount of funding available in the sector.

### **Social impact may not be delivered**

As well as financial risks, investors face the risk that the social return is not achieved. For example, a project that aims to get 350 young people into employment may only end up helping 150 to get jobs, with 35 losing their jobs after six months.

Funders can reduce this risk in two ways. First, they can understand the evidence base for the intervention being used, asking the question: How do we know if the intervention being delivered is going to fix the problem we're trying to solve?

For some interventions, we may have a very good idea of the answer. For example, there have been several high-quality randomised controlled trials using multi-systemic therapy (which is being used as part of the social impact bond to prevent young people going into care in Essex) that show a good success rate. For other interventions where we have less solid evidence, there is a higher risk that the social impact will not be achieved.

The second way funders can reduce the risk of a social return not being delivered is by ensuring that the investee providing the intervention has the capacity and capability to deliver. Understanding what organisations effective at delivering social change look like is an area that NPC has researched extensively and our framework for analysing charities, *The little blue book*, can be found on our website.

### **There are reputational risks**

Social investment programmes may create a reputational risk for funders, especially where things go wrong. In the event of an investee being unable to repay a loan a funder has the right to recall the loan. However this decision can be difficult and cause the funder to weigh the reputational risk of doing so against their contractual rights.

## For investees

### Advantages

#### **(Accelerated) growth of services and investment in assets that support social impact**

Social investment can support the growth of successful financial models by helping them to expand and grow. For example, the social enterprise Turning Point received investment and expertise from Big Issue Invest to develop its new social enterprise, Connected Care, which delivers health, housing and social care services. These services are paid for by local authority contracts, which are used to repay investors.

Social investment can also help organisations to create an impact more quickly than with grant funding or fundraising. For example, Hartlepool Hospice took out a loan to purchase its new hospice building, then successfully used grants and donations to pay the loan back.

#### **Improved access to finance**

Social investment provides charities and social enterprises with access to finance, which they may struggle to find elsewhere. NPC has heard that charities find it hard to secure finance for even basic low-risk products, such as mortgages or working capital. In some cases, the interest rates demanded by mainstream banks are not affordable. In other cases, mainstream banks see charities as high risk—either because they do not understand charities' business models or because they are concerned about the reputational risk of things going wrong.

#### **Does not use valuable cash that may be needed elsewhere**

Social investment is appropriate for some charitable activities (such as running an employment programme with an income stream) and inappropriate for others (such as campaigning). Where social investment is used appropriately, it can free up scarce grant funding to be used for activities that are difficult to fund and where social investment is not appropriate.

#### **More funding opportunities**

Funders willing to open up their balance sheets to social investment potentially increase the total size of the funding pot that charities can access. Social investment may also attract investors into the social sphere who may not have been philanthropists in the past but may be interested in taking a finance-first approach to investment. NPC has seen limited evidence to support this idea, but even so, there is certainly a benefit for the investee in diversifying sources of income.

#### **Potential for sustainability**

Social investment might help some charities become more sustainable over the long term. This is because social investment requires an income stream in order to pay the investor back. Once an investment has been returned, this income stream will potentially make the charity less reliant on grants and donations in future. However, if taken on by the wrong organisation for the wrong project it can damage an organisation's sustainability through diverting resources to repay the investment.

#### **New financial discipline and rigour**

Proponents of social investment suggest that it brings a new discipline and rigour to investees. For example, a charity may need to invest in new financial systems in order to manage and repay an investment, and may need to develop social impact measurement systems to report back on investors' social return.

## Disadvantages

### Charities may need help to get investment ready

In our experience of working with charities, many are far away from being investable propositions. Charities that have historically received most of their income from grants and donations may not have the financial model, skills or systems to manage and repay an investment. Funders that want to invest in charities may therefore have to provide a great deal of support to help a charity prepare to take on an investment.

Funders may find more investable opportunities among social enterprise models, such as community interest companies, which are designed to generate revenue streams.

### Charities may require a culture change

Social investment sometimes faces cultural barriers. Charities may feel that repaying an investment (potentially with interest) jars with their values and diverts funds away from helping people in a great deal of need.

### Repayment may delay or reduce social impact

The key difference between social investment and grant funding is that the former involves repayment. So the investee has to use resources that it would otherwise be using for its own purposes to repay the investment.

For instance, if a charity receives a £100,000 grant to invest in a shop, all the profit from the shop is immediately available as unrestricted income for use, say, in a charity campaign. But if the charity receives the same funds in the form of a loan, the profits from the shop in the years during the payback period would have to be directed to repayment of the loan, unless it could be refinanced externally. The profits would only become available to the investee once the loan is repaid.

Of course, if the investee is offered no choice (no grant is available, but a loan is available), then the charity may decide that the loan is still a good option.

## Risks

### The investee may be unable to repay investment

An investee may not be able to repay its investment for several reasons. Perhaps the charity's forecasts were wrong: it may have misjudged demand for its services, or it may have been affected by factors beyond its control (such as the local government spending cuts). The timing of its income may also have changed. For example, income may be generated at a slower rate than was originally anticipated.

The impact of being unable to repay an investment will vary, often according to the terms of investment and the patience and motivations of the investor. Investments can be restructured (ie, a new set of payments will be agreed) and/or rescheduled (ie, the timing of the payments will be renegotiated).

As a last resort, the investor could enforce repayment, which may involve the appointment of an administrator to run the operations and recover money. If administration fails, a liquidator will sell assets to recover the loan and wind up the operation. If the investment is a secured loan, the lender can recover its money from the sale of assets or mortgaged buildings in preference to other creditors.

This may well cause a conflict between the financial interests and charitable objects of a funder. For example, the social investment foundation Panahpur, takes the approach on a case-by-case basis to write off the loan rather than enforce repayment if it would be detrimental to the charitable objects. This presumes that the investee has acted in good faith but has still been unable to repay the loan. However, it is crucial that the

investor maintains the right to enforce repayment if it chooses, rather than creating the expectation that loan forgiveness is acceptable.

### **Social investment may cannibalise grant funding**

Those nervous about social investment worry that it may actually reduce the total amount of funding in the sector because funders will start offering investments instead of (rather than as well as) grants. If financial returns from social investment are lower than returns from mainstream investments, this will in the longer term reduce the value of the endowment and inevitably the amount available for grants. However, NPC is clear that grant funding will always be required for certain areas of the charitable sector and that social investment should be seen as an additional tool, not an alternative to grants.

### **Social investment may cause the investee to stray from its mission**

There is a risk that potential investees will pursue investment opportunities in order to help secure a revenue stream, which will result in the investee delivering services that are not well-aligned to its mission. This is also a danger with grant funding, and NPC has not seen any evidence to suggest that it is any more of a risk with social investment.

## **Summary**

- Funders considering social investment should focus on how they can use social investment to achieve their mission.
- Funders may be constrained by the terms of their endowment. However, the Trusts (Capital and Investment) Act 2013 may facilitate more social investment in the future.
- The advantages of social investment for funders include aligning assets with mission, potentially achieving more social impact through the recycling of funds, and increasing the accountability that funders have with their investees due to the long-term nature of a social investment. Disadvantages are mostly practical but still significant, especially for less well-resourced organisations. The largest risk is that the potential expected returns—social and financial—are not achieved.
- For investees, there are advantages in having a new source of capital, with a knock-on impact on sustainability and rigour. However, their readiness for social investment and the culture change that might be required could cause problems. The main risk for investees is the repayment required.

## 3. SHOULD I MAKE A GRANT OR A SOCIAL INVESTMENT?

Funders interested in getting involved in social investment should think about their mission and what they are trying to achieve. In this report, social investment has been introduced as a new tool that can be used alongside grant-making. But many funders have had little experience with social investment and how it can be used.

This section looks at the choice that a funder may have between grants and social investments. In some cases funders may have a choice between the two: from a funder's perspective, a project or organisation that looks attractive for a social investment might also look attractive for a grant. From a charity's perspective, however, a grant may be more desirable even if a social investment is feasible, because there is no repayment requirement. However, funders should be aware making a grant over a social investment in this situation may deny grants to those with no investment option, and can also lead to a missed opportunity for the organisation receiving the grant—the opportunity to develop greater sustainability.

The second part of this section uses a hypothetical example to take the funder through the decision-making process of choosing between a grant and social investment, assuming that the funder is driven by the desire to maximise its impact. NPC thinks that funders should consider a social investment if the financial sacrifice (assuming lower financial returns from a social investment compared to a mainstream investment) is compensated by the additional social impact gained.

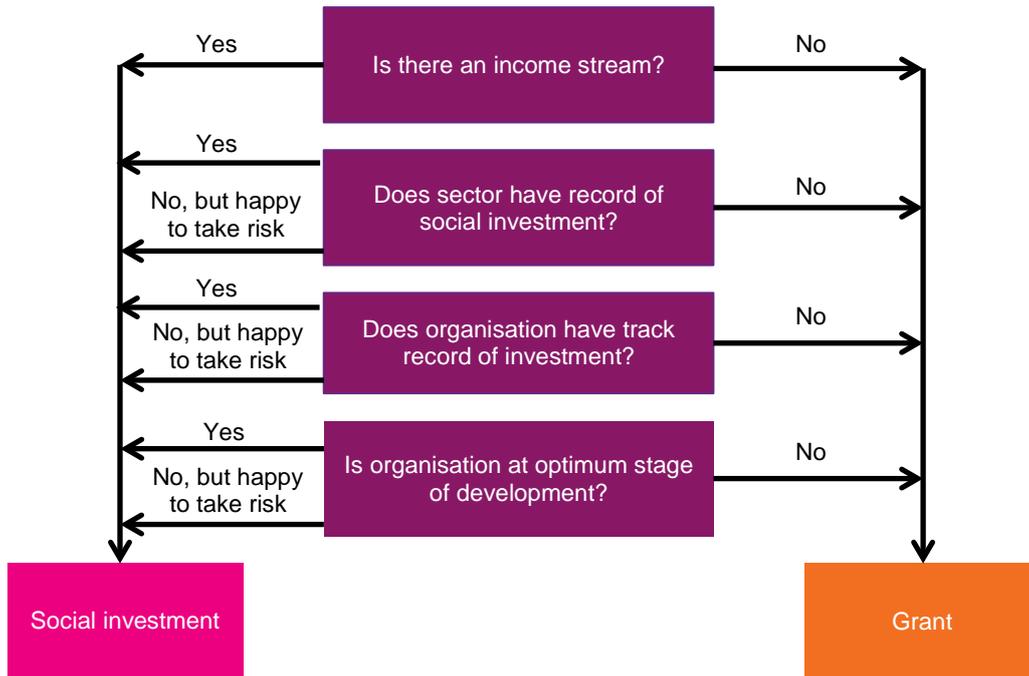
### What are the considerations?

When deciding if social investment might be a way to help them achieve their mission, funders should consider four key factors:

- Is there an income stream to repay an investment?
- Does the sector have a track record of social investment?
- Does the organisation have a track record of repaying social investment?
- Is the organisation at the optimum stage of development?

The decision tree in Figure 4 lists these considerations and suggests when a funder might consider that a grant is preferable to a social investment. These paths are not hard and fast rules but more a rule of thumb.

**Figure 4: Decision tree for social investment**



These questions are explained in more detail below. If a funder has answered mostly ‘no’ to the questions, then a grant is likely to be the most suitable funding option. Social investment in these circumstances is likely to be very high risk and so should either be avoided or used only where the funder accepts the risk and is prepared to be engaged and monitor the investment closely.

### Is there an income stream attached to the goods or services being provided?

For a social investment to be considered, there must be a revenue stream or other source of repayment that will allow the funder to receive its money back. Table 3 lists some of the goods or services with an income stream that a charity or social enterprise might seek investment for.

**Table 3: Goods and services that generate income**

Goods or service	What might the investment be used for?	Income stream	Who pays for the goods or service?
Supported-living service for adults with mental health problems	To cover up-front costs of a new or expanded service	Contract to deliver services	Government
Charity shops	To refurbish new shops, employ staff and buy stock	Trading	Charity shop customers
New hospice building	Bridge funding to enable the building to start without waiting for all donations to come in	Donations	Hospice’s donors
Community café	Set-up costs for the café, including hiring staff and	Trading	Café customers

	buying equipment		
Employment support services	Working capital to run the service until the results payments are received	Payment by results contract <sup>20</sup>	Government
Supported housing for disabled people	To build the supported housing	Rent and/or housing benefit	Tenant and/or government

Not all activities that a charity or social enterprise provides will be able to generate revenue and, for these kinds of activities, a grant is likely to be more appropriate than investment. This may be because there is no obvious revenue model—as is the case with many campaigning activities, where there is no obvious ‘buyer’. In other cases, it might be inappropriate to charge for the good or service. For example, an organisation that provides a confidential support service for people who have experienced abuse could in theory charge for the service, but many organisations feel this is not appropriate.

Some organisations do not have any activities for which they can immediately start generating revenue, but they have the potential to do so in the future. For example, a start-up that is set up to provide positive activities for young people might, in future, be in a position to bid for contracts from the local authority, for example, to provide youth services or support for vulnerable young people. Here, a funder could choose to support the organisation either with a grant or, if there is the appetite, with a long-term high-risk investment. Alternatively, venture philanthropy might be an option (see Box 6).

#### Box 6. What is venture philanthropy?

*‘Venture philanthropy works to build stronger social purpose organisations by providing them with both financial and non-financial support in order to increase their social impact.*

*As venture philanthropy spreads globally, specific practices may be adapted to local conditions, yet it maintains a set of widely accepted key characteristics: high engagement, tailored financing, multi-year support, non-financial support, involvement of networks, organisational capacity-building and performance measurement.’*

European Venture Philanthropy Association<sup>21</sup>

Venture philanthropy sits between a conventional grant and a social investment. It is different from a grant because of the high level of engagement between the funder and investee that goes beyond what is usually seen in traditional grant-making. It is different from a social investment because the funder is not looking for capital to be repaid, but it does share with social investment a focus on organisational capacity-building and performance measurement.

<sup>20</sup> A payment-by-results contract is one where a portion of the funding is withheld until an agreed result has been achieved. There is growing government interest in using payment-by-results contracts and to date, the most notable example of this arrangement has been the Work Programme, the government’s welfare-to-work initiative whereby those providing the service are paid according to the number of people who go into sustained employment.

<sup>21</sup> <http://evpa.eu.com/knowledge-centre/what-is-vp/>

## Does the sector have a track record of investment?

Some sectors are more suited to taking on social investment than others. For example, several funders we spoke to mentioned that it is challenging to find viable social investment opportunities in the arts sector, and there are more deals in the employability sector.

The reasons for this are varied, but one important factor is the potential to earn income from goods or services delivered by organisations in that field. Opportunities may be particularly good in sectors where charities and social enterprises can win contracts to provide government services, which have the potential for a reliable income stream.

Sectors in which charity or social enterprise services can save government money may be more attractive for social investment: social impact bonds are predicated on the idea that the intervention used will deliver substantial cost savings to local or national government, and have been developed in the fields of prisoner rehabilitation, homelessness, and children in care on that basis. Sectors that have been using social investment to good effect include:

- **Health and social care services:** Social investment is used to finance innovation and expansion of services, including new mutuals (often spun out from the health service) offering medical services, or charities providing residential or home-based social care. The statutory nature of these services means that demand from government is steady and continuing. Services offering marginal cost savings, greater efficiencies or improved outcomes are likely to win here.
- **Criminal justice:** The first social impact bond was developed in this sector to reduce reoffending. Criminal justice services provided by potential investees are often government commissioned and there are opportunities for savings to the state if services improve outcomes.
- **Young people:** There is a policy focus on early intervention and prevention services for young people who are at risk of poor outcomes in adulthood. This focus offers similarly promising savings, so parts of this sector may also be attractive to social impact bonds.
- **Sectors with financeable community assets:** Such assets include community centres, community-owned pubs or shops, and charities with buildings that can be rented out. Assets bought by communities can be run on a commercial basis given the right mix of up-front funding. The Big Lottery Fund and Big Society Capital have pledged £250m for community investment over the next ten years.
- **Environmental services:** These services offer the potential for financial savings to both the public sector and private consumers. The environmental sector has a lengthy track record in revenue-generating activities, including local waste digestion, recycling facilities, home insulation schemes, carbon payments, and renewable energy.

## Does the potential investee have a track record of investment?

Funders may have more confidence in making a social investment where the investee has a track record of successfully taking on and repaying a social investment. For example, some investors found Mencap's Golden Lane Housing bond attractive because Mencap had issued a bond before.

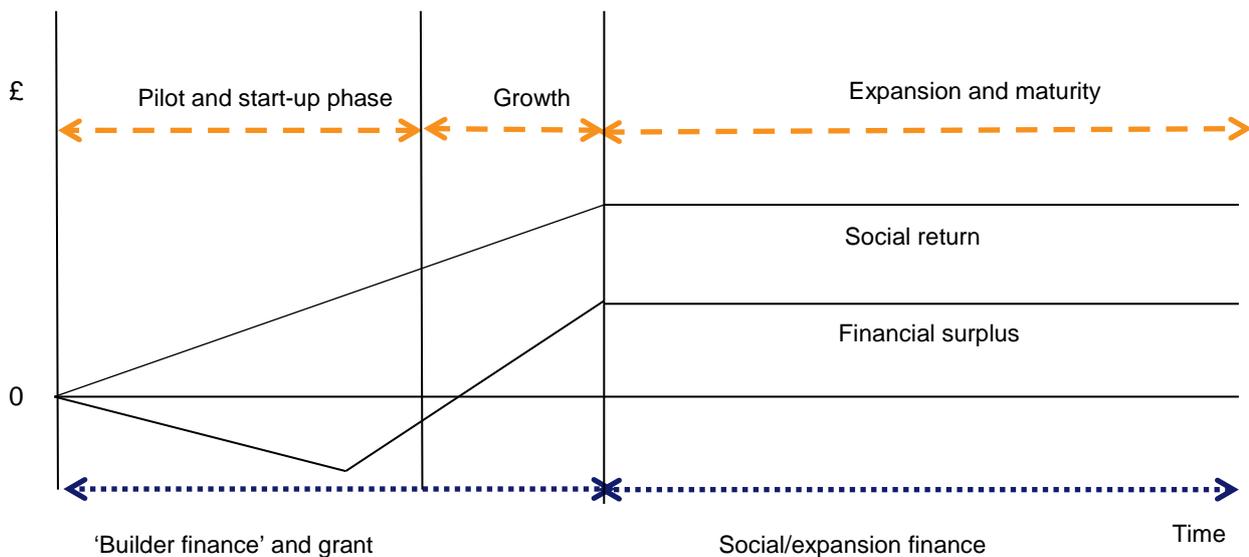
However, funders may find it hard to follow this principle all the time: as social investment is at an early stage, many potential investees do not have a track record yet. This does not mean that a funder should reject the idea of giving a social investment, but it may mean taking more care to assess the financial systems and capabilities of the investee's staff.

## Is the organisation at the optimum stage of development?

Organisations at different stages of development are more or less suited to repaying a social investment.

Organisations that are just starting up or are piloting new activities will not be generating surpluses because the revenues will be lower than the costs. If an organisation is not making a surplus, it will have difficulty paying back a loan. This is illustrated in Figure 5, adapted from a graph by Tomorrow's People.<sup>22</sup> Only when an organisation generates a financial surplus can it think about repaying capital. Funders must therefore understand the potential risk of making a social investment at particular stages of an organisation's development.

**Figure 5: Social return and financial surplus**



Adapted from: Davison, R. and Heap, H. (2013) *Can social finance meet social need?* Tomorrow's People and CanCook.

- Grant funding or builder finance (such as long-term patient capital, equity or quasi equity) is appropriate during the early stage of an organisation's development. For a start-up charity or social enterprise, its ability to repay a loan may be limited (as illustrated by negative finances in Figure 5). At this stage, revenue is unlikely to exceed costs—the organisation may be incurring capital costs associated with starting up and revenue streams may not be established. Even where income streams are already established, they may not yet be reliable enough.

In these situations, a grant (or venture philanthropy) rather than a social investment may be the most appropriate way to support a start-up. This was echoed in our conversations with funders and intermediaries for this research, several of whom cautioned against using social investment to support the development of a newly established organisation. For them, social start-ups are extremely high-risk propositions and investors are likely to lose money.

Although investment at this stage may be high risk, there is demand for it among investees—who often find start-up capital hard to access. The charity Tomorrow's People and social enterprise CanCook suggest that early-stage charities or social enterprises need builder finance that will support the investee as a whole to

<sup>22</sup> Davison, R. and Heap, H. (2013) *Can social finance meet social need?* Tomorrow's People and CanCook.

develop and grow. The report *Growing the Social Investment Market* also found that there was still not 'sufficient identified high-risk unsecured social investment' for third sector organisations.<sup>23</sup>

- Financial value only turns positive in the growth phase of an organisation's development. Expansion finance is appropriate once the model is proven and revenues exceed costs in the expansion and maturity phase.

Once the charity or social enterprise has become established—crucially, when revenue exceeds costs—then social investment may become more appropriate. Investment might be to support expansion of services or it might be to invest in an asset, where the charity has a good track record of stable revenue income streams to repay.

- In this model, investors initially only receive social returns, but once revenue streams have been established, investors 'may wish to provide instruments that convert into providing a financial return once the business has achieved certain benchmark performance criteria for revenues, financial surplus etc'.<sup>24</sup>

## What if I have a choice: will a grant or social investment have more social impact?

So far, the discussion has started from a default position that funders should give grants unless a number of conditions are in place that make social investment a viable opportunity. But if those conditions are in place and there is a clear opportunity to make a social investment, how can a funder weigh up the two options?

We have broken down this decision-making process into three stages:

1. Which will create a higher social return?
2. What is the financial trade-off?
3. Putting the social return and financial trade-off together.

### Which will create a higher social return?

The social return of a grant is the social impact on beneficiaries from increased capacity and effectiveness of the organisation. Assuming a funder is investing in the same project, the social impact of a social investment is:

Social impact on beneficiaries arising from increased capacity and effectiveness of organisation

**PLUS**

Additional social impact from recycling funds

**MINUS**

Costs of repayment

- The social investment will enable the organisation to grow, provide a new service or activity and hence create social impact for its beneficiaries, in the same way as a grant would. In addition, social investment may increase the effectiveness of the organisation by more than a grant through the insistence on impact measurement and financial rigour (see Box 2).
- When the social funder's investment is repaid, the funds can be recycled into more social investment and create further social impact. In debt finance, when a bond matures, the investor receives his or her capital

<sup>23</sup>

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/205295/Social\\_Investment\\_Strategy\\_Update\\_2013.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205295/Social_Investment_Strategy_Update_2013.pdf)

<sup>24</sup> Davison, R. and Heap, H. (2013) *Can social finance meet social need?* Tomorrow's People and CanCook.

back, which can then be reinvested. This is an additional opportunity to achieve social impact, compared to a grant. However, some funders may need the capital for their own purposes and be unable to offer such recycling.

- The repayment of a social investment can lower the initial social impact of the investment, compared to a grant. This is because the organisation has to find the means to repay the investor, which diverts some funds away from potential beneficiaries until the investment is repaid. This is not necessarily bad: if the investment has enabled the organisation to scale up, then the cost of repayment will be small in comparison with the benefit. However, the social impact cost of the repayment is important to consider and is often overlooked by market commentators. The costs of repayment risk place a future burden on investees, which could reduce their overall capacity.

These last two bullets go to the heart of the conundrum: who will be most effective at recycling the funds created by the investment? The investor or the investee?

## What is the financial trade-off?

The financial trade-off is complicated because social investments are generally made from the endowment and grants are generally made from income (generated by the endowment).

If a social investment is made from the grant allocation, there is no financial opportunity cost to making that investment. However, if the social investment is made from the endowment, there is a financial opportunity cost. This is the difference between the financial return expected on the endowment and the financial return expected on the social investment. For example, if the endowment is expected to return 5% per annum and the social investment 2% per annum, there is a financial trade-off of 3% per annum.

## Putting the social impact and financial return together

Funders should initially consider a social investment if the financial sacrifice (assuming lower financial returns from a social investment compared to a mainstream investment) is compensated by the additional social impact gained.

- Rule of thumb: would you be willing to make a grant equivalent to the size of the financial loss in return for the additional social impact you gain from making the social investment?

If 'yes', then you should make the social investment.

Box 7 takes a funder through this process using two financially comparable scenarios and then considering a straightforward grant.

### Box 7: Social investment scenario

Consider a funder that has £100,000, which it wants to use to support a social housing building project. Assume in all cases that the funder seeks to maximise social impact.

The social impact for the grant or investment will be:

- A house for a family to live in. We assume that £100,000 covers the costs of building a house.
- A sustainable income stream for the investee. The family that occupies the house will pay rent. We assume that this is £10,000 a year.

The funder has a choice of:

- **Scenario 1:** Socially investing £100,000 from the endowment and getting 2% per annum return over five years.
- **Scenario 2:** Commercially investing £100,000 from the endowment and getting 5% per annum over five years, which is used to make an annual £5,000 grant (ie, £25,000 total).

NPC sometimes meets funders who ask: *‘Why am I lending this amount when I could give it directly?’* So we have run a third scenario, where the funder is able to spare the whole amount and give it as a grant.

- **Scenario 3:** Making a grant of £100,000 (not financially comparable but a relevant issue for some funders).

Using a hypothetical housing bond example, the three scenarios are worked through below.

#### Scenario 1: The funder invests £100,000 from the endowment into the social housing bond



Scenario 1 shows how investing £100,000 in the bond results in a house being built immediately and occupied by a family. It also generates income for the housing provider as the family pays rent. In addition, investees can benefit from the increased discipline required of social investment. However, the housing provider must offset the rent against interest and capital repayments on the loan, which limits funds available for building more houses. The initial investment can also be recycled once it has been repaid.

**Scenario 2: Investing £100,000 commercially and using the return to make a grant of £5,000 per annum**

**Social impact of current project**

- Social impact of project created by investee
- Increased organisational effectiveness of investee

Example:

- Social impact is what can be achieved with a £5,000 grant, investee cannot build the house upfront.
- As the house cannot be built upfront, there is no additional income stream.

**Opportunity cost as £100,000 cannot be recycled**

Example:

Investor has kept capital and can continue making small annual grants.

In this scenario, the social impact is limited to what can be achieved with a 5% per annum return, and an annual grant. It takes 20 years to build a house, or alternatively, the cash could be used to pay salaries. However, as with Scenario 1, there is the potential to create further social impact by using future returns on the commercial investment.

**Scenario 3: Funder makes a grant of £100,000**

**Social impact**

- Social impact of project created by investee
- Increased organisational effectiveness of investee

Example:

- Housing provided for one family.
- Investee receives £10,000 per year in rent.

**Opportunity cost as £5,000 cannot be recycled**

Example:

Once the funder has committed the grant to the housing project, it is gone for good.

In Scenario 3 the funder uses the £100,000 to make a grant to the housing project. In return, the investee benefits from the capital upfront, allowing it to build the house straight away. As there are no repayments to make, the investee can benefit from the rent straight away, potentially allowing it to build the next house immediately (even if at a slower rate—using the rent alone, it will take ten years).

However, for the funder, there is no possibility of recycling the funds and so there is the opportunity cost of not being able to support any other projects. However the investee can recycle the rental income within their organisation.

Scenarios 1 and 2 are more comparable than Scenario 3. The choice between Scenarios 1 and 2 would resonate with a foundation seeking to conserve its capital long term. Should the foundation put its endowment into traditional investment vehicles, or use the capital for social investment? The choice between Scenarios 1 and 3 would resonate with a foundation spending down its capital over the short to medium term. What advantages are there to investing the money, versus making the grant?

## Social impact

Table 4 summarises and compares the social impact of each of the three scenarios. Note that for each scenario, the social impact achieved will be slightly different.<sup>25</sup>

**Table 4: Summary of the social impact from the three scenarios**

Scenario	House built?	Income stream for charity?	Repayment burden?	Potential for further social impact by recycling
<b>Scenario 1</b>	Yes	Yes	Yes	High*
<b>Scenario 2</b>	No	No	No	Medium**
<b>Scenario 3</b>	Yes	Yes	No	Low

\* Assuming all £100,000 is re-invested socially.

\*\* Assuming only the return is used socially to make grants and the capital remains invested commercially.

At first glance, it would seem that social impact (both now and in the future) is most efficiently created in Scenario 1—when the £100,000 is invested in the housing bond. While the social impact in Scenario 3 is initially similar (or even better as the investee does not have to repay), it does require the investor to part with all of the capital upfront and does not expect a financial return, hence is not fully comparable with Scenarios 1 and 2.

In Scenario 2, the immediate social impact is lower as the investee would need 20 years' worth of grants to be able to build the house. However, there would be no repayment burden and there is the potential for the funder to make grants (albeit only from the returns from the commercially invested capital).

## Financial cost

Looking at Table 4, Scenario 1 looks like the most attractive option. However, just looking at social impact, it does not take into account other constraints that funders might have, such as the need to retain capital. Although Scenario 1 might maximise social impact, this comes at a cost: the funder is sacrificing 3% of the capital invested in order to achieve a social return.

Comparing the financial returns on investment, funders in Scenario 1 would lose out on £15,000 more than funders in Scenario 2:

- In Scenario 1, the return on £100,000 invested in the social housing bond over five years at 2% per annum is £10,000.
- In Scenario 2, the return on £100,000 invested commercially over five years at 5% per annum is £25,000.

In conclusion, the investor should consider Scenario 1 (the social investment) if it considers that the loss of £15,000 is compensated by the additional social impact gained from making the social investment. However this is not to say that social investments are always going to have more of an impact than grants—each scenario is different and grant funding will always have its place in the charitable sector.

The housing example shows that funders seeking to maximise social impact need to think about how they cover the costs they incur (such as operational costs, legal fees and due diligence fees) and whether they need to retain the value of their endowment. Depending on their circumstances, funders may need to sacrifice the additional social return now in order to ensure that the foundation can continue to have enough funds to pass on to future generations. Even where funders are in theory willing to take a lower financial return, they need to consider whether the additional social impact gained from investing is worth the financial cost.

## Monitoring risk

Assuming that both a grant and social investment are suitable for the same opportunity, and that the funder is prepared to take a lower financial return in order to maximise social impact, then it may be that a social investment is preferable to a grant from the income of the endowed fund.

However, potential social investors should also consider the higher risk of a social investment going wrong. As the social investment market is still young, the tools for assessing the suitability and risks of a social investment for an organisation are relatively underdeveloped.

One approach to monitoring risk in the portfolio is that taken by the social investor Panahpur in its Hope Fund, where more risky social investments are priced at the time of investment according to their estimated level of risk.<sup>26</sup> This can mean that a high-risk investment may be written down initially and then subsequently may be written back up if appropriate. Most importantly it allows Panahpur to assess the total loss expected from its portfolio and allocate its portfolio risk budget accordingly.

Assessing the risk return of individual investments is covered more fully in the next section.

## Summary

- Social investment is not always a suitable option for a funder. Its suitability depends on factors specific to the opportunity, such as the potential income stream of the investee, the organisation's stage of development and the funder's risk appetite.
- There is a mismatch within the social investment market between the funder's risk appetite and that of the available social investment opportunities. To date, funders are proving to be more risk averse, preferring to invest in expansion capital rather than builder finance. However, there is a demand for builder finance for early stage organisations, which is only appropriate if funders are prepared to invest for the long term and have a high tolerance for risk.
- Unlike grants, social investment is about the blend of social value and financial return, so funders have to balance the two considerations. The ability to recycle capital needs to be offset against the cost of repaying the investment.
- Even where there are good social investment opportunities, the need to ensure the financial return on an endowment, for example, will mean that social investment may not be an option.

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<sup>25</sup> We have also made the following assumptions: Firstly, that the bond is repaid in a single repayment at the end of 12.5 years. Secondly, that there is no inflation. Investors should take into consideration the erosion effect inflation has on capital, but for simplicity we have kept it out of these equations.

<sup>26</sup> <http://www.panahpur.org/investment-portfolio/hope-fund/>

## 4. GETTING STARTED WITH SOCIAL INVESTMENT

If you are interested in social investment, it can be hard to know where to start. Being clear about what you want to achieve and taking decisions one step at a time can help make sense of a seemingly complex area.

It is crucial to make a plan. A plan sets out your approach and priorities for social investment. It provides the structure that is used to frame and support all subsequent decisions. Such a plan starts by clarifying the motivations that are driving the interest in social investment.

This section is in two parts:

- The first part helps funders at the beginning of the social investment journey to think through what their plan might look like and how it might be implemented. We do not attempt to provide detailed guidance on setting up the social investment process or monitoring and measuring investments (please see Appendix 2 for resources that can help with that), but instead provide some advice on creating a plan. We take funders through a checklist of five questions that we think all funders need to address. It may be that after considering these questions, some funders decide that social investment is not a suitable option for them.
- The second part is for funders who decide to go ahead with social investment and need to think about how to implement their plan. It focuses on finding and appraising social investment opportunities: areas where making social investments differs from mainstream/financial investing or grant-making. In an emerging market like social investment, it can be hard not only to access all the information required to make a decision but also to know how to put it together to come to a reasoned decision.

### Make a plan

As the social investment market is relatively new and constantly developing, it is important for funders to have a clear sense of what they want to achieve and how. Funders may have to be flexible in implementing their strategy in order to engage with social investment in a meaningful way. But they should be clear about when they are being flexible and why. Answering the questions on the checklist in Box 8 will help with this. The following sections explore these questions in detail.

#### Box 8: Social investment plan checklist

Why do I want to make social investments?

What are my objectives?

What returns do I require, both financial and social?

What risks am I prepared to take?

What resources do I need?

## Why do I want to make social investments?

This is the fundamental question that a funder needs to answer, because motivations will influence the formation of a plan and many of the subsequent decisions in the investment process.

Funders are drawn towards social investments for lots of different reasons, but it is possible to pull out a few dominant themes: funders can be driven by values, interested in building the market, keen to maximise impact or drawing on their personal history. The themes are not mutually exclusive and funders are often driven by more than one.

### Values driven

The values driven funder is seeking to ensure that all the assets in the organisation, including the financial assets, are being used in a manner which is consistent with the values that underpin the mission of the organisation. An ethical portfolio is likely also to be using environmental, social and governance factors to screen investments.

Figure 6 illustrates how financial assets are increasingly used for social investment, starting with the traditional segregation of financial assets and grants through to an investment approach that uses all the assets to deliver social impact.

**Figure 6: Assets committed to social investment**



Adapted from: Imbert, D. and Knoepfel, I (2011) *360 degrees mission*, MISTRA.

### Market builder

The early adopter or market builder is driven by a belief in the importance of the social investment market as a source of alternative capital for social organisations and its potential to create social innovation. The funder is prepared to take on more risk in the early stages of the market in order to encourage its growth and to invest in organisations that would not be able to access capital otherwise. Some trusts and foundations have taken on this role in the market. Big Society Capital also has a role to play through funding intermediaries trying to build the market.

### Impact maximiser

The impact maximiser uses the assets of the organisation in a way that creates most impact for the organisation. For an endowed foundation, this can involve calculating the trade-off between using assets to

generate financial return for a grant-making programme and making direct investments in social enterprises to generate direct social impact. A funder who funds out of a regular income flow may approach from a different perspective and consider the best way of financing an organisation for maximum impact by comparing a grant against an investment, as the following statement from The Nationwide Foundation illustrates.

*‘We are keeping an open mind about the division of funding between grants and social investments: each project which applies to us will be judged on its merits against how well it might achieve our strategic outcomes, so we have no stipulations around the proportion of money we give in each guise. Everything we fund, whether grant or social investment, will be required to measure and report to us on the social impact of the work.’*

**Leigh Pearce, Foundation Manager, The Nationwide Foundation**

### Personal history

Some funders have a background that leads them to prefer social investment over grant giving. These funders are motivated by their professional background or business experience and seek to create sustainable and accountable organisations by requiring a combined social and financial return to be generated from activities.

For example, a funder supporting the emerging social investment market to encourage social innovation will pursue a different strategy (investing in different opportunities) from a funder who considers social investments alongside grants as a method of deepening relationships with grantees.

### What are my objectives?

The goals that the funder is seeking to achieve from the social investment are influenced by the motivation of the funder, but are also related to the mission and aims of the organisation. The objectives can be the same as or broader than those of the grant-making programme.

For example, the objectives of the Esmée Fairbairn Finance Fund, illustrated in the following quotation, include growing the social investment market by acting as a market builder committed to accepting higher levels of risk at the early stage of the market.

*‘In 2008 we launched the £21m Finance Fund. We subsequently increased its size to £28m in 2013. It makes investments that combine a social and financial impact. It has three broad objectives. The first is to make our money work harder (because the funds can be recycled). The second objective is to support the development of new sources of funds for the voluntary sector by attracting investment finance even though it may achieve lower rates of return than more conventional investments. Our third objective is to help grow and support this fledgling market in keeping with our interest in the sustainability of the voluntary sector and our commitment to taking risks.’*

**Esmée Fairbairn Finance Fund<sup>27</sup>**

As a comparison, The Nationwide Foundation has one overall funding strategy that applies to both the social investments and grants that it makes.

<sup>27</sup> <http://esmeefairbairn.org.uk/what-we-fund/finance-fund>

*‘As an income-based funder, social investments and grants are made from the same budget and when assessing a social investment opportunity we consider how well it fits with our strategic outcome first and foremost.’*

**The Nationwide Foundation**

The objectives of a social investment policy must be consistent with the objects of the trust or charity. It may be that the objects in the trust deed of the funder are broader than those of the programme aims. This would enable the funder to consider social investments that were broader than the programme aims but still fall within the objects of the trust.

## What financial and social returns do I need?

A social investment produces a blended return of financial return and social impact.

Ideally, a funder will obviously look for high social and financial returns, and these opportunities may sometimes be available. But a funder must decide what trade-off between financial and social return is required and when, given the expected level of risk. The Barrow Cadbury Trust explains this trade-off in its social investment strategy:

*‘As we aim to recycle our funds we would hope to recover all our financial investments, ideally with a financial return, as well as a clear and measurable social return. We do recognise that social investments may attract a lower financial return than financial investments for the equivalent risk, and this will be compensated for by the social return.’*

*‘Where the potential investments are aimed at institutional and individual investors and we are making the investment to catalyse the market, we would normally expect a level of financial return which will attract interest from new investors, i.e. more in line with financial investments.’*

**Barrow Cadbury Trust<sup>28</sup>**

However, the financial and social returns of social investments are not well known, since the track record is both limited and short.

### Financial return

Financial return is the amount of additional funds received across the entire period of the investment, over and above the initial capital put in. Financial returns can be classified in two ways:

- a market return, where funders are compensated with sufficient financial return for the amount of financial risk taken; and
- below market returns, where the financial return is below what would be expected given the level of risk. These are more common in social investment as few social enterprises can afford market rates for capital.

Below market returns cover a spectrum from grant funding, which can be viewed as 100% loss of capital, to investments that repay capital either with or without an additional return. For example, social investment loans can be repayable at lower interest rates than charities or social enterprises could get from a mainstream bank,

<sup>28</sup> <http://www.bctrust.org.uk/social-investment/>

and can sometimes be 0%. In the event of an investee being unable to meet the repayment terms, the funder can choose to write off the investment, in effect treating it as a grant.

For example, CAF Venturesome has been making social investments for over ten years and currently has £13m under management. Venturesome has about 60 high net worth or family office clients. These clients invest between £10,000 and £2.5m for three to six years in a low risk fund, the CAF Social Impact Fund, which provides loan finance to charities and social enterprises and expects to return capital only to investors.

A foundation that aims to maintain the value of its endowment (adjusted for inflation) in order to maintain its grant-making programme and preserve assets for future use, will find it difficult accepting returns that are below inflation or below market. The following excerpt from City of London Corporation Social Investment Fund, which manages charitable money drawn from Bridge House Estates, illustrates the point:

*‘The Fund seeks to preserve its capital and achieve a total return on its portfolio of investments of 2.7% or above, and a minimum return per investment of 2%. These targets will be reviewed in October 2015.’*

**City of London Corporation Social Investment Fund**

The financial return objectives of Big Society Capital reflect its responsibilities to protect capital, cover costs and make a return for shareholders:

*‘Over the long term the blended financial performance of our portfolio should: first, protect our capital by covering our operating costs and covering impairments, provisions and write-offs; second.. meet our obligations under the Subscription Agreement with our bank shareholders to generate a small positive return.’*

**Big Society Capital’s Investment Policy<sup>29</sup>**

A funder making social investments from a grant-making budget can approach return differently from a funder seeking to maintain the cost of capital. In this case, the market return may not be a consideration, as long as the costs of making the social investment are covered. The Nationwide Foundation, for example, views the social impact as the overriding priority when making these investments.

Funders should be aware that the financial return of a social investment is often more limited than a mainstream investment, for a number of reasons:

- **It can be hard to sell and therefore to realise the financial value of a social investment** due to the difficulty in exiting the investment. Mainstream financial investments can be easily sold, which enables a financial return to be realised. It is more difficult to do this with social investments: they are rarely equity-based and so you cannot sell your shares to realise your financial return. Revenue or profit participation features have been developed to allow investors to realise their financial value, but these are relatively rare and often complex.
- **Financial risk and return are poorly linked:** Unlike the commercial market, the social investment market is unlikely to offer increased financial returns as financial risk increases. So if the financial risk is high, and the financial return does not match this, investors should seek excellent social impact to compensate.

<sup>29</sup> <http://www.bigsocietycapital.com/sites/default/files/pdf/BSC%20investment%20policy.pdf>

## Social return

Social return refers to the social impact that is expected from the investment—the difference that you are making to the social problem that you are trying to solve (see Box 2 earlier in the report). Another way of thinking about the impact of social investments is their effect on the investee. For example, it might be that the investment improves the governance of the charity or its financial management. It might also increase the resilience or the financial stability of the investee.<sup>30</sup>

Social return is often unique to each social investment, and it is very difficult to make comparisons across different investments. However, several initiatives are increasing common measures of social impact. Investors should encourage investees to use common measures, as good measures should help investees and beneficiaries as well as helping investors. However, if available common measures do not fit what an organisation is trying to achieve, then other measures, based on a theory of change,<sup>31</sup> should be explored. Ultimately investees are better off measuring what is relevant to their mission and strategy, and useful to their leadership and staff, rather than something externally imposed.

Current measures include:

**Big Society Capital: Evidencing Social Value framework:** Launched in February 2013, this framework contains 13 outcomes maps produced by NPC in partnership with the SROI Network, Investing for Good and Big Society Capital. Each map examines a particular issue area or domain, and aims to document the relevant outcomes and indicators that are currently being measured by charities, government, academics and practitioners working in this field.<sup>32</sup> It does not cover every sector or every activity.

**Shared measurement frameworks:** NPC and other organisations are working on agreed sets of common outcomes and indicators within specific fields. The **Journey to employment framework (JET)** identifies common outcomes and indicators in young people's journeys to employment.<sup>33</sup> The framework can be used by charities to help think through how their work contributes to young people's employability, and to plan approaches to evaluation.

**International impact measurement initiatives:** Work is underway through the EU's group of experts on social entrepreneurship (GECES) impact measurement subgroup to develop guidance for European social investment funds on impact measurement. The guidance is due to be published later in 2013. A similar initiative is likely to emerge from the G8 taskforce on social investment.

**Impact Reporting and Investment Standards (IRIS):** IRIS is a catalogue of performance metrics, mostly outputs, which leading impact investors use to measure social, environmental and financial success, and to evaluate deals. IRIS is an initiative of the Global Impact Investing Network.<sup>34</sup>

**Social Stock Exchange (SSE) Impact Report<sup>35</sup>:** The report is a key component of the SSE admissions process and is prepared by an independent social impact specialist. Following admission to the SSE, each member company must have its Impact Report updated annually. It includes the social or environmental purpose of the company and the impact it will deliver; who benefits as a result of the company's social impact;

<sup>30</sup> NPC is currently undertaking more research into funder impact measurement practices in collaboration with the Association of Charitable Foundations and the London Benchmarking Group. This research will be published in autumn 2013.

<sup>31</sup> A theory of change shows a charity's path from needs to activities to outcomes to impact. <http://www.thinknpc.org/publications/theory-of-change/>

<sup>32</sup> <http://www.thinknpc.org/publications/mapping-outcomes-for-social-investment/>

<sup>33</sup> Plimmer, D and Copps, J (2013) Inspiring Impact. The journey to employment. A guide to understanding and measuring what matters to young people. NPC

<sup>34</sup> <http://iris.thegiin.org/about-iris>

<sup>35</sup> <http://www.socialstockexchange.com/impact-report>

how a company's products, services and operations deliver that social impact; how a company involves and consults with all its stakeholders, and what evidence a company has of its social impact and how that is collected, measured and reported.

## What risks am I prepared to take?

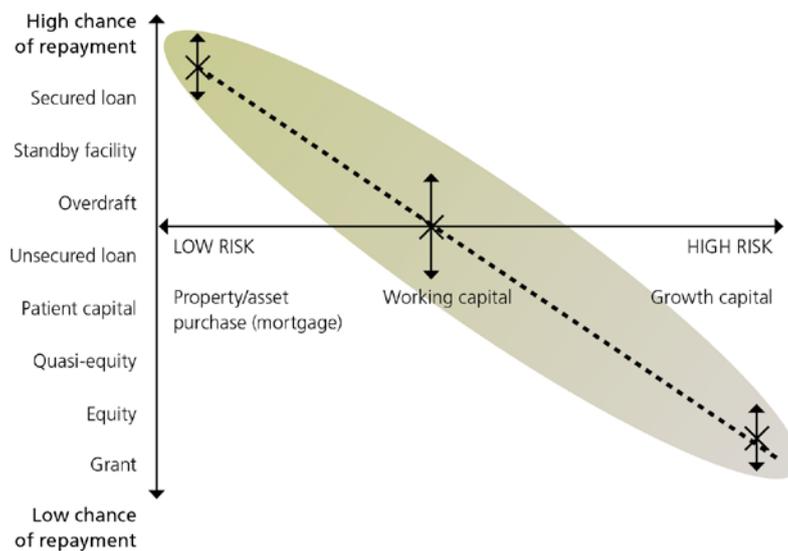
The total risk of a social investment is a combination of the financial risk and the social impact risk, and is based on the likelihood that social and financial returns are achieved. As neither social nor financial returns are well understood, this serves to increase the level of risk for the market as a whole.

### Financial risk

Financial risk is determined by the certainty (or uncertainty) of returns. The level of financial risk varies across different kinds of social investment in the same way as mainstream investments.

Figure 7 illustrates the relationship between the chance of repayment and risk across various instruments. It shows that funding with a high chance of repayment is the lowest risk. This means that investments with the most predictable return, such as a secured loan or a standby facility, are the lowest risk. The highest risk, the least predictable return, comes from equity or quasi-equity capital (and grants that do not expect to be repaid). For example, an investment that helps a charity to buy a building and that is secured against that building is a low-risk investment. An investment in a start-up social enterprise or a new instrument, such as one based upon payment by results contracts, is high risk.

**Figure 7: Matching appropriate funding mechanisms with funding needs**



Source: CAF Venturesome (2010) *Financing the Big Society: Why social investment matters*.

Some 'market builder' social investors, many of whom entered the market at an early stage, have been prepared to accept high levels of risk in order to support the market's growth. For example, they have done this by making investments in new products, such as social impact bonds, which do not have a track record.

However, newer funders with different motivations—especially those that face pressures maintaining the real value of their capital and providing sufficient funding for their grant-making—can find that the financial risks of social investment are not adequately compensated for by the financial return. These funders may therefore opt for lower-risk instruments until the market matures and the risks are understood more clearly, as the following statement from City of London Corporation Social Investment Fund illustrates:

*‘Please note that as a new fund, first investments are likely to be in low risk instruments.’*

#### City of London Corporation Social Investment Fund

A clear preference for low-risk investments is leading the social investment market increasingly towards secured lending, rather than providing higher risk start-up capital for new charities and social enterprises.

### Social impact risk

The social impact risk is the risk of not achieving the anticipated social impact from an investment. For example, for the social impact bond at Peterborough prison, the social impact risk is that the interventions put in place by the service provider, the One Service, do not succeed in reducing the number of reconviction rates of short sentence prisoners in the 12 months after their release from prison.

The relationship between social impact risk and return is poorly understood, but it is unlikely to operate like the financial element, where a higher financial risk expects a higher financial return. Instead, social impact risk and return may not be directly proportional—it will not necessarily be the case that a higher social return means a higher level of risk.

Social impact risk can be reduced if:

- the investment is made in evidence-based interventions;
- the intervention is delivered by an effective organisation; and
- the organisation has a track record of delivery.

The charity Action for Children is contracted to deliver an intervention in the Essex Social Impact Bond, launched in 2013. Action for Children has a strong track record in delivering children’s services, and the intervention, multi-systemic therapy, established an evidence-based record of success in the US before it was introduced to the UK. This combination goes some way to reducing the social impact risk of the bond. Social impact risk is likely to be higher for a social investment in innovative interventions or in a start-up charity or social enterprise.

Funders also need to be aware of a few other risks concerning social impact:

- **The risk of an investment not achieving the expected impact** and the consequent impact on the beneficiaries and society of an unsuccessful programme. In the Peterborough social impact bond, the social impact desired is to reduce the rate of re-offending. If this does not succeed, the impact is that re-offenders may return to prison and society continues to pay the social and financial costs.
- **The reputational risk of investing in a high-profile social investment**, such as the first social impact bond in Peterborough, which does not produce the expected returns. Social investment is controversial for some and any perceived failure may receive significant publicity. This could restrict future fundraising for the sector.

- **The risk that arises from changes in local or national policy**, which may influence the ability of an investment to produce the expected impact.

An investor committing secured social investment capital alongside the grant-making programme to known grantees will likely mitigate both the social impact risk and the financial risk. The social risk is mitigated because the funder is familiar with the investee and its programmes. The financial risk is mitigated because the investee has a financial track record and the capital is secured on the investee's assets. NPC is not aware of many funders that make social investments alongside their grants.

## What resources do I need?

Various resources are required to pursue a social investment strategy. As well as the need for investment funds, there are implications for governance, organisational structure and personnel.

### Funds for investment

- **How much should I put in social investment?**

The size of funds committed to social investment will partly depend on the investor's motivation (values driven, market builder, impact maximiser or personal history).

Some funders commit a percentage of their total assets to social investment. The most common allocation we came across is 5%, but some funders, such as Panahpur, are committed to investing 100% of their assets in social investment. However, a funder that considers social investment alongside a grant portfolio (an impact maximiser) may not have a fixed budget for social investment.

The size of funds committed also depends on the financial position of the funder. Foundations that have taken the strategic decision, or are required by the trust deed, to maintain the real value of their capital may keep their allocations to social investments low, because they deliver below-market returns.

- **Where will the funds come from?**

The majority of funders to date have sourced the funds for social investment from mainstream investment assets. The social investment portfolios are then run as 'carve-outs' from the main commercial investment portfolio. A carve-out portfolio is a separate portfolio from those assets run by an external manager. The carve-out is easier to monitor and value by virtue of being discrete and standalone.

However, it is taking some time for the early adopters of social investment to make sufficient investments to reach their target asset allocation. This is because the number and size of investment opportunities is limited. Meanwhile, the assets that have been committed are ring-fenced within the mainstream portfolio and are drawn down as and when suitable investments are identified. Over time, the social investment portfolio receives repayments on earlier investments, which are usually recycled into the market.

The alternative option is to take funds for social investment from the grant-making pot, although few funders we spoke to have done this so far. The risk of this approach is that it reduces the pool of funds available for grants, which will always be required by the sector. This is also counter-productive to one aim of social investment, which is to access new sources of capital.

### Governance

The existing governance structure of a funder may require changing to accommodate social investments. Boards of trustees are not always well placed to make social investment decisions, nor are conventional asset managers. Many funders have different committees for overseeing their financial and grant-making activities. Some funders have chosen to create a separate social investment committee and have invited external

experts to participate. The need for a different committee will be influenced by the scale and complexity of the investments that are made and the level of expertise already present within the funder.

### Skills, capacity and the need for advice

Grant-making, financial and legal skills are required to make social investments.

- Grant-making skills are necessary to assess the organisation that is delivering the social impact. The purpose is to determine the quality of the organisation and whether it has a record of delivering social impact or the potential to do so in the future.
- Financial skills are necessary to analyse the ability of the organisation to pay any annual interest and to repay the funder's investment at the end of the term. The financial analysis includes an additional perspective to that of grant-making, which focuses on the cash flow projections from the investment opportunity.
- Legal skills are required because social investment structures are not standard and are often contract based. Direct investments have a variety of legal forms, some of which can be very complex (for example, social impact bonds), whilst co-mingled funds are often structured as limited partnerships. Legal advice is not always available in-house and the cost of advice must be included when assessing the attractiveness of an opportunity.

Where the funder does not have sufficient skills in-house, it may want to and need to seek advice from a specialist. In some cases, funders are obliged to take advice on their investments (see Box 9). Ideally, funders should look for an advisor who can give investment advice (ie, is regulated by either the Financial Conduct Authority or the Prudential Regulation Authority) but who also understands the social impact dimensions of social investment.

NPC's experience is that relatively few intermediaries provide specialist social investment advice, and we found that there is not yet sufficient demand for advice among social investors. Investment advice is available from some of the social investment finance intermediaries listed in Appendix C.

Funders should also consider that they will need to commit extra time for social investment, especially in the start-up phase when knowledge levels are being built. Extra resources will also be needed on an ongoing basis for the due diligence and monitoring of social investments.

#### Box 9: Bates Wells Braithwaite on the need to take advice on social investment

Under section 5 of the 2000 Act, charity trustees must obtain and consider 'proper advice' about the way in which, having regard to the duties of suitability and diversification, any investment power of the charity should be exercised.

In this context, proper advice is *'the advice of a person who is reasonably believed by the trustees to be qualified to give it by his ability in and practical experience of financial and other matters relating to the proposed investment'*.

There is an exception to the duty to acquire proper advice before making investments where the trustees reasonably consider it unnecessary or inappropriate in the circumstances. Advice may be unnecessary or inappropriate where the charity has a track record of making the relevant type of investment or where the trustees understand the risks.

However, many charities engaging in social investments will be engaging in new forms of investment which carry unusual risks and promise uncertain returns. As well as professional advice on investment execution, many trustees may wish to obtain advice on the relative merits of social investment opportunities, given the developing nature of the social investment market and the various lessons that are slowly emerging.

In any event, charity trustees should act with reasonable care when making investments and should be mindful of the ultimate obligation to act in the best interests of the charity with a view, ultimately, to the advancement of the charitable objects.

In this section, we have presented these areas as separate for ease of discussion. In reality, there is much overlap here, and once a funder has answers to all these questions, it will need to think about how they fit together and form a coherent strategy. This will involve making sure that each element of the strategy is balanced and consistent with the other. For example, a funder with few resources to spare for social investment should not pursue a proactive investment style.

## Putting a plan into action

Having created a plan, how does a funder actually start to make investments? Social investment is not like financial investment—there are no fund managers who will manage it for you and charge you an annual management fee. The purpose of this section is to highlight the main areas in which making social investments differs from mainstream investing or grant-making. We do not aim to provide a comprehensive guide to every part of the investment process. This section addresses two questions:

### Putting a plan into action

How do I find social investments that meet my needs?

How do I appraise a social investment opportunity?

## How do I find social investments?

Some funders have expressed their interest in making social investments but have not been able to find sufficient opportunities. Although there has been a lot of coverage of social investment in the media, the number of deals available to foundations and individuals has been limited. Newcomers to the market find it difficult to get involved.

We categorise the way funders source deals as reactive, proactive and collaborative. The method chosen takes into account the motivation and strategy of a funder but also reflects the practicalities the funder faces in terms of available resources. A funder may pursue different strategies to achieve different objectives at different times.

### Reactive

A funder who decides to invest reactively will wait for suitable opportunities to be offered. This style suits funders with limited resources and broad social investment objectives, as these funders can invest across the

social investment market unconstrained by programme aims. Funders that want to fund specific programme objectives may find that a reactive approach limits the number of opportunities for investment.

### Proactive

A proactive funder will seek out investment opportunities in line with its objectives, as well as reacting to investment opportunities that arise. This approach is likely to be more attractive to funders making investments in line with specific programme aims, for instance, by sector or geography.

There are not yet enough deals to provide a large volume and wide variety of investment opportunities that match funder programme aims. This shortage of deals may force funders to take a proactive approach if they are going to make a reasonable number of investments. However, taking a proactive approach will require more resources than reactive investors. Box 10 gives two examples of proactive deal sourcing.

#### Box 10: Examples of funders taking a proactive approach to sourcing social investments

**Barrow Cadbury Trust:** The funder has taken a market builder approach with investments in several social impact bonds. Alongside this, the fund has recognised the need to help organisations become investment ready and is providing grants to local infrastructure organisations around Birmingham to build capacity and generate investment opportunities in the future.

**The Esmée Fairbairn Finance Fund land purchase facility:** The fund has purchased land for a number of Wildlife Trusts and the Woodland Trust. The facility also extends to RSPB. When land comes up for sale, the conservation organisation cannot always raise the funds quickly enough to buy it. In this situation, the fund will buy the land and give the trust the option to buy the land back from the fund at a fixed price in the future. This is in line with the funder's programme aims and fills a funding gap in the market. The relatively low financial return comes from interest charged to the conservation organisation, which also bears the transaction costs. It is balanced by the security of owning the land and the relatively rapid recycling of funds within a 22-month period when the land is sold.

### Collaborative

There is a strong ethos of collaboration and co-investing in social investment. This is enabled by the relatively small numbers of participants, a recognised forum for discussing ideas and the common goal of market building.

When presented with a new investment opportunity, many funders we spoke to had a preference for co-investing with other funders. The advantages of co-investing include the ability to share due diligence and to split legal fees. Some funders may feel that co-investing reduces their risk if they can invest with more experienced social investors. In some cases, funders may even make their participation contingent on another funder's participation.

A funder that agrees to be a cornerstone investor in a deal or fund can increase the attractiveness of the investment opportunity to other investors. The catalytic effect of bringing in other funders is a way of maximising the funder's social impact.<sup>36</sup>

<sup>36</sup> Cabinet Office (2013) *Achieving Social Impact as Scale. Case studies of seven pioneering co-mingling social investment funds.*

## Newcomers

For funders that are coming to social investment for the first time, taking a proactive approach may not be attractive or possible given the resources at their disposal. Newcomers to the market could find out more by:

- **Joining sector interest groups:** The social investment market is characterised by strong networks for information and knowledge sharing, and new funders may find these a good source of deals. Prominent among these is the Social Impact Investing Group, an informal forum for funders making or likely to make social investment. The group meets on a quarterly basis to discuss upcoming deals and to share their experiences on social investment. More information on the Social Impact Investing Group is available from Brian Whittaker, Programme Director at Lankelly Chase ([brian@lankellychase.org.uk](mailto:brian@lankellychase.org.uk)).
- **Learning through networking and collaborating:** This recommendation was made by Stephen Brenninkmeijer, who has been investing in social enterprises for over ten years. He suggested that new or reactive social investors should invest in pooled products and funds as a way of building knowledge on social investments, and should attend conferences to build up personal networks. This may be particularly useful to individual investors, who many not be on the radar of many social investment intermediaries.
- **Using existing contacts:** These might include grantees, other funders, and professional contacts such as auditors, lawyers and asset managers.
- **Consulting intermediaries:** A growing number of social investment finance intermediaries connect social investors with social sector organisations that need capital to create social impact (see Appendix C).

## How do I appraise a social investment opportunity?

Various issues arise when funders begin to assess the social investments that have met the criteria laid out in their strategy. Some of these issues are similar to those found in the due diligence that occurs in grant-making, but social investment also requires additional analysis of the finances of an organisation concerning the ability to repay the investment. Where funders do not have sufficient experience or knowledge to conduct such analysis, they should seek advice.

In this section, we look at four factors that investors should consider:

- the organisation;
- the investment type;
- the value of the investment; and
- the fit within the portfolio.

### The organisation

The initial assessment of a charity or social enterprise is the same for grants and investments. The purpose is to determine the overall quality of the organisation and whether it has a record of delivering social impact, or the potential to do so in the future. NPC provides a useful charity analysis framework in *The little blue book*, covering activities, results, leadership, people and resources, finances and ambition.<sup>37</sup>

The funder must consider the reason that the organisation is looking for a social investment rather than a grant or commercial loan. Services that have a trading income, such as community cafes, are more suitable than services with no trading income, such as campaigning.

<sup>37</sup> Vernon, B. and Copps, J. (2010) *The little blue book: NPC's guide to analysing charities, for charities and funders*.

Due diligence on the investee should consider the ability of the organisation to pay any annual interest and to repay the capital upon maturity. There is no obligation to repay equity that remains permanently invested in the organisation. The financial analysis undertaken should therefore focus closely on the cash flow projections from the investment opportunity and the balance sheet strength that underpins the opportunity. This is driven by the risks of the projected income not being realised and the projected costs being insufficient to deliver what is required by the plan.

### The types of investment opportunities

Social investment opportunities cover a full range of assets from cash to real estate. Table 5 shows some common examples. Some new investment structures, such as development impact bonds, are being developed.<sup>38</sup> A full guide to the different types of investment and who provides them can be found on the Know How Non Profit website.<sup>39</sup>

**Table 5: Examples of social investment opportunities**

Assets	Opportunities	Examples
Cash	Charity bank deposits	Charity Bank Savings Account
Debt	Charity bonds	Golden Lane Housing 2013 4% Bond Issue
Direct investments	Direct, not intermediated debt	Social Justice and Human Rights Centre with Ethical Property Company and various foundations
Public equity	SRI screened funds	Sarasin EquiSar Socially Responsible
Private equity	Social enterprise investment funds	Big Issue Invest Social Enterprise Investment Fund; Bridges Ventures
Real estate	Social landlord bonds	Places for People Capital Markets PLC 5% Notes 27/12/2016
Social impact bonds	Payment by results investment structures	Essex Social Impact Bond

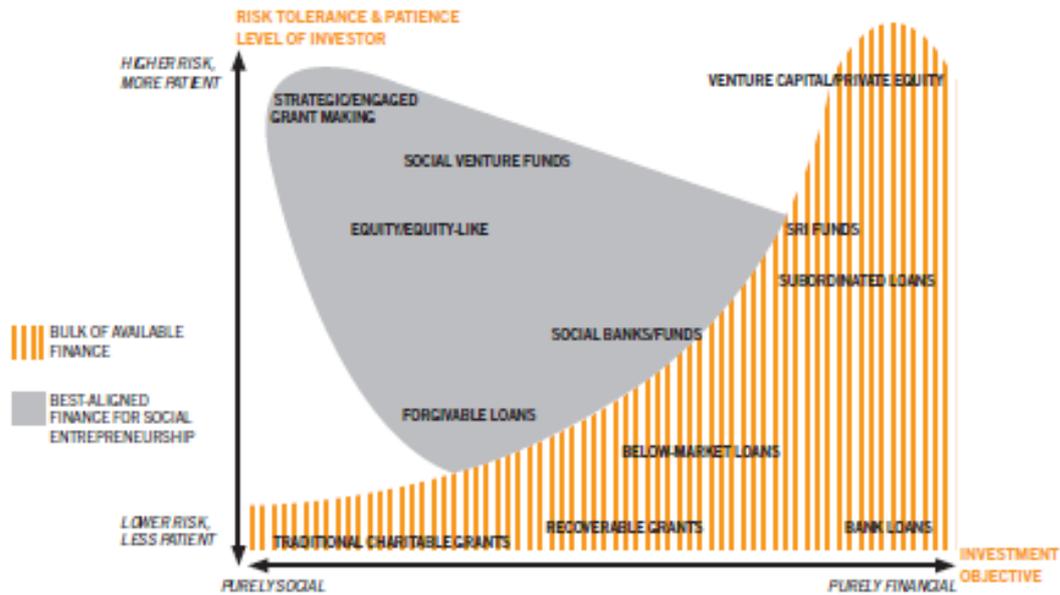
The majority of social investment to date has been loan driven—typically for working capital, bridging finance, expansion capital and asset purchase. Equity finance is less commonly used than debt finance because the legal structures of charities prevent them from issuing shares or making profits.

There is demand for patient or start-up capital from those social enterprises that can issue shares or quasi equity, and a number of funds invest in this way. Figure 8 illustrates this by plotting the investment objective along the horizontal axis, which ranges from purely social to purely financial, against the risk profile of the investor. The chart shows that the best aligned finance for social entrepreneurship is least available. These opportunities include equity and equity-like and strategically engaged grant-making (proactive deal sourcing).

<sup>38</sup> Development Impact Bond Working Group Report. Consultation Draft (2013) Social Finance, CDG

<sup>39</sup> <http://knowhownonprofit.org/funding/social-investment-1/investment-types>

Figure 8: Landscape of investment opportunities in social investment (adapted from Alter, 2007)<sup>40</sup>



Source: Nicholls, A. (2008) *The Landscape of Social Investment: A Holistic Topology of Opportunities and Challenges*. Oxford, Said Business School.

Investors can choose to invest directly into an individual charity or social enterprise or to invest through one of the growing number of fund structures. Table 6 illustrates the main differences between investing directly and investing through a fund.

Table 6: Direct investments compared to investing through funds

	Direct investment	Invest through funds
Required expertise	Very hard to find, structure and assess deals	Low because sourcing, structure and due diligence delegated to manager
Due diligence costs	Significant, recurring costs to monitor investments	Low, upfront due diligence focused on fund manager
Diversification	Limited	Medium (8–15 deals) within a fund
Management fees	None	Often 2% on fund assets
Profit sharing	None	20% after reaching performance target of 6–8% per annum
Access to deals	Self originated	8–15 deals per fund, co-investments possible
Required engagement	Very high throughout investment term	Varies from small to medium if co-investing or taking on governance role
Control over decisions	Full control	Limited control because delegated to fund manager

<sup>40</sup> Alter, K (2007) Social investment. Presentation at Said Business School, April 19

Learning curve	Steep initially, flattens out over time	Medium initially, flattens out over time
In line with programmatic aims	Yes	Depends upon investment strategy of fund
Personal impact	High, direct impact	Low-medium, diversified impact from portfolio

Adapted from Jaquier, B. (2011) *Guide to Impact Investing for Family Offices and High Net Worth Individuals*.

Investing in a fund is attractive to investors for the diversification of risk that is offered and the lower up-front costs. However, there is a longer-term trade-off against the fund's ongoing management and performance fees. The level of engagement that a fund offers and knowledge on individual investments may be lower when investing through fund structures. Some funds do allow co-investing by funders on deals and investors may also join the board. Those investors who want to invest in specific sectors (such as criminal justice) or geographies will currently struggle to find a fund that matches these objectives.

The costs of social investment should reduce as more products are developed and familiarity increases. The market currently relies on subsidies from the social investment finance intermediaries and the willingness of the early funders to take risk and share due diligence, which keeps costs down.

### Valuing a social investment

Determining the value of investments in the social investment market is at an early stage, and so is fairly hard to do. There are a small number of products to look at that have short track records. The ability to sell an investment is also limited because there are few platforms for trading.

Feedback from potential investors can help product providers develop attractive investment opportunities through discussions during the product development stage. This can ensure a product is offered to investors at a valuation most likely to lead to be attractive to them.

The majority of social investment structures do not provide an early exit for investors who should be prepared to hold the investment to term. Funders must take this into account when determining the attractiveness of an investment opportunity. A funder wishing to exit a social investment will need to take its capital out of the enterprise, which may weaken it. For financial investors, the exit route is clearer—a funder can sell on its investment to another interested party, thereby not reducing the assets of the enterprise.

An attractive investment opportunity will primarily depend upon the risk return characteristics of the investment in both social and financial terms. Cambridge Associates have termed this the 'combined risk return' of an investment, which comprises the combined financial and social return and the combined social and financial risk.<sup>41</sup> Importantly, this framework allows for *all* investments—social and purely financial—to be evaluated and compared in the same way. As the diagrams in Box 11 show, there are three steps in the valuation process:

1. Assess the financial risk return profile of the opportunity (shown as a star on the diagram).
2. Assess the social risk return profile, taking into account the factors listed in the central box in the diagram. The valuation of the social impact of an investment is subjective. At this stage in the market there is no single social impact measure and the funder will either have to choose which framework to use and apply it consistently, or use his or her own judgement as to whether the social impact and the risk of achieving it are sufficient to justify the financial trade off.

<sup>41</sup> Laing, N. et al (2012) *The UK Social Investment Market: The Current Landscape and a Framework for Investor Decision Making*. Cambridge Associates Limited.

- Combine the financial and social risk return assessment to create a combined profile. If the social risk return profile does not sufficiently compensate for the financial risk return profile by moving the investment within the attractive zone, the opportunity is not optimal.

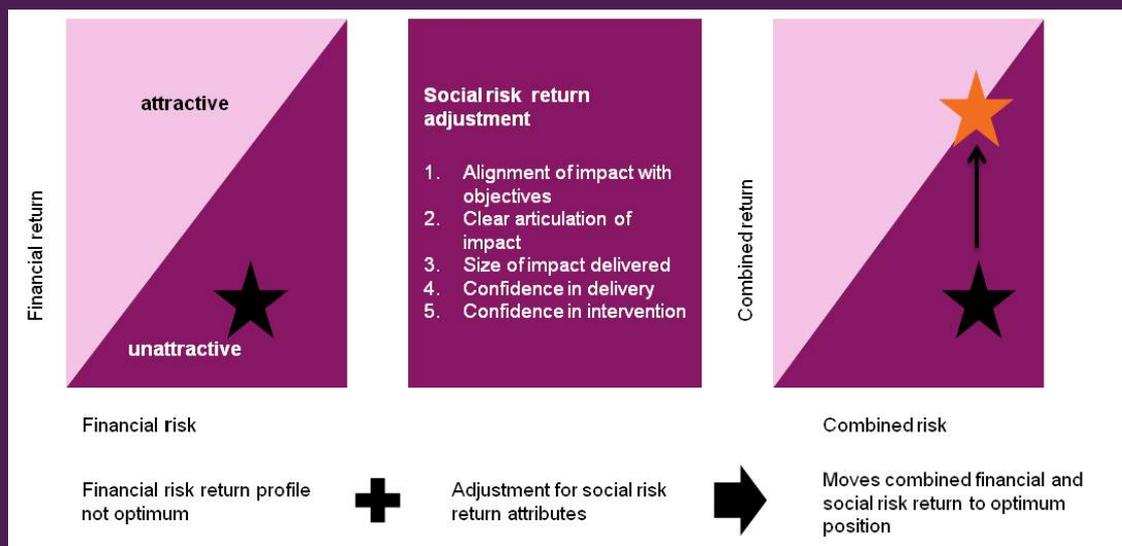
To illustrate what these steps look like in practice, we have set out four scenarios in Box 11.

### Box 11: Combined risk return scenarios

#### Scenario 1: Strong social impact compensates for unattractive financial risk return

The financial return is not compensated for by the financial risk, as shown in the left-hand diagram. An assessment of the investment’s social risk return moves the opportunity to a more attractive position on the combined risk return profile by increasing the return but not reducing the risk.

A funder focused on maximising impact, investing in an instrument such as a social impact bond, might well make this adjustment, confident of the value of the impact of the intervention, but accepting that there is a high delivery risk.

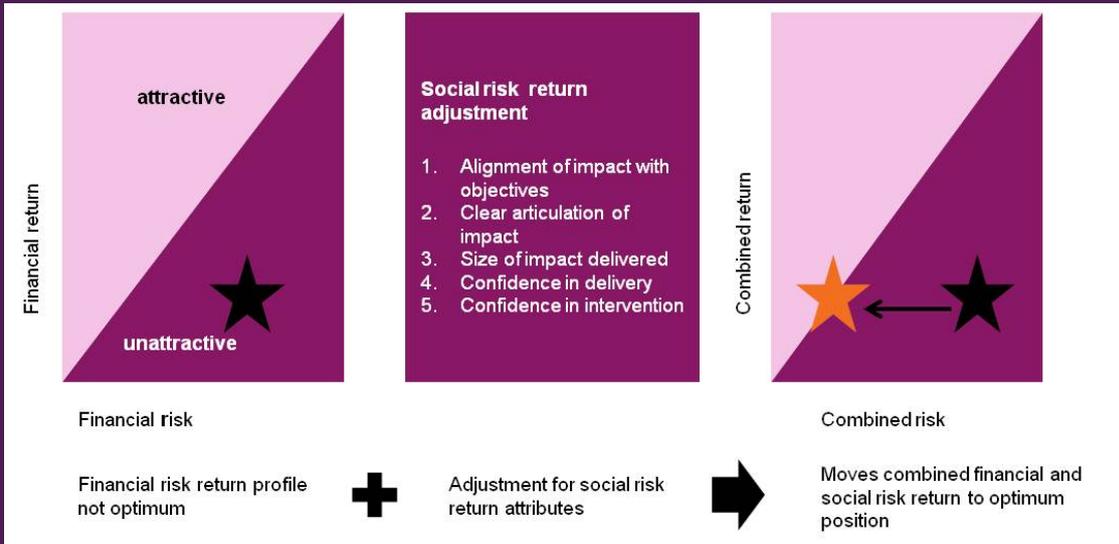


#### Scenario 2: Low social impact risk compensates for unattractive financial risk return

The financial return is not compensated for by the financial risk. An assessment of the investment’s social risk return moves the opportunity to a more attractive position on the combined risk return profile by decreasing the risk but not increasing the return. The social risk of an opportunity may be reduced if the funder is confident of the ability of the organisation to deliver, possibly through a previous experience of working together.

Under this scenario, a funder might be providing unsecured working capital to an investee where the direct impact is expected to be sound rather than stellar, but the investee has a solid track record of delivering a good service.

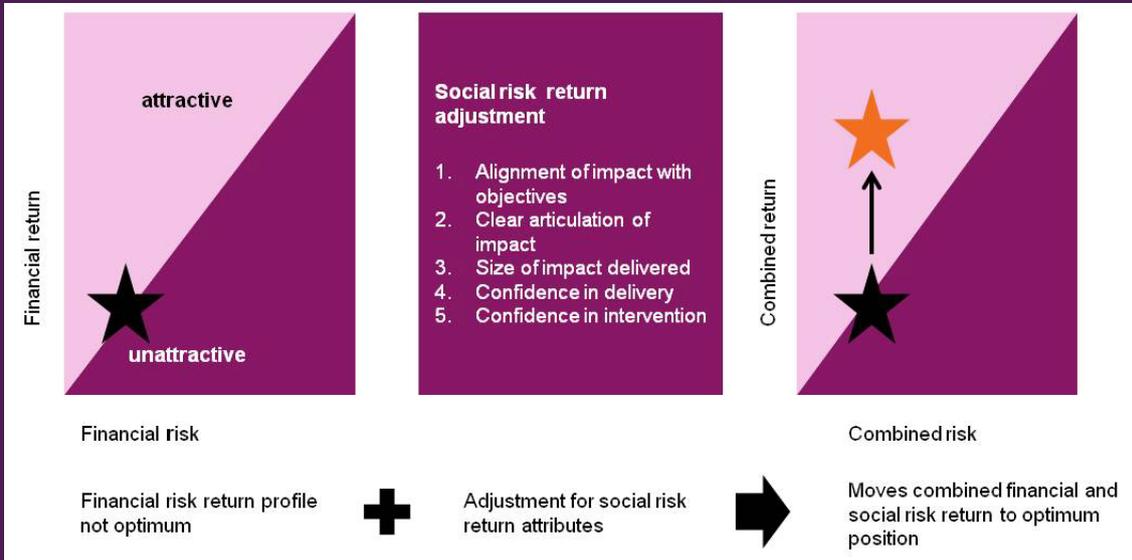
(Scenario 2 continued)



**Scenario 3: Acceptable financial risk return improved by social impact**

The financial risk return of the opportunity is acceptable but not exciting. The social risk return adjustment serves to increase the level of combined return by delivering high social impact.

A funder that is only prepared to make low-risk investments might fund a secured loan or mortgage that is used to purchase assets, such as care homes.



**Scenario 4: Social impact not significant**

If the social risk return adjustment does not move the opportunity from the unattractive zone on the chart, the investment should not be considered further.

## Fit within the portfolio

Regardless of whether social investment is being run as a separate carve-out portfolio/allocation or being run within the mainstream portfolio, the investments must align with the charitable objects of the funders. In addition the funder should be clear where social return has been traded for financial return and the effect this might have on the total return of the portfolio. The funder will also have to take into account that most social investments are not easily sold and therefore will need to be held for their duration.

The principles of diversification and prudence apply to the construction of social investment portfolios, and the investor should avoid being unduly exposed to one particular area. Box12 below summarises trustees' investment duties in this regard. Directly related to this, one foundation mentioned the risk of being overly exposed to the London property market if too many investments were secured on London property.

### Box 12: Bates Wells Braithwaite on trustee investment duties

The Trustee Act 2000 (the '2000 Act') sets out the investment duties of trustees. The 2000 Act applies equally to trustees of charitable trusts as it does to trustees of pension funds. It is also usually considered to apply by analogy to the directors of charitable companies, who have fiduciary duties analogous to those of trustees of charitable trusts.

The 2000 Act provides that, in exercising any power of investment, trustees must have regard to the 'standard investment criteria'. The standard investment criteria are set out in section 4(3) of the 2000 Act, as follows:

- a) the suitability to the trust of investments of the same kind as any particular investment proposed to be made or retained and of that particular investment as an investment of that kind, and*
- b) the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust.*

These duties are described as the duties of suitability and diversification, respectively. Put simply, the duty of suitability is a duty to ensure that any particular investment is suitable for the charity and the duty of diversification is a duty to diversify investments across the portfolio of the charity's investments, so that risk is appropriately distributed.

### Charity trustees v other trustees

The duties of suitability and diversification require trustees to consider what is suitable and how investments should be diversified in the context of a trust's circumstances.

The courts have tended to interpret these duties in the context of private trusts and pension funds and there is only limited case law in relation to charities specifically. In the context of private trusts and pension funds, the courts have tended to emphasise the importance of seeking maximum risk-adjusted financial returns. Unlike private trusts and pension funds, which exist for the benefit of specific individual beneficiaries, charities exist for public benefit generally, as set out in sections 1 and 2 of the Charities Act 2011. This means that the duties of suitability and diversification need to be understood and interpreted in the context of the overarching duty to advance a charity's purposes. This in turn provides charities with greater investment freedom.

Charities are able to grant money and to give it away for no consideration provided it is done in advancement of the charity's charitable objects. With the exception of charities with permanent endowment, charities have no express or implied duty to seek to preserve capital, which permits charities to be creative and innovative when socially investing.

## Summary

The first step for a funder interested in social investment is to consider five questions:

- Why do I want to make social investments?
- What are my objectives?
- What returns do I require, both financial and social?
- What risk am I prepared to take?
- What resources do I need?

The answers to these questions will help a funder create an appropriate social investment. Every funder's strategy is unique, with the importance of some issues overwhelming others.

Once a strategy has been developed, the funder can start to think about where to find investments and how to assess them. It may well be that external advice is required at this stage, or possibly earlier, and the appendices provide guidance on where this can be found along with other useful links.

## CONCLUSION

Social investment is a growing field in the UK, recently valued at over £200m and expected to reach £1bn by 2016. The investor base is starting to expand from a small number of market-building grant-making trusts, and interest is high amongst a broad range of individuals and foundations. There are also growing numbers of instruments that constitute social investment—social investment bonds may dominate the headlines, but secured loan finance to the charity sector still accounts for the vast majority (90%) of the total market.

Social investment is an attractive proposition for funders. Alongside grants, it can help them achieve their mission by enabling charities and social enterprises to scale up their work, develop new activities, and become more sustainable by developing a reliable income stream.

It can also help funders to maximise their social impact by aligning their investment values with their grant-making values. Social investment makes funders' money work harder: funders can recycle their repaid funds into new investments, meaning that the same money can create social impact several times over.

Even so, social investment is not for everyone. Not all charities and social enterprises are in a position to take on a social investment. Some are not established enough to warrant an investment; some do not have a reliable income stream with which to repay an investment; and others do not have the leadership, financial capability or resources to take on an investment.

Equally, social investment is not appropriate for all funders, so funders must think about what they are trying to achieve and consider whether social investment is the right tool to help them do this. Social investment has plenty of advantages both for the investor and the investee, but there are also some disadvantages (such as the additional resources required to make and monitor investments) and risks (financial, legal and regulatory). In some cases, social investment is the best option; in other cases, grants are more suitable.

Investors need to be ready and informed about social investment, especially as the market is so new and developing so quickly. Social investment can be complex to navigate, so having a decent plan is crucial. Once investors have fully considered the risks and established that social investment is suitable for them, they can turn their plan into reality, make their money work harder and ultimately achieve more impact.

# APPENDICES

## Appendix A: Definitions

The social investment world is littered with jargon, which we have tried to avoid as far as possible. Here are definitions of some key terms used in this report.

- **Bond:** A formal contract to repay borrowed money with interest at fixed intervals. A bond is like a loan.
- **Capital:** Money for investment, rather than for the payment of goods and services.
- **Capital repayment:** Repayment of the original investment to the investor.
- **Debt:** A type of investment that requires a borrower to repay the amount borrowed along with some form of interest, and sometimes an arrangement fee.
- **Equity:** A type of investment in which an investor owns shares in a company.
- **Fund:** A collective investment scheme that provides a way of investing money alongside other investors who have similar objectives.
- **Grant:** A conditional or unconditional gift of money with no expectation of a financial return.
- **Income:** Money received by a charity from donations or as a result of providing goods or services.
- **Investee:** The recipient of social investment (usually a charity or social enterprise).
- **Investor:** An individual or organisation providing capital to a charity or social enterprise, either directly or using a social investment intermediary.
- **Lender:** An individual or organisation that lends money to a charity or social enterprise, sometimes taking security to guarantee the loan.
- **Loan:** A sum of money that is borrowed and has to be paid back, usually with interest.
- **Loan forgiveness:** Writing-off of a portion of one or more loans to a financially troubled firm by its lender(s).
- **Opportunity cost:** The opportunity cost of a choice is the value of the best alternative forgone, in a situation in which a choice needs to be made between several mutually exclusive alternatives given limited resources.
- **Patient capital:** Loans or equity investments offered on a long-term basis (typically five years or longer) and on soft terms (eg, capital/interest repayment holidays and at zero or sub-market interest rates).
- **Quasi-equity:** An equity-style investment for organisations, such as charities, that do not have shares. Investors receive success-based rewards for their investment.
- **Secured debt/loan:** A loan that is backed by property (in the case of a mortgage) or assets belonging to the borrower.
- **Social enterprise:** A business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners.
- **Social investment:** Repayable finance invested in organisations that have a social purpose, such as charities and social enterprises.
- **Social impact bond:** A form of outcomes-based contract in which public sector commissioners commit to pay for significant improvement in social outcomes, which deliver a saving to the public purse.

- **Social investment finance intermediary:** An organisation that uses capital provided by investors to invest in charities and social enterprises.
- **Unsecured loan:** A loan that does not take security over an organisation's assets. Because the risk for the lender is greater, interest rates are usually higher than for secured loans.
- **Working capital:** Finance used to manage the timing differences between spending money and receiving it (income and expenditure).

## Appendix B: Research

Big Society Capital's website contains a comprehensive list of social investment research:  
<http://www.bigsocietycapital.com/research>

We have found the following reports useful:

### Understanding the background to the market

Brown, A. and Norman, W. (2011) *Lighting the touchpaper: Growing the market for Social Investment in England*. The Young Foundation and The Boston Consulting Group.

Brown, A. and Swersky, A. (2012) *The First Billion: A forecast of social investment demand*. Boston Consulting Group.

Lloyd, S. and Fletcher, L. (2012) *Ten reforms to grow the social investment market*. Bates Wells Braithwaite.

Nicholls, A. and Pharoah, C. (2007) *The Landscape of Social Finance*. University of Oxford: Skoll Centre for Social Entrepreneurship.

### Guides

Godeke, S. with Bauer, D. (2008) *Mission Related Investing*. Rockefeller Philanthropy Advisors.

Institute for Philanthropy (2011) *Practical advice for impact investors*.

Investing for Good (2013) *The Good Investor*.

Jaquier, J.B. (2011) *Guide to Impact Investing For Family Offices and High Net Worth Individuals*.

Laing, N. et al (2012) *The UK Social Investment Market: Current Landscape and Framework for Investor Decision Making*. Cambridge Associates.

### Funder issues

Cabinet Office (2013) *Achieving social impact as scale: case studies of 7 co- mingling funds*.

ClearlySo (2011) *Investor Perspectives on Social Enterprise Financing*. City of London Corporation, City Bridge Trust and Big Lottery Fund.

Evenett, R. and Richter, K. (2011) *Making good in social impact investment: Opportunities in an emerging asset class*. Social Investment Business.

Jenkins, R. (2012) *The Governance and Financial Management of Endowed Charitable Foundations*. Association of Charitable Foundations.

Jenkins, R. and Rogers, K. (2013) *I Association of Charitable Foundations*.

Share Action, formerly Fair Pensions (2012) *The Enlightened Shareholder: Clarifying Investors' Fiduciary Duties*.

Venturesome (2008) *Financing civil society: A practitioner's view of the UK social investment market*.

### Investee issues

Institute for Voluntary Action Research (2013) *Charities and social investment*. The Charity Commission.

Rickey, B., Joy, I. and Hedley, S. (2011) *Best to borrow? A charity guide to social investment*. New Philanthropy Capital.

## Appendix C: Social investment finance intermediaries

A social investment finance intermediary is an organisation that connects those interested in investing for social impact with social sector organisations that need capital to achieve positive social change. This includes raising funds for social investments, managing funds, designing financial instruments, providing platforms that connect investors and investees and providing business support. Several social investment finance intermediaries operate across several areas.

Some of the main intermediaries are listed below. See Big Society Capital's website for a full directory of social investment finance intermediaries: <http://www.bigsocietycapital.com/finding-the-right-investment>

National social investment intermediaries	
<b>Allia</b> <a href="http://www.allia.org.uk">www.allia.org.uk</a>	Allia's mission is to raise funds for charities working to tackle unemployment and disadvantage. Its charitable bond invests in social housing and distributes profits to charities.
<b>Big Issue Invest</b> <a href="http://www.bigissueinvest.com">www.bigissueinvest.com</a>	A specialised provider of finance to social enterprises and trading arms of charities that find business solutions to create social and environmental transformation.
<b>Bridges Ventures</b> <a href="http://www.bridgesventures.com">www.bridgesventures.com</a>	Establishes funds that aim to achieve social and/or environmental goals as well as financial returns for investors.
<b>CAF Venturesome</b> <a href="http://www.cafonline.org">www.cafonline.org</a>	Provides loans to charities, social enterprises and community groups when grants may not be available and access to traditional financial institutions is difficult.
<b>Charity Bank</b> <a href="http://www.charitybank.org">www.charitybank.org</a>	Finances social enterprises, charities and community organisations, with the support of depositors and investors who want to use their money to facilitate real social change.
<b>Clearly So</b> <a href="http://www.clearlyso.com">www.clearlyso.com</a>	Connects social business and enterprises with potential investors and corporations looking to engage with the social economy.
<b>Investing for Good</b> <a href="http://www.investingforgood.co.uk/">http://www.investingforgood.co.uk/</a>	Mobilises investment capital into social purpose organisations. It has developed the Social Bond Programme for social purpose organisations to raise unrestricted, unsecured investment capital.
<b>Nesta</b> <a href="http://www.nesta.org.uk">www.nesta.org.uk</a>	An independent body with a mission to make the UK more innovative. Its recent work on social investment includes running a Big Society Finance Fund to prototype wholesale social investment activities in order to demonstrate the role the Big Society Bank could play.

<b>Rathbone Greenbank Investments</b> <a href="http://www.rathbonegreenbank.com/">http://www.rathbonegreenbank.com/</a>	Ethical and sustainable investment management services.
<b>Resonance</b> <a href="http://www.resonance.ltd.uk">http://www.resonance.ltd.uk</a>	Works with social enterprises in the UK, assisting them in their development strategies and matching them with investors. It currently manages two funds financing property and community share underwriting.
<b>Sarasin</b> <a href="http://www.sarasin.co.uk/">http://www.sarasin.co.uk/</a>	Specialist fund manager with a focus on sustainable and ethical investment.
<b>Shaftesbury Partnership</b> <a href="http://www.shaftesburypartnership.org">www.shaftesburypartnership.org</a>	Develops mechanisms to support the incubation and funding of large-scale social initiatives, working with high calibre young people with the help of institutional and retail philanthropic investors.
<b>Social Finance</b> <a href="http://www.socialfinance.org.uk">www.socialfinance.org.uk</a>	Supports social organisations to raise and deploy capital; works with government to deliver social change; and develops social investment markets and opportunities. Social Finance developed the social impact bond concept.
<b>Social Investment Business</b> <a href="http://www.thesocialinvestmentbusiness.org">www.thesocialinvestmentbusiness.org</a>	Helps civil society organisations prosper through better access to finance, support and long-term strategic thinking. Runs Adventure Capital Fund and Social Enterprise Investment Fund.
<b>Social Investment Scotland</b> <a href="http://www.socialinvestmentscotland.com">www.socialinvestmentscotland.com</a>	Aims to help grow the size of the social business marketplace in Scotland. Runs the Social Investment Scotland Loan Fund and Scottish Investment Fund.
<b>The Young Foundation</b> <a href="http://www.youngfoundation.org">www.youngfoundation.org</a>	Provides research and policy advice on social investment to local and national governments as well as internationally. It also works in partnership with charities and social ventures to develop their business model and strategies including the design of social impact bond and payment by results models.
<b>Triodos</b> <a href="http://www.triodos.co.uk">www.triodos.co.uk</a>	Describes itself as the world's leading ethical and sustainable bank. Provides products for charities and social enterprises.
<b>Truestone</b> <a href="http://www.truestoneimpactinvestment.co.uk">www.truestoneimpactinvestment.co.uk</a>	A UK-based fund management company that is actively involved in impact investing, seeking to generate financial and social returns to investors from different geographical and sector investments.
<b>Unity Trust Bank</b> <a href="http://www.unity.co.uk">www.unity.co.uk</a>	A specialist bank for civil society, social enterprises, councils, trade unions and small businesses.

<p><b>UnLtd</b> unltd.org.uk</p>	<p>A complete package of resources from direct funding to ongoing advice, networking and practical support, typically for community entrepreneurs.</p>
<p><b>Regional social investment intermediaries</b></p>	
<p><b>GLE OneLondon</b> www.gle.co.uk</p>	<p>Provides a range of financial products to unlock the potential of businesses and organisations across the UK, from grants and loans, to cashflow and equity finance.</p>
<p><b>The Key Fund</b> www.thekeyfund.co.uk</p>	<p>Provides grants and loans, investment, and support for social enterprises, charities, community and voluntary organisations.</p>
<p><b>The Social Enterprise Loan Fund</b> www.tself.org.uk</p>	<p>Provides loans to charities and social enterprises that are unable to secure sufficient funding from mainstream sources.</p>
<p><b>Ulster Community Investment Trust</b> www.ucitltd.com</p>	<p>Provides affordable finance and free support for community organisations, charities and social enterprises.</p>

## Appendix D: Where to find investments

Ethex	Platform for investing in ethical businesses.	<a href="https://www.ethex.org.uk/">https://www.ethex.org.uk/</a>
GIIRS (Global Impact Investment Rating System) Fund Directory	Database of rated impact investment funds and investors. Not many UK funds at this stage.	<a href="http://giirs.org/for-investors/fund-directory">http://giirs.org/for-investors/fund-directory</a>
ImpactBase	Searchable, online database of global impact investment funds designed for investors. Not very many UK funds at this stage.	<a href="http://www.impactbase.org/">http://www.impactbase.org/</a>
Shared Impact	Platform for donating funds for social investment.	<a href="http://www.sharedimpact.org/">http://www.sharedimpact.org/</a>
Social Impact Investing Group	Informal forum for funders.	<a href="mailto:brian@lankellychase.org.uk">brian@lankellychase.org.uk</a>
Social Stock Exchange	Platform identifying businesses committed to creating social impact.	<a href="http://www.socialstockexchange.com/">http://www.socialstockexchange.com/</a>

## TRANSFORMING THE CHARITY SECTOR

NPC occupies a unique position at the nexus between charities and funders, helping them achieve the greatest impact. We are driven by the values and mission of the charity sector, to which we bring the rigour, clarity and analysis needed to better achieve the outcomes we all seek. We also share the motivations and passion of funders, to which we bring our expertise, experience and track record of success.

**Increasing the impact of charities:** NPC exists to make charities and social enterprises more successful in achieving their missions. Through rigorous analysis, practical advice and innovative thinking, we make charities' money and energy go further, and help them to achieve the greatest impact.

**Increasing the impact of funders:** We share the passion funders have for helping charities and changing people's lives. We understand their motivations and their objectives, and we know that giving is more rewarding if it achieves the greatest impact it can.

**Strengthening the partnership between charities and funders:** Our mission is also to bring the two sides of the funding equation together, improving understanding and enhancing their combined impact.