Access – The Foundation for Social Investment

Social Investment Tax Relief: call for evidence

July 2019

Access – The Foundation for Social Investment (Access) is pleased to provide this response to the HMT call for evidence on SITR.

Our response draws on our experience in supporting charities and social enterprises in England via our capacity building and blended finance programmes. We also draw on evidence from our sister organisation Big Society Capital's response to the call for evidence, and fully endorse the more detailed response they have provided. We also note the response provided by the Social Impact Investing Implementation Taskforce and similarly endorse its proposals.

Below we provide responses to selected questions from the call for evidence.

Question 1: If you are a social enterprise, are you interested in or planning to scale up? How do you intend to achieve this and how much do you hope to raise in investment?

Social Enterprise UK provide sector leading data on the growth plans and financing needs of the social enterprise sector.[1]

Most commonly the amount of capital sought by social enterprises aimed for ranges between £10,000 and £50,000 (37%), with an overall median amount sought of £80,000, a slight increase from the median figures in 2015 (£60,000) and 2013 (£58,000).[2]

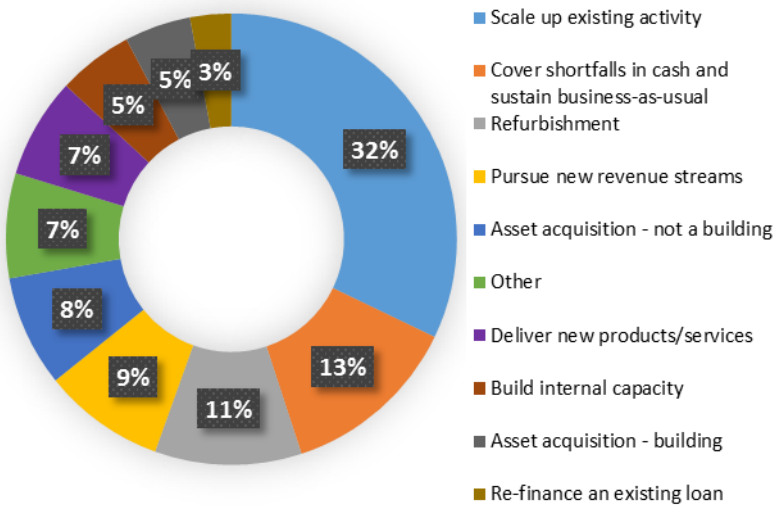
Until recent years access to this sort of finance for charities and social enterprises has been difficult to obtain. In addition to seeking relatively small amounts of investment, social enterprises seek unsecured, flexible and affordable capital. Given the relatively small scale of many social enterprises and the fact that social impact is often delivered through trading in very challenging market conditions with small (or non-existent) margins, subsidy is required for investors to be comfortable in investing in social enterprises seeking this sort of finance.

[1] https://www.socialenterprise.org.uk/the-future-of-business-state-of-social-enterprise-survey-2017
[2] Ibid. p43

Initiatives such as SITR and blended finance schemes like our Growth Fund[3] are critical in providing this subsidy and increasing the supply of capital which charities and social enterprises need.

Of the 297 investees who have received a loan through the Growth Fund, the primary purpose of the investment has been mainly to scale up existing activity, as shown below:

Figure 1: Primary purpose of investment raised via the Growth Fund



Question 2: Other than individual investors, what sources of finance do trading social enterprises seek and acquire?

For social enterprises which cannot access finance from a mainstream lender like a bank, many social enterprises seek to raise finance from specialist social investment funds. Historically most of these funds have themselves borrowed in order to on-lend. This model of capitalising funds has meant that those funds are not well placed to provide the sort of smaller scale unsecured flexible finance which social enterprises seek (see question 1).

Over the last three years Access has been delivering the Growth Fund in partnership with the National Lottery Community Fund and Big Society Capital. The £50m programme has invested in sixteen loan funds, which in turn offer small loans of under £150k to charities and social enterprises in England.

The funds receive a blend of grant and debt to on-lend. This grant provides subsidy for three specific elements of the programme, the lack of which had previously prevented this sort of lending activity from happening:

1. To help meet the operating costs of the fund manager, acknowledging that making a large number of low value loans is an expensive and uneconomic enterprise

[3] https://access-socialinvestment.org.uk/blended-finance/the-growth-fund/

2. To protect the capital provider (in this case Big Society Capital) by providing a first loss layer which can be eroded should there be loan defaults within the fund. Within the Growth Fund there is a range of loss coverage from 10% to 36% depending on the individual loan fund, with a weighted average of 29% across the whole programme.
3. To provide non-repayable element to the charities and social enterprises to help reduce the overall cost of capital to them and to allow for investment in elements of their capacity which would not in themselves be revenue generating.

The 16 fund managers delivering the Growth Fund have made 297 loans to date (as of 31 March 2019). The average loan is £64k at 7.3% over four years. The median turnover of the borrowers is 232K, much smaller than other social investment initiatives.

According to BSC's open data[4], the Growth Fund was responsible for 29% of all social investment deals made in 2018.

More data on the Growth Fund can be seen on our dashboard, which is updated every quarter.[5]

The blended model has a key role to play in helping to meet the capital needs of charities and social enterprises. It relies, however, on significant amounts of grant subsidy being made available into these structures which is eroded over time, £22.5m in the case of the Growth Fund. Social investment funds managing the Growth Fund will make new loans over a period of around five years, until 2021.

More blended finance programmes are undoubtedly needed and there are various organisations who may play a role in providing the grant subsidy which is required to make this work. At this point though it is unclear how the demand stimulated by the Growth Fund will be met post 2021.

However even assuming more grant subsidy is made available for blended finance programmes, these on their own will not be able to meet the growing demand for finance from charities and social enterprises. The combination of SITR and blended finance programmes working unison provide the best opportunity to incentivise lending activity for charities and social enterprises seeking to access smaller amounts of unsecured finance and where subsidy is required.

We outline below in our response to question six the particular financing need which can be met through attracting individual investors via continued use of SITR.

Question 3: How difficult or easy is SITR to access for social enterprises?

Accessing SITR is not possible for many social enterprises and difficult for others. The relief has eligibility limitations which significantly reduce the universe of organisations

[4] https://public.tableau.com/profile/big.society.capital#!/vizhome/DealLevelDataDec2018blog/Who
[5] https://access-socialinvestment.org.uk/wp-content/uploads/2019/06/Quarterly-Dashboard-Q1-2019.pdf

who are able to benefit. It is also a complex process, which is particularly challenging for small and resource stretched social enterprises.

Significant limitations on eligibility include:

- Limitations on asset leasing activities
- Non-inclusion of nursing and residential care homes
- Non-inclusion of community owned energy projects
- Ineligibility of organisations older than seven years
- Ineligibility of social enterprises with subsidiaries which are companies limited by guarantee
- Ineligibility for individual investors seeking to invest in a charity of which they are a trustee
- The specific requirement to invest in the charity parent of a CIC rather than directly into a CIC.

Complexities in the process include the requirement for social enterprises to deduct tax at source from interest paid to investors, which is a significant and unnecessary burden.

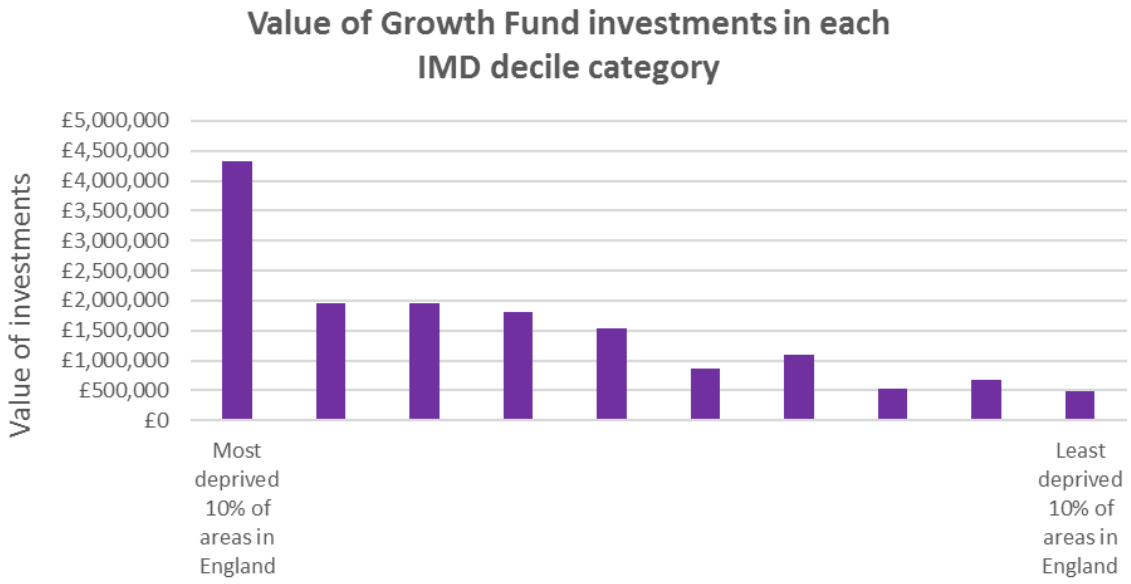
In our response to question 14 we make proposals for how these challenges could be addressed.

Question 4: What are the factors that lead to a successful trading social enterprise?

Like all businesses Social Enterprises need access to markets, access to appropriate capital (see above), access to a talented workforce and capacity to pursue opportunities when they arise.

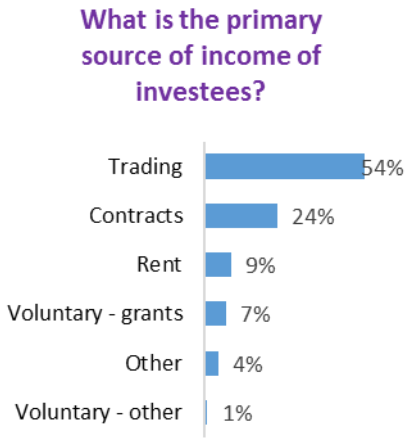
Social enterprises disproportionately operate in more deprived communities. There are costs of trading in areas of market failure and social enterprise therefore often operate with very challenging business models. Investments made from the Growth Fund highlight the strong focus of social enterprise activity in more deprived communities.

Figure 2: Value of Growth Fund loans (total £15.2m) made to December 2018 by deciles of IMD based on postcode of registered office of borrower:



Organisations who have taken on loans from the Growth Fund report their primary sources of income as being:

Figure 3: Primary sources of income for Growth Fund investees:



Successful social enterprises are able to manage significant challenges in making their business models work. For those seeking to trade with the public there are challenges around ensuring that revenue from trading activity can meet the organisation's cost base, which his likely to be higher than that of any competitors because of the impact achieved within the enterprise model. These increased costs may come from employing people far from the labour market (such as those who have been in prison or have experienced homelessness) or through ensuring an ethical supply chain. Revenues may be lower if the organisation deliberately targets

a client group with limited resources. There are also challenges with ensuring that the public are aware of the distinctive model of social enterprise.

For those social enterprises who are mainly trading with government through the delivery of public service contracts there are challenges around their ability to compete for large contracts, the margins which can be achieved on those contracts and the emphasis placed on social value by the relevant commissioners.

Question 5: Do you think social enterprises need private investment and for what purposes?

The data from SEUK is clear that access to appropriate finance is a major need for social enterprises, cited as the most significant barrier to sustainability for the fourth biennial survey in a row.[6] The proportion of social enterprises who report this is around 20% higher than similar responses from SMEs.

Our own data from the Growth Fund shows a clear need for finance, as shown in figure 1 above.

Question 6: Is tax the most appropriate lever for supporting funding for social enterprises?

As outlined in our response to Question 2, blended finance models play a critical and significant role in helping to meet the capital needs of charities and social enterprises. However the combination of SITR and blended finance programmes working unison provide the best opportunity to incentivise lending activity for charities and social enterprises seeking to access smaller amounts of unsecured finance and where subsidy is required.

In his report, *What a Relief*[7], David Floyd outlines two distinctive needs for capital subsidy for social enterprises:

- Clearly socially useful, not quite commercial – investment into charities and social enterprises that are close to being commercially investable, but whose business models' would be significantly damaged by the attempt to repay an unsubsidised commercial investment.
- Venture Capital (VC) risks / ISA returns – investment into charities or social enterprises that, if the investment is successful, would generate positive social impact that is: (a) on a huge scale (b) unusually transformative or (c) both on a huge scale and unusually transformative. While the potential social returns

[6] https://www.socialenterprise.org.uk/the-future-of-business-state-of-social-enterprise-survey-2017 p. 41
[7] https://www.sibgroup.org.uk/sites/default/files/files/What%20A%20Relief%20-%20SITR%20research%20report.pdf

are the equivalent of those of a tech startup seeking VC funding, the potential financial returns are relatively modest even if the investment is successful.

As the report explains, these two examples illustrate how different tools can meet the needs of different social enterprise models. Blended finance may be well suited to the first model, because the impact model is well developed and is therefore a low risk grant opportunity. Blended finance may be less well suited to the second model because it is a less tested impact model and therefore both a high risk investment and grant opportunity.

In other words, blended finance can help to reduce the cost of capital to a point where it is affordable for the business model of the social enterprise. Tax relief can help individual investors to make investments which would simply not happen without the subsidy.

Tax relief is also a significant tool because of the scarcity of grant for blended finance. There are limited sources of grant available to provide subsidy into blended finance programmes at the scale required to meet the need in the market.

If SITR can play its promised role in attracting more individual investors to meet the capital needs of social enterprises then the call on large sums of grant for blended finance structures may be reduced over time, enhancing the long term sustainability of the social investment market.

Question 7: What criteria would be the best measure of success for SITR?

Criteria for success of SITR could include:

- Resilience of charities and social enterprises who have received investment
- Accessibility of capital for charities and social enterprises
- Cost of capital, which is unsecured and flexible in nature, compared to 2014 benchmark
- SITR awareness amongst social enterprises and advisors (independent financial advisors, accounts and lawyers)
- Number of organisations that have used SITR, relative to the size of the market. Compare this to EIS and SEIS equivalents
- Number of retail investors using SITR, including those that have made a social investment for the first time

Question 8: Is the SITR limit of £1.5 million appropriate?

As outlined below in our response to Question 15, the cap should be increased to £5 million, especially if restrictions around eligible enterprise activities are lifted.

Question 9: If you are an investor, have you made an investment that was eligible for SITR? If not, why not?

Access is not a private investor and is therefore not able to claim relief. As explained in our response to Question 2 we have provided subsidy in the form of grant from the National Lottery Community Fund into 16 blended capital funds which provide small scale unsecured finance to charities and social enterprises in England.

Question 10: Would you invest in social enterprise without tax relief?

There are many social enterprises in which one could invest without the need for subsidy. However as outlined above, data from SEUK suggests that the average amount of investment sought is £80k, and the sector requires unsecured flexible and affordable capital.

Bridging the gap between the capital needs of social enterprises and the risk and return expectations of investors is the role of subsidy in its various forms. SITR does this for individual investors. Blended finance does this for institutional investors. As outlined in our response to question 6, different forms of providing subsidy meet differing needs in the social enterprise sector and blended finance models need to coexist with SITR.

Access has published details on the levels of grant subsidy across the 16 funds established under the Growth Fund.[8]

The grant has three uses within the Growth Fund structure, one of which is to provide a loss protection layer in the funds (what we call Grant B). This loss layer ranges from 10% to 36% of the capital available for lending across the 16 funds, with a weighted average of 29%.

This is very similar to the 30% tax relief under SITR.

Question 11: What are your expectations when you invest in social enterprise? For how long do you expect to invest? Would you expect / prefer to invest in equity or debt?

The average length of loan within the Growth Fund is four years. However the fund managers who deliver the Growth Fund report to us that there continues to be strong unmet demand for more long term equity-like capital for charities and asset locked social enterprises.

Equity cannot be issued by charities and many social enterprises. Therefore the fact that SITR qualifying investments can be in the form of unsecured debt is critical to its take up in the sector and an important distinction from EIS and SEIS.

[8] https://access-socialinvestment.org.uk/wp-content/uploads/2019/06/Subsidy-report-II-final.pdf

Question 14: As an investor, enterprise or interested party, do you have a view as to why the take up of SITR has been less than expected?

It is too early to tell whether SITR has been a success. The challenges around eligibility and process have also reduced the number of organisations seeking to raise qualifying investments.

BSC report that 68 charities and social enterprises have raised more than £11.5m using SITR. Deals range from £1,200 to £1.46 million, with the mean being £170,000 and median £130,000, and are well spread around the country.

The seven year sunset clause does not present sufficient time to assess the viability of SITR, especially given the prolonged period of uncertainty caused by the changes in 2017. EIS took a long time to reach the volumes now seen.

The challenges identified in our response to question 3 have reduced the number of organisations seeking to utilise SITR in raising capital. To address these challenges, and to significantly enhance the take up of SITR we strongly recommend some specific extensions to the SITR eligibility and some technical changes and simplifications.

- Leasing: Generating income from leasing space is a very common model for charities and social enterprises which own buildings. Community Anchor organisations, such as members of Locality[9], are primary examples of this but examples are found across the sector and across the country. The policy of community asset transfer, which has been pursued by many local authorities, is largely dependent on this model. The 20% limit therefore excludes a significant swathe of the sector. For those who may still qualify but undertake some leasing keeping within the limit can create a range of perverse incentives and may be out of their control, for example if they lose a contract reducing their other income.

  We therefore recommend redefining the eligibility requirement to allow for leases shorter than one month. If this is not possible then we recommend significantly increasing the threshold. BSC estimate that this would result in up to £38.5m of new investable deals over the next five years.

- Nursing and residential care homes: Charitable providers of care services make up around 13% of the market, for which there will be a significant increase in demand over the next decade. HMT have previously indicated that they will introduce a scheme to accredit nursing and residential care homes in order to make them eligible for SITR.

  We recommend that this accreditation scheme is introduced as soon as possible.

[9] https://locality.org.uk/

- Community owned renewable energy projects: Since the removal of the feed-in tariff there is no longer a subsidy for the development of community owned renewable energy projects. As outlined in BSC's response to this call for evidence, while private sector renewable developers may be able to operate without subsidy the same is not true of community owned schemes. BSC's response also deals with how some of the concerns around this proposal could be mitigated.

  We therefore recommend that renewable energy projects owned and managed by asset locked community organisations should benefit from SITR. BSC estimate that if SITR could compensate for the losses of other subsidies this would represent an incremental SITR investment of up to £28m.

- Seven year limit: The logic that younger organisations are at an earlier stage of developing their enterprise model and will need certain types of capital does not necessarily hold in the social enterprise sector. Many social enterprise business models evolve from within established charities and therefore may need early stage development capital even if the organisation has bene established for a long time. More established organisations are more likely to be able to manage the process of taking advantage of SITR.

  We therefore recommend removing the seven year age limit on eligible organisations. BSC estimate this would be worth up to £42m over five years of new investable deals.

- Lifetime limit: The lifetime limit should be raised from £1.5m to £5m, especially if other eligibility restrictions are lifted. Should this happen, BSC identify specific opportunities between £6m and £20m in the community owned renewable sector alone.

We also fully endorse BSC's proposals in other areas including technical adjustments:

- Remove the restriction which prevents social enterprises with subsidiaries which are companies limited by guarantee from qualifying.
- Allow investors to qualify for SITR when they are investing in charities of which they are a trustee.
- Eliminate the need to deduct tax at source from interest paid to investors, as it is a significant and unnecessary burden for social enterprises.
- Eliminate the requirement to invest in the charity parent of a CIC rather than directly into a CIC.

To help further enhance the potential of SITR we also recommend:

- Increase transparency on rejected applications, and
- Increase efficiency of tax reclaims.

About Access:

Access works to make charities and social enterprises in England more financially resilient and self-reliant, so that they can sustain or increase their impact.

We do this through supporting the development of enterprise activity to grow and diversify income, and improving access to the social investment which can help stimulate that enterprise activity.

We were set up in 2015 and will be around for a decade, but the need for this work will continue well beyond that. So our approach is to work through others to create partnerships which can outlive us, test and learn from new approaches, and generate knowledge which improves the work of others seeking the same goals.

Our current five-year strategy prioritises three strands of work:

1. Providing £40m to support a broad range of enterprise development activities in partnership with other foundations, social investors, sector infrastructure bodies and enterprise advisors. This support will help charities and social enterprises to earn more of their own income and specifically develop business models which can be further supported through utilising social investment.

2. Managing and promoting blended finance models which bridge the gap between charities and social enterprises on one side and social investors on the other. These models help make the social investment easier to find and more relevant for charities and social enterprises, and help social investment reach parts of the sector which are yet to benefit.

3. Learning from our programmes and listening to the changing investment needs of the sector in order to influence our future work and that of others who support charities and social enterprises; and building systems which make that knowledge easier to understand and use for the long term.

The evidence on which we have based our strategy, and the lessons from our work to date, has informed this response.

For more information please see: https://access-socialinvestment.org.uk/