Social Shares

Risk finance for social enterprises and charities

A Flip Finance report for the Access Foundation – February 2017

FLIP FINANCE

ACCESS
The Foundation for
Social Investment

Contents

Chapter 1

About the project

Flip Finance - who we are

- A social enterprise-led approach to designing and developing practical social investment solutions.
- A group of researchers, designers and social entrepreneurs.
- An initiative built off the back of the Alternative Commission on Social Investment and Social Invest Fest.

What we do

- ➜ **Research** – into the development of the social investment market and access to finance for social enterprises and charities.
- ➜ **Engagement** – with providers and potential users of social investment products.
- ➜ **Action** – working with stakeholders to develop products and support services the meet demand and promote positive social change.

The project - why we've done it

- There is a strong perceived demand from charities and social enterprises for 'risk' finance.
- Quasi-Equity and other revenue participation-based risk finance models are much talked about but rarely used.
- Access is keen to find out if/how these models could be used to meet demand via their Growth Fund.

What we were trying to find out

Is Quasi-Equity being used in social investment?

What are experiences of Quasi-Equity to date?

Is there a need for more Quasi-Equity in social investment?

Are there alternative models of Quasi-Equity /risk finance that could be tested?

How we've done it

Desk-research on past/present use of Quasi-Equity in social investment

Informal interviews with social investors and social investment leaders

Mini-hack event with interested participants in social investment market

Chapter 2

Introduction to Risk Finance and Quasi-Equity

Why is there a need for Risk Finance?

- Many social enterprises and charities carry out 'high risk' activities and it is not certain how, when or if they could repay an investment.
- Challenging economic circumstances mean that this kind of risk-funding is less likely to be provided via grants.
- Most socially structured organisations don't issue shares and cannot, therefore, take on equity and may end up taking on loans that have to be repaid in set installments, whether or not the business is generating enough income to pay.
- Quasi-Equity investments are based on organisations repaying an investment as a percentage of their annual revenue (or profits, or product revenue), so they don't have to repay the investment if they are unable to.
- Despite relatively low knowledge of the model, the biggest survey of investee demand - 'Investment Readiness in The UK', NPC (2012) - reported that 11% of social enterprises and charities that are 'currently looking for investment' were interested in Quasi-Equity.

Models of social Risk Finance beyond the scope of this report

There are a number of approaches currently in use within the social investment market that help to meet the wider need for risk finance but are not relevant to most of the charities and social enterprises that Access is seeking to support. These are;

➜ **Community Shares** – withdrawable share capital offers made by cooperatives and community benefit societies raising investment from members

➜ **Social Impact Bonds*** – payment-by-results contracts delivered by charities and social enterprise with finance provided by social investors

➜ **Equity investment in 'profit-with-purpose' businesses** – equity investments into companies limited by shares based on the company's commitment to creating social impact

*Subsequent slides note that some Social Impact Bonds include Quasi-Equity investments as part of an overall investment package – however the Social Impact Bond model , as an investment related to specific contracts, is a distinct approach to risk finance operating within particular public service markets and is therefore not a primary focus for this report

What is Quasi-Equity?

a financial instrument that aims to reflect some of the characteristics of shares (preference or ordinary)

‘Quasi-Equity: Case study in using Revenue Participation Agreements’ - CAF Venturesome (2008)

What does that mean?

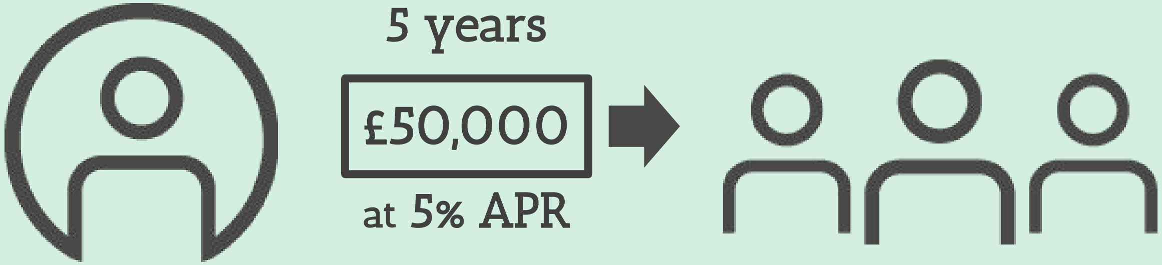
An investor puts money into an organisation but - rather than making a loan to be repaid in regular installments - they buy the right to receive (part of) that organisation’s future revenues: a Revenue Participation Agreement (RPA).

This is (roughly) equivalent to an investor buying shares in a company and receiving dividends from the organisation’s profits.

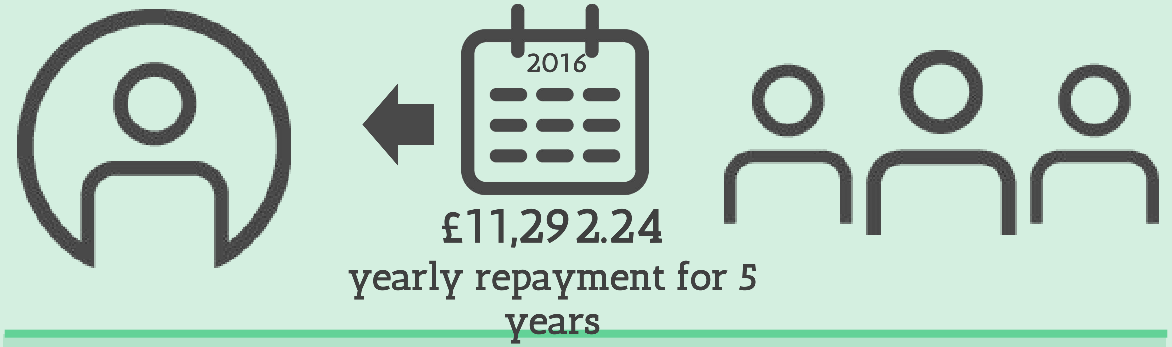
How Quasi-Equity works

Standard Loan Agreement

Loans can be structured in many different ways but this simple model illustrates the general principle - compared to Quasi-Equity deals.



Investor loans organisation £50k for 5 years (60 months) at 5% APR.



Organisation repays £941.02 per month / £11,292.24 per annum.

Total repayment = £56,421.20

Total cost of credit = £6421.20

How Quasi-Equity works

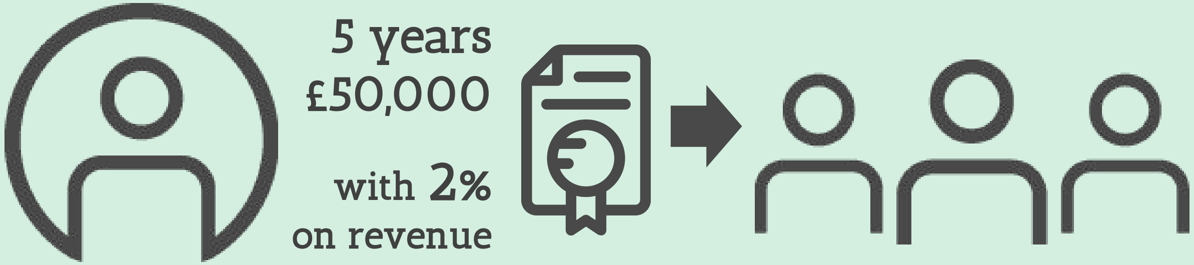
Quasi-Equity Agreement

This is a simplified example to help show the difference between the models. In reality, most Quasi-Equity social investments are repaid over a longer time period than standard loans.

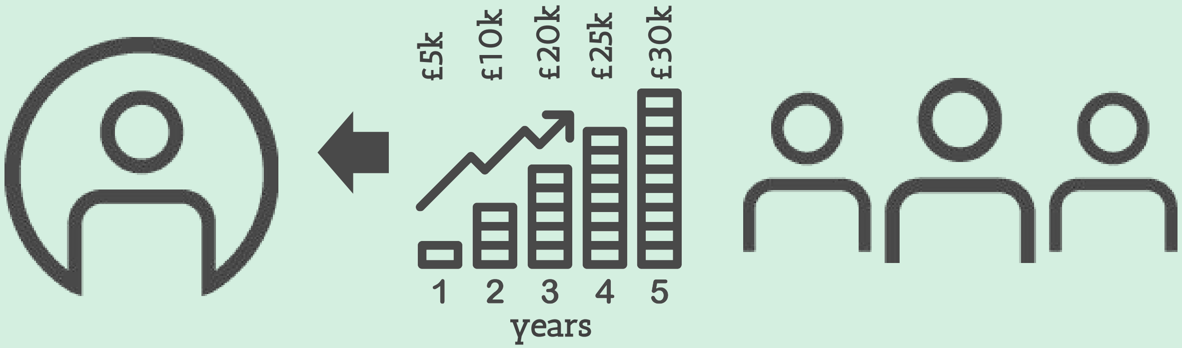
Total payment = £90,000

Total cost of RPR = £40,000

Note: organisation pays based on when/whether they generate revenue and investor risks getting less / nothing if turnover is lower



Investor pays organisation for a Revenue Participation Right (RPR) with agreement that organisation pays investor 2% of revenue for 5 years.



For example, in first year, if the organisation generates £250,000 revenue, they pay the investor £5000. Then £500,000/£10,000 (year 2); £1,000,000/£20,000 (year 3); £1,250,000/£25,000 (year 4) and £1,500,000/£30,000 (year 5).

Quasi-Equity in wider context

Beyond the world of social investment there are many examples of investors providing upfront payment to be repaid based on the success of a business activity:

- In the world of **book publishing**, authors receive an advance on royalties before they write a book, and then only begin to receive a percentage of the profits from sales once that advance has been repaid.
- Recording artists are funded (more heavily) on a similar model with **Prince** famously signing a contract with Warner Brothers that saw him receive a $10million dollar advance for each new album as long the previous one had sold 5 million units. This covered the cost of repaying the labels investment based on Prince's 20% royalty.

Quasi-Equity in wider context

➜ In 1492, **Christopher Columbus** raised a significant portion of the investment he needed for his plan to discover “a western route to the Orient” via a Quasi-Equity-style investment from the Court of Spain:

- King Ferdinand and Queen Isabella negotiated a deal which promised the explorer a range of benefits is he succeeded including:
  - the rank of Admiral;
  - appointment as Viceroy and Governor of the new lands claimed for Spain;
  - the option of buying ⅛ interest in any commercial venture with the new lands; and
  - 10% all the revenues from the new lands in perpetuity.
- In this early example of the complexities of Quasi-Equity, the King and Queen reneged on the deal in 1500 and legal disputes between the Columbus family and the Spanish Crown continued until 1790.

A brief history of Quasi-Equity

'Quasi-Equity: Case study in using Revenue Participation Agreements' - CAF Venturesome (2008)

- ➜ Explained function of Quasi-Equity where 'debt finance is inappropriate or too onerous' and 'use of share capital is simply not possible'.
- ➜ Provided example of £50,000 Quasi-Equity deal between CAF Venturesome and the Charity Technology Trust.
- ➜ Outlined lessons for 5 Quasi-Equity deals including accounting queries.

A brief history of Quasi-Equity

'Growing the Social Investment Market: The Landscape and Economic Impact' – ICF GHK (2013)

- ➜ Overview of the social investment market highlighted Quasi-Equity investments worth £0.3 million = 0.2% of £202 million social investment market in 2011/12.
- ➜ 3 Quasi-Equity investments made out of a total of 765 social investment deals.
- ➜ 85% of organisations receiving social investment were potential customers for Quasi-Equity based on corporate structure (charity, CLG or CIC).

A brief history of Quasi-Equity

'The Size and Composition of Social Investment in the UK' - Big Society Capital (March 2016)

- ➜ Latest overview of social investment market highlights 'equity-like products' as 2% of £1.5 billion market for outstanding investment - 123 out of 3463 deals / £427 million (annual investment total) - 35 deals out of 709 deals.
- ➜ This is a broader category than the one used in the ICF/GHK report and many of these deals are not Quasi-Equity (many are Convertible Notes*).
- ➜ These products are viewed as part of Big Society Capital's work on 'social innovation - provision of capital to help the most innovative approaches to social problems grow and quickly replicate'.

*A Convertible Note is a short-term loan that is converted into equity at the point that a business sells its first round of shares - based on the terms set out in the note.

Examples of Quasi-Equity deals

Investor	Investee	Size of deal	Year	What the money was invested in	Results of making the investment
CAF Venturesome	Motivation	£75,000 (of total £200,000)	2009	Production and distribution of wheelchairs in the developing world	Motivation increased turnover from £2,178,229 in 2009 to £4,970,193 in 2015
Bridges Ventures and other social investor	Hackney Community Transport (HCT)	£4,000,000	2010	Funding to support bidding for/running more bus routes	HCT repaid the investment by 2015 and subsequently raised further investment of £10,000,000
Big Issue Invest	My Time CIC	£200,000	c 2011	Supporting 10 new franchises of a mental health community support service	The company was taken over by Richmond Fellowship in 2014

Chapter 3

The current situation

The story so far...

The need for ‘high-risk’ social investment is widely cited, yet available data suggests very few Quasi-Equity deals have taken place in the UK.

Barriers to take up include, but are not limited to:

- ➜ Organisations not understanding its relevance
- ➜ Investors are mainly sceptical
- ➜ Necessary subsidies not being available

Quasi-Equity investments to date

30 - 50 Quasi-Equity deals have been made in total in the social investment market out of a total of (at least) 3463*

$\frac{12}{500}$

CAF Venturesome have made 12 Quasi-Equity investments out of total of around 500 since 2005

12

Young Foundation have made at least 12 Quasi-Equity investments across their programmes since 2010

1+

Other social investors including **Bridges Ventures, Resonance, Big Issue Invest** and **Social & Sustainable Capital** have made one or more Quasi-Equity deals

*Suggested figures from available data: 'The Size and Composition of Social Investment in the UK' - Big Society Capital, (March 2016)

Key factors in successful deals

1. **Social enterprise or charity has a clear commercial model**, or needs an incentive to develop one.
2. **Social enterprise or charity has clear understanding of why Quasi-Equity is a better option than conventional loan finance**.
3. **Strong alignment to Social enterprise or charity's business model** e.g. organisation is a product-sales focused business where revenues and costs vary significantly based on number of products sold.
4. **Social enterprise or charity gains significant benefit from Quasi-Equity over conventional debt on the balance sheet,** e.g. organisation's financial position is more attractive to commissioners.

The wider Quasi-Equity landscape

- Quasi-Equity investments provide some or all of the finance for several Social Impact Bonds.
- Some deals made as part of the Cabinet Office's Social Incubator Fund have a Quasi-Equity element.
- The largest cohort of Quasi-Equity-style investments, 63 match-funding deals as part of UnLtd's Big Venture Challenge - but maximum repayment is 50% of original investment.
- Guy's and St Thomas' Charity have made social investments based on a right to a royalty from sales of a particular product - an alternative Quasi-Equity model to paying % of revenue or profit.

Why investors are sceptical

Desire to make Quasi-Equity type investments in charities and social enterprises is currently small among investors because:

- ➜ Quasi-Equity deals are complicated and expensive to set up compared with conventional loans.
- ➜ Revenue participation-based models are complicated to monitor and process, which risks creating perverse incentives.
- ➜ Quasi-Equity may attract organisations who regard them as investments that don't need to be repaid.
- ➜ If Quasi-Equity deals are successful and returns are high, investee organisations feel 'ripped off' by investors.

Why demand is limited

Demand for Quasi-Equity type investment among charities and social enterprises is limited largely because:

- Quasi-Equity is not widely promoted by social investments.
- Many organisations are not aware that Quasi-Equity exists, or aware of situations where it could be useful.
- Deals are complicated and take a long time to arrange.
- If organisations are in a position to predict revenues with confidence, Quasi-Equity is unlikely to offer as a good a deal as a conventional loan.

Chapter 4

Ideas for new approaches

Principles for repayment models

Terms are not ambiguous

1

Not destructive to investee's business

2

Perceived as fair by all parties

3

Provides good value for subsidy

4

Emerging ideas

1. **Business Event Trigger** - investment repayable when business achieves specific milestone eg. wins contract; achieves planning permission.
2. **Permanent Capital** - investment made with no fixed repayment date or specific plan for repayment; investee pays fee for continued use of money plus agreed return.
3. **Investment Veto** - investment made with no fixed repayment date but investor has veto over further investment until repaid with return.
4. **Trust-based Seed Capital** - small scale early stage investment with simple terms relying on trust between investor and investee.
5. **Royalty Investment** - product-based investment repaid as a percentage of the sales price for each product sold .

Emerging ideas

[1] Business Event Trigger

An investment is made into charity or social enterprise (often) to fund early stage development work.

Repayment

How it's repaid

At the point a particular 'business event' occurs - e.g. building work receives planning permission - the investment becomes a repayable loan.

When it's not repaid

If the specified business event does not occur the investment is converted into grants.

Application

Makes sense

If a specific business event is fundamental to the success of a business and is likely to happen.

Doesn't make sense

If it is likely that the business event will not happen.

Examples

A. CAF Venturesome's Community Land Trust Fund

B. Key Fund investments into early stage regenerations projects

Emerging ideas

[2] Permanent Capital

An investment is made into a social enterprise or charity with no fixed repayment date or plan for repayment. Social enterprise or charity pays an agreed fee for continued use of the money after a specified point.

Repayment

How it's repaid

Money is repaid when social enterprise or charity no longer needs it.

When it's not repaid

The social enterprise or charity is not obliged to repay the money at all but would save money in fees by doing so if it no longer needs it.

Application

Makes sense

For social enterprises or charities seeking to strengthen their balance sheet for expansion or growth.

Doesn't make sense

As an investment in early-stage social enterprises seeking to become sustainable without significant growth or expansion.

Examples

New idea suggested by a social entrepreneur as part of this research.

Emerging ideas

[3] Investment Veto

An investment is made into a social enterprise or charity with no fixed repayment date. The investor has a veto over the social enterprise or charity taking on future investment until the investment has been repaid with an agreed return.

Repayment

Investor's exit

Veto is lifted when the social enterprise or charity repays the investment with an agreed return.

Alternative exit

Repayment may be triggered at the point the social enterprise or charity's reserves exceed the value of the original investment.

Application

Makes sense

When a social enterprise or charity is pursuing a fast, high growth business model.

Doesn't make sense

If a social enterprise or charity is not planning to grow significantly and is unlikely to seek further investment in future.

Examples

New idea suggested by a social entrepreneur as part of this research.

Emerging ideas

[4] Trust-based Seed Capital

A small early stage investment (up to £25,000) made into a charity or social enterprise based on a simple Revenue Participation Agreement .

Repayment

How it works

The investor works closely with the investee to support the development of the business - providing advice and nominating a board member.

How it's different to a grant

The investee signs up to the principle of repayment via revenue participation right if possible but investor accepts significant chance of losses.

Application

Makes sense

For seed investments where a complicated process would make the investment unviable for both parties.

Doesn't make sense

For larger investments and in situations where either investor or investee does not want to establish trust-based relationship beyond funding.

Why it's worth trying

Currently, some investors are expending significant legal and administrative resources creating and monitoring very small Quasi-Equity investments. In situations where the business does not generate significant income and cannot repay an investment, this is irrelevant. In situations where the investee generates income and is happy to honour the agreement, it is not necessary. So set-up expense is based on guarding against the possibility that a social enterprise or charity ends up in a position where they could repay an investment but refuses to do so. A fund testing this model would be able to test the likelihood of a social enterprise or charity - receiving investment to be repaid on the basis of trust (rather than the ultimate prospect of legal action to recover the money) - would seek to avoid repayment.

Emerging ideas

[5] Royalty Investment

An early stage investment made to support the development of a product which is repaid based on sales of the product.

Repayment

How it's repaid

Investor receives a percentage of the sales price for each product sold.

When it's not repaid

If there are no sales, no repayment is due.

Application

Makes sense

For social enterprises or charities with no revenue, and investors seeking to support the development of new products in new markets.

Doesn't make sense

For investments into social enterprises or charities who are not developing a new product.

Examples

Guy's and St Thomas' Charity made a £50,000 unsecured loan to a charity to support the design, development and manufacture of a new consumer assistive technology. The investment is being repaid based on 6% of net sales price as a contribution to the principle and 5% as a royalty on sales.

Chapter 5

Next steps & further questions

Next steps

Carry out research to better understand demand for Quasi-Equity

Assess applicability of Quasi-Equity models to the Access Fund

Conduct a process with social enterprises, charities, investors and others to develop Quasi-Equity models

Seek bids to the Access Growth Fund from investors offering Quasi-Equity and related finance

Further questions

Related research is needed on:

1. Technical queries e.g. does Quasi-Equity have to be debt?
2. How the need for risk finance can be met in other ways e.g. equity investments in CICs Limited by Shares.
3. The role of subsidy in social investment - who/what should be subsidised and how/why should they be subsidised?

Appendices

Research interviews & mini-hack on Quasi-Equity

Research interviews

The Flip Finance team carried out 12 informal interviews with social investors and social investment leaders between 13 May 2016 and 20 June 2016.

The interviews focused on:

- Previous experiences of making or taking on Quasi-Equity investments - or products fulfilling a similar function.
- Views on the need for and applicability of Quasi-Equity.
- Ideas for new models of Quasi-Equity-style products that might meet the demand for risk finance from social enterprises and charities.

Interviewees

Ben Rick & Vinay Nair – Social & Sustainable Capital

Holly Piper & Amir Rizwan – CAF Venturesome

Kieron Boyle – Guy's & St Thomas' Charity

Arvinda Gohil – Access / Community Links

David Curtis – Access

John Kingston – Access

Daniel Brewer – Resonance

Carolyn Moore – Motivation

Matt Smith and Garry Brown – Key Fund

Laura Kromminga – Ashoka

Ben Warren – Big Society Capital

Gemma Rocyn Jones – Right to Succeed

Mini-hack on Quasi-Equity

On 28 June 28 2016 the Flip Finance team held a mini-hack event at the offices of Big Society Capital, which was attended by a mixture of social investors, social entrepreneurs and other experts including lawyers and accountants.

The event consisted of:

- ➜ An introduction to the research so far.
- ➜ Discussion of attendees' experiences of and ideas about Quasi-Equity.
- ➜ Some practically focussed group work to understand the situations where Quasi-Equity may be useful - and to explore potential new models.

Characteristics / dimensions of a social investment deal

Mini-hack attendees worked in groups to map out the different elements that make up an investment deal :

- ➜ fixed term vs open-ended vs. evergreen
- ➜ all revenue vs ringfenced
- ➜ capped return vs uncapped return
- ➜ capped downside vs capital at risk
- ➜ patient vs impatient (including holiday)
- ➜ liability for investor vs no liability / asset for investor (spectrum of junior, senior and contingent etc)

Characteristics / dimensions of a social investment deal

- ➜ whether interest is element or not
- ➜ events of default
- ➜ control vs no control
- ➜ costs of set-up and monitoring absorbed by investee or investor
- ➜ high risk vs low risk
- ➜ high or low return
- ➜ break clause / convertibility

Group work

Pros and cons of Quasi-Equity

	INVESTOR	INVESTEE
✓	✓ equity type return expectations ✓ eg. accelerator type funds – volume of deals. ✓ uncapped return: high returns!	✓ high risk project w. unclear timelines/ revenue expectations. ✓ social impact bond/project finance ✓ larger organisations that can't take the risk of debt? vs.... ✓ smaller, high risk ventures
X	x short term fund. x fixed return expectations of LPs x control investee costs. X challenging LP expectations X need to be bespoke (vs. commoditised)	X misconception of risk vs. return. X controlling costs to absorb cost of capital. X need to give away control X have high assets (would borrow vs. them) [though QE <u>could</u> still be relevant]

Group work

Sketching out a Quasi-Equity deal

Funder

suited to Foundation

Fin instrum

- staged investmt
- Repaymt → linked to sales revenue from commissioning

Investee

PRODUCT / SERVICE TYPE

End user?

- → Whole organization funding
- → Capped "downside" protn through staged invmt
- → Early termination rights investee (favouring)

Mini-hack attendees

Bertrand Beghin - Numbers for Good - investor / intermediary

Vinay Nair - Social & Sustainable Capital - investor / intermediary

Isabel Newman - Nesta Impact Investments - investor / intermediary

Malavika Raghavan - Lawyer / NCS - expert / social enterprise

Amir Rizwan - CAF Venturesome - investor / intermediary

Julia Morley - LSE - expert

Madeleine Anderson - Catch 22 - charity / social enterprise

Josiane Smith - Enpact - government / infrastructure

Mike Wright - Guy's & St Thomas' Charity - investor / grantmaker

James Teasdale - Young Foundation - investor / intermediary

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A Flip Finance report for the Access Foundation

February 2017

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