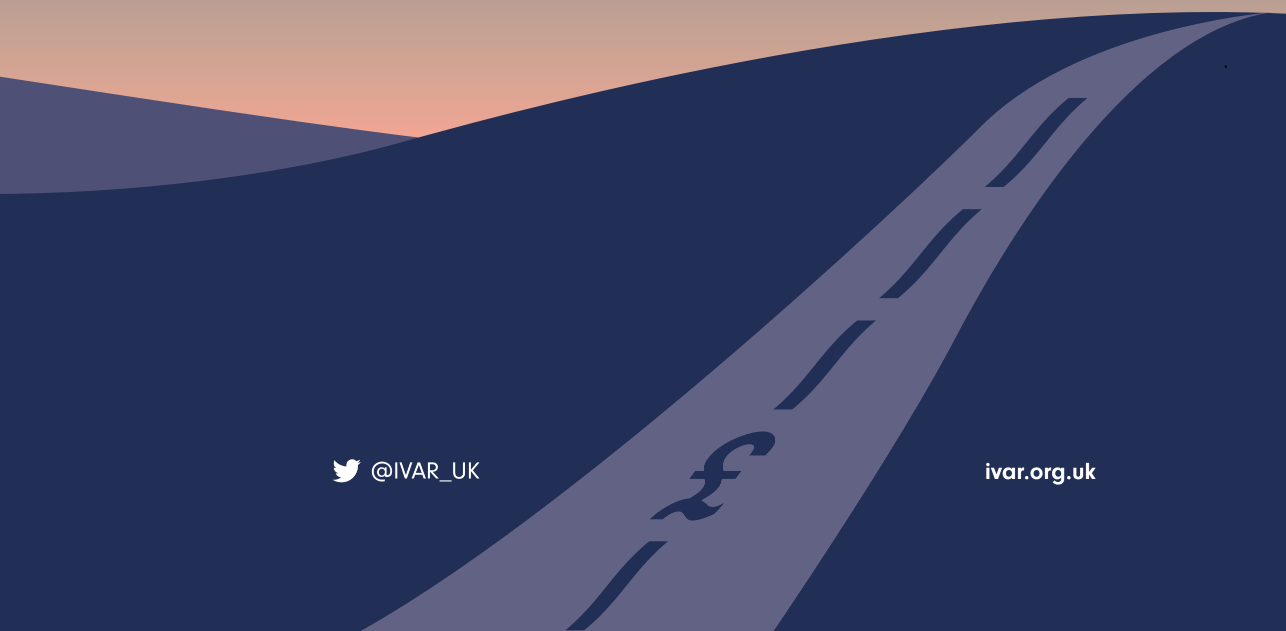
Institute for Voluntary
Action Research

Small charities and social investment



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Authorship and acknowledgments

This report has been written by Leila Baker and Niamh Goggin and is based on research carried out by the authors together with Rebecca Moran and Tess Pendle.

We are grateful to the senior staff and trustees in the 25 charities who made time to have us visit them and discuss, often over several hours, their perceptions, opinions and experiences of social investment.

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Foreword

This report seeks to shine a light on the as yet underserved part of what ought to be a more varied social investment market place. It revisits the study that IVAR undertook in 2012–13 for the Charity Commission on how social investment was playing out in the charitable sector. For that report, the method was to seek out the 'user experience' and reflect on the implications and trends of what smaller operating charities say about the products, processes and obstacles they found on their social investment 'journeys'. Some of it makes uncomfortable reading.

The piece of work is timely. Since 2013 the landscape has begun to change. Government and the Big Lottery Fund have listened to those voices, our own included, who have been saying for some time that a pure 'finance first' model will inevitably continue to fail large parts of the social sector. So now we have the Access Foundation, Power to Change and other initiatives. Their very existence is changing the broader narrative about the uses of social investment relative to the capacity needs of smaller organisations.

What the researchers found was closely aligned with what we have experienced, and readers will recognise many of the themes in the report: the need for blended finance, for example, or for high-risk patient capital at lower cost; the centrality of good governance to the success of any social initiative and some of the difficulties of achieving this; the frustration that everything takes longer than you think – whether growing a social enterprise to a sustainable scale or trying to borrow money to achieve it; the ongoing need for investment readiness and capacity-building support; and the dispiriting crash when it doesn't all go to plan.

And yet in spite of all this, amazing people with vision, drive and hope keep going. We in the social investment market must continue to serve them better. We hope the lessons that can be drawn from the report will influence our practice and yours in ways that will enable them to pursue their missions more effectively.

Sara Llewellin, Chief Executive, Barrow Cadbury Trust
November 2016

Contents

> *You must live by the ethos that brought you into this. You've got to meet your charitable aims. After that it's got to be a business case.'*

Charity CEO

Key findings

This research draws attention to a range of common challenges for small and medium-sized charities seeking to address mainly social welfare needs in their communities of geography or communities of interest. Some are deeply familiar – governance, for example, while others are not exactly new but more sharply drawn because of the financial and policy pressures that charities currently face. These include the need for working capital because of long delays in payments or being forced to accept payments significantly in arrears when delivering public sector contracts.

Few charities see social investment alone as a way forward to continue to fulfil their mission and charitable objects. However, some can conceive a time where loans might form one plank of a diversified funding portfolio alongside grants and donations. There is a need for significantly improved communication of the key components and requirements of the social investment process.

Social investors interested in forming long-term relationships with charities and their trustees; who understand the realities, uncertainties and style of entrepreneurialism that have characterised the charity sector for many years; and who are willing to simultaneously champion and challenge charities and their trustees, may be best placed to achieve this.

The aim of all social investments should be to leave an organisation in a stronger position not only financially but also in relation to its ability to pursue its mission.

Key findings

To do that requires:

Broad assessments including, but not limited to, due diligence

Thorough assessment will enable investors to understand the social and financial potential of the charity applicants, including the role they play in their communities and the capacity of investment to strengthen resilience and impact.

A willingness to engage with inexperienced charities to help them survive

This could lead to an investor choosing to support an application for social investment driven by necessity in a charity that is likely to struggle with the application process, but when investment will enable that charity to survive.

Alignment of mission and values

Securing social investment requires commitment and persistence, time and a willingness to acquire new skills, all underpinned by devotion to the organisation's mission and its beneficiaries[1].

Financial products and associated outreach and marketing tailored to charity need

Financial products need to be tailored to what charities need in order to fulfil their mission rather than to help build the social investment market, in order to generate demand[2].

Recognition that not all social investment is impact investment

Sometimes charities require the supply of a range of financial products and services similar to those provided by banks and other financial intermediaries to small businesses; overdrafts; working capital; leasing; factoring; commercial mortgages, etc.

Critical evaluation of property transactions

Most social investments taken by small and medium-sized charities relate to property. Robust challenges by experienced social investors as to whether particular property investments are the best option could help relatively inexperienced charities to make better strategic decisions.

[1] Baker, L. and Goggin, N. (2013) Charities and social investment: *A study for the Charity Commission*, London: IVAR.
[2] ibid

Understanding the social investment journey both from a charity and from an investor perspective could alleviate some of the difficulties that both parties experience in working together.

Key findings

Many of the problems that arise can be addressed, first, through improved communication: most charities have never been through the process before and are essentially piloting it for their own organisation; and second, through deeper understanding of the drivers leading to charities engaging with social investment and the way charities experience investment.

Building good relationships

– Charities are driven by mission first and appreciate working with social investors whose values are aligned with their own.

– Charities want to develop good relationships with social investors, rather than just experiencing a good transaction. What charities mean by 'good relationships' is to have an investor who understands and supports their social purpose and wants a long-term relationship that will focus on delivering on mission as well as financial viability. A good relationship can be underpinned by a lender's ability to judge whether a charity's finances are stable based on a realistic assessment of the current operating environment and the level of uncertainty that most charities live with currently.

– A good relationship between the CEO and Chair is critical when dealing with social investment. An indirect benefit of social investment can be a strengthened Board.

Suitable products and processes

– If the demand for social investment is driven by necessity, stability and development, then national and local outreach and marketing should reflect that reality, rather than focusing primarily on impact and scalability.

– Financial products, outreach and marketing should be driven by charity need not investor market-building.

Funding working capital and charity reserves

– Changes in local authority commissioning and contracting mean that many smaller charities find themselves at the end of long supply chains. This increases risk and requires the generation of surpluses to fund reserves and working capital.

Part 1:
Introduction

Geographical location of the 25 charities that took part.

Organisation focus
— Arts and culture x3
— Community x3
— Disability x2
— Education x1
— Families and children x3
— Health x1
— Housing and homelessness x4
— Lesbian, gay, bisexual and trans x1
— Social welfare x2
— Women x1
— Young people x4

1.1 Introduction

This report presents findings from a study carried out between September 2015 and July 2016 by the Institute for Voluntary Action Research. In it we present and discuss 25 charities' experiences of seeking, receiving and managing social investment. Our focus was on small and medium-sized[3] registered charities with an income under £1million in England. The majority of the charities (20) went ahead and secured investments while five walked away from this finance option.

The study addressed the following questions:

— *What were the drivers in charities' decisions to seek social investment?*

— *What were the main factors that drove success in the investment?*

— *What were the main barriers and risks that they encountered?*

— *What kinds of advice and support did the charities receive and what did they need?*

— *Why did some charities decide against social investment and how did they see their charity's finances now and in the future?*

[3] Understood as organisations with an income of £10,000 to £100,000 (small) and between £100,000 to £1million (medium), NCVO (2016) *UK Civil Society Almanac 2016*, London: NCVO

1.2 Context

We begin by explaining our decision to focus on registered charities in England with an income under £1million. We then summarise findings from the literature.

Why charities under £1million?

There were three main reasons for concentrating on registered charities with an income under £1million. First, small and medium-sized voluntary organisations, including registered charities, total 62,789[4] in comparison to 4,273 large and major organisations in England. Therefore, they merit consideration as a significant market segment in their own right. Recent research from National Council for Voluntary Organisations (NCVO) and Institute for Public Policy Research (IPPR) tells us that, overall, smaller charities have lost proportionally more income than larger charities; have undergone substantial income fluctuation/volatility; and that the smaller the charity, the more they have lost in income from local and central government.[5] The small and medium-sized charities we have spoken to share this experience. They have felt blown about by changes in local authority contracting and commissioning arrangements and by turbulence in the policy contexts of their particular work. This includes changes in the criminal justice system and potential and actual changes to housing and other welfare benefits.

Second, our review of the literature on social investment told us that the experience of large charities that receive social investment, and of charities that make social investment, is relatively better understood and more 'visible' in debates about social investment than that of small and medium-sized charities. This gap in research means that the voice of small and medium-sized charities as potential investees is largely absent from discussions about their participation in the social investment market. One way in which this gap is being addressed is through the recently created national body, Access – the Foundation for Social Investment, which has as its mission to bridge the gap between charities and social enterprises on the one side and social investors on the other, to help make social investment easier to find and more relevant for charities and social enterprises.

Third, we wanted to capture the voice of the 'established' voluntary sector and their experience of social investment alongside grants, donations and public sector contracts. Concentrating on registered charities enabled us to do this.

[4] NCVO (2016) *UK Civil Society Almanac 2016*, London: NCVO
[5] NCVO (2016) Navigating Change: *An analysis of financial trends for small and medium-sized charities*, London: NCVO; IPPR NORTH (2016) *How small and medium-sized charities are adapting to change and challenges*, Manchester: IPPR NORTH

Small charities merit consideration as a significant market segment in their own right.

Appraising the literature

We updated our literature searches carried out to support our 2013 research for the Charity Commission[6] looking mainly for insights into small and medium-sized organisations. Here we make some comments about the literature itself.

- **Charity voice**
  There is a gap in research, meaning that the voice of small and medium-sized charities (those with a turnover of £10,000 to £1million) is not being heard in the social investment debate. Of the 40 items included in our literature review, only a handful[7] involved direct consultation with charities and only our previous study for the Charity Commission concentrated on small and medium-sized charities. In addition, no material was found about charities that have been turned down for social investment.

- **Terminology**
  There is a confusion/elision of terms used in the research. These include social sector, third sector, charity (incorporated, unincorporated, company), voluntary organisation, community business, community interest company, social enterprise (asset and profit locked/asset locked/non-asset and profit locked), social entrepreneur, social firm, social business, B-corporation. Organisations falling within these definitions have different missions and funding models. It is difficult to interpret research findings and attach meaning to them if we are not clear what kinds of organisations have taken part, or are being referred to. Finally, many studies appear to conflate investment levels with engagement levels.[8]

- **Market segmentation**
  Some analysis by market sector (arts, heritage and sport, natural environment, etc.) has been carried out by Big Society Capital. However, more detailed segmentation of the market would be helpful, both to social investors and to charities themselves. This would investigate the market by organisation size, funding models, legal structure, charitable status, asset and profit-distribution locks, region, trading history, etc. Wider research into charity finance and financial capabilities has much to offer social investment research; it would be good to see social investment and charity finance research linking up together.

Insights from the literature on small and medium-sized voluntary organisations

The literature (which mainly looks at voluntary sector organisations in general rather than charities in particular) suggests that the social finance needs and experiences of small and medium-sized organisations are different from larger organisations; and that small and medium-sized charities interested in social investment may find it harder to access this kind of finance.

Below, we highlight three insights from the literature.

- **Mission**
  Charities' effectiveness – especially smaller charities – needs to be measured by their capacity to deliver on their mission, not on their investment-readiness. Some charities will never need to be investment ready, as that status is not relevant to their capacity to deliver their mission. For others, investment readiness shows how they have opened up strategic and funding options and thus built their capacity to deliver. Investment readiness needs to be seen as related to mission, rather than a goal in itself.

- **Capacity**
  Smaller organisations can find it difficult to dedicate time and resources for negotiating with third party investors, and generating the impact evidence that such investors require. This contributes to limiting their access to finance.[9] The Futurebuilders Fund learned that organisational size, along with its stage of development, was related to the likelihood that an organisation would default on its loan. Organisations that defaulted had an average turnover of *'half the size of the rest of the closed portfolio'* and 67% of defaulters were 'start-up'/growth investments, *'compared to 30% in the rest of the portfolio, which was mainly composed of expansion investments'*.[10]

- **Demand**
  The demand for social finance within small and medium-sized organisations has also been discussed in the literature. For example, research into the activities of social enterprises found that organisations with a turnover of more than £1million were almost three times more likely to seek repayable finance.[11] Recent research by NCVO also acknowledges that the majority of charities are small and many are still unincorporated, thus *'meaning that the personal risk to the majority of trustees in taking on debt would likely be considered unacceptable'*.[12] Research from Cass Centre for Charity Effectiveness has found that *'40% of charities feel that social investment will bring little or no change to their organisations, or are openly negative about it. However, 60% see social investment and borrowing as either positively changing their business models, or being transformational to them'*.[13]

  Some of the reports that we reviewed suggest that there is a potential demand for social finance in some smaller organisations wanting to 'scale up' in order to achieve greater impact and greater economies.[14] In particular, in small and medium-sized charities, what is anticipated is a demand for smaller value, unsecured investments.[15] However, the literature suggests that there is a gap in the supply of the kind of higher risk investments – what Helen Heap and Robbie Davison refer to as 'builder finance' – that this would require.[16] Moreover, in order to make a profit, there is an incentive for investors to concentrate on higher value transactions associated with larger, more mature organisations. Intermediaries can address these issues by designing funds that have *'an explicit goal to appropriately balance its service offering across large and small organisations at various stages of profitability and maturity'*.[17] CAF Venturesome has been given as an example of this.

[6] Baker, L. and Goggin, N. (2013) *Charities and social investment: A study for the Charity Commission*, London: IVAR
[7] For example, Baker, L. and Goggin, N. (2013) *Charities and social investment: A study for the Charity Commission*, London: IVAR; Big Society Capital and ACEVO (2015) *What do charity leaders think about social investment?* London: Big Society Capital; James, D., Kane, D. and Ravenscroft, C. (2016) *Understanding the capacity and need to take on investment within the social sector: Summary report*, London: NCVO; *Growing the social investment market: update on SIFI social investment; ICF Consulting (2016) Growing the social investment market: Update on SIFI Social Investment The landscape and economic impact*, London: Department for Work and Pensions and the Cabinet Office.
[8] James, D., Kane, D. and Ravenscroft, C. (2016) *Understanding the capacity and need to take on investment within the social sector: Summary report*, London: NCVO
[9] Moullin, S. and Shanmugalingam, C. with McNeil, B. (2011) *Growing Interest? Mapping the Market for Social Finance in the Youth Sector*, London: The Young Foundation; and James, D. (2016) *Understanding the capacity and need to take on investment within the social sector: Case Studies*, London: NCVO.
[10] Brown, A., Behrens, L. and Schuster, A. (2015) *A tale of two funds: The management and performance of Futurebuilders England*, London: The Boston Consulting Group.
[11] Lyon, F. and Baldock, R. (2014) *Financing social ventures and the demand for social investment*, Birmingham: Third Sector Research Centre.
[12] James, D., Kane, D. and Ravenscroft, C. (2016) *Understanding the capacity and need to take on investment within the social sector: Summary report*, London: NCVO.
[13] Salway, M. (2016) *"HEAD AND HEART" Social investment as a new charity finance tool*, Cass Centre for Charity Effectiveness.
[14] Ludlow, J. (2009) *Capitalising the Voluntary and Community Sector: A review for the NCVO Funding Commission*, London: NCVO.
[15] Kane, D, and Ravenscroft, C. (2016) *Understanding the capacity and need to take on investment within the social sector: Analysis of financial data on charities and social companies*, London: NCVO.
[16] Heap, H. and Davison, R. (2013) *Financing Social Enterprise: The Role of Builder Capital in Funding Innovation To Address Social Need*, London: Seebohm Hill.
[17] Charities Aid Foundation (2011) *The Impact Investor's Handbook: Lessons from the World of Microfinance*, London: CAF.

1.3 Approach and methods

**This was a qualitative research study in three main stages.
The research was supported throughout by a project advisory group.**

Stage 1: Scoping

— **Literature** – focusing on research that shed light on charities under £1million
— **Sample** – we built the sample carefully to provide a spread of experience (see below)

Stage 2: Data collection in 25 charities

— **Interviews** – semi-structured face-to-face interviews with CEOs and Chairs (a small number of interviews were over the phone mainly due to trustee availability, or were with a trustee other than the Chair because of their insight into the social investment experience)
— **Finance data** – analysis of each charities' accounts and loans (term, amount, purpose)

Stage 3: Testing and reporting

— **Interviews** – we shared and discussed emerging findings with 12 national bodies and forums
— **Analysis** – we shared and discussed our findings as we went along in briefings[18] and presentations

Building the sample of 25 charities
Access to charities for interview was negotiated via key intermediary bodies and investors including CAF Venturesome, Charity Bank, Key Fund, RBS Social and Community Capital and Co-operative and Community Finance as well as members of the Social Impact Investors Group including Esmée Fairbairn Foundation and the Barrow Cadbury Trust. We used a purposive sampling method to deliberately select charities with a range of experience including: a spread of experience across at least four lenders to avoid bias in our findings due to different investor and intermediary practice, and a balance between charities who have been seeking and managing investment for some time and those for whom this was a new experience.

It was exceptionally difficult to find five charities that had walked away from social investment and were willing to take part. It was hard to find lenders that could refer such charities to us and we also found this a challenge using our own networks. We think this was because lenders were uncertain what had happened to those charities that they had turned down or lost touch with; and charities themselves did not want to put themselves forward as never planning to seek investment. Although we would have liked to interview more charities with an income under £100,000 it was not easy to find them and only one such organisation took part; this is likely to be related to the level of interest and perceived appropriateness of social investment for small organisations.

[18] Available to download at http://www.ivar.org.uk/news-events/news/what-do-small-charities-have-say-about-social-investment

1.4 Key Terms[19]

Social investment

Social investment is a broad term for the use of a range of finance to deliver positive social impact. For the purposes of carrying out this study we understood social investment to be the provision and use of finance to generate social and financial returns.

Social investors

The social investors providing this money include specialist banks, individuals and charitable trusts, as well as organisations and funds that have been specifically set up to make social investments.

Social Investment Finance Intermediaries (SIFI)

Organisations that connect charities, voluntary organisations, social enterprises and others with investment, either by raising investment funds or by helping enterprises to find investment.

Social lender

A particular type of SIFI that provides loans, rather than equity, quasi-equity or guarantee funds. All of the charities in the study that received social investment did so in the form of term loans; that is loans to be repaid over a specified period or term.

1.5 Report

We refer to those who took part in the evaluation as 'interviewees' or 'charities'. Their views are presented anonymously and are illustrated with unattributed quotations (indicated in italics). Where appropriate we indicate if opinions were expressed by a particular group, such as trustees or CEOs. Given that this was a qualitative rather than a quantitative study, we do not indicate the number of people holding any particular point of view.

[19] Big Lottery Fund, Matter and Co, Social Enterprise UK (2014) *Social Investment Explained.*

Part 2:

Findings: The social investment journey

All 25 organisations that took part in this research are registered charities in England with an income under £1million, offering a wide variety of services, activities and facilities.

2. Profile of the sample

Summary of charity characteristics

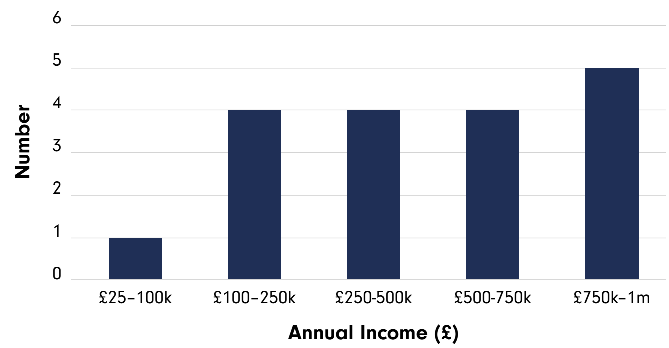
All 25 organisations that took part in this research are registered charities in England with an income under £1million, offering a wide variety of services, activities and facilities. In the last reported financial year, total income ranged between £35,000 and £1.2million[20], with a majority in the upper and middle bands of the NCVO definition of 'medium-sized'.[21] The charities are distributed across four different lenders and loan sizes range between £5,000 and £200,000. The majority of social investments were secured, one-off loans relating to the purchase and/or refurbishment of property. A small number of loans were for working capital, cash flow or new projects and most of these charities had borrowed more than once. Of the 36 loans made to the 20 borrowers (five organisations did not proceed with investment), five were grant/loan combinations.

Charity financial data in more detail

The charts below show financial data for those organisations that received social investment (20 organisations in total given that five organisations in our study did not proceed with investment), excluding two outlier organisations whose data would obscure the overall findings (n = 18). The graphs below are based on data collected from organisations' last published accounts from the Charity Commission website (2014/15 in all but one of the cases). When presenting a range, the data has been sorted into numerical order so that 'organisation A' is not always the same organisation within each of the graphs presented below.

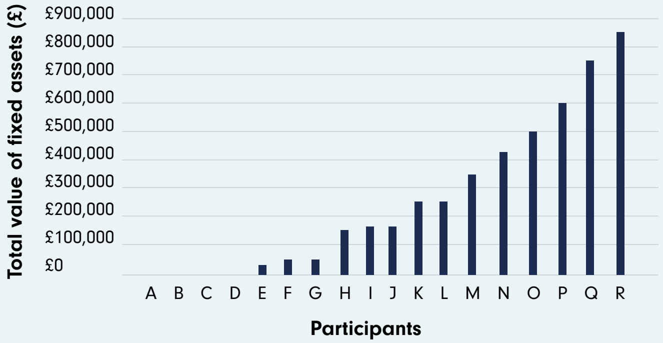
Figure 1 below shows that organisations across the income spectrum have been included within this research.

Figure 1: Number of participating organisations within each income band



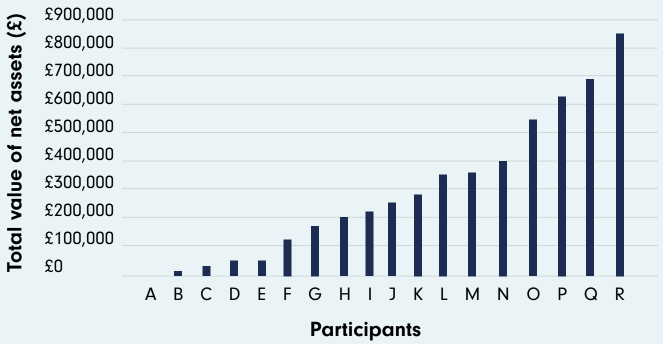
[20] One charity had turnover under £1million when selected for the study, but exceeded that limit in its next reported financial accounts.
[21] We used the definitions in NCVO (2016) *Navigating Change: An analysis of financial trends for small and medium-sized charities*, London: NCVO to organise our sample. This defines charities as follows: small (£10,000–£25,000); and then medium (£25,000–£1million) is subdivided into lower (£25,000–£100,000), middle (£100,000–£500,000) and upper bands (£500,000–£1million).

Figure 2: Range of 'fixed assets' held by the participating organisations



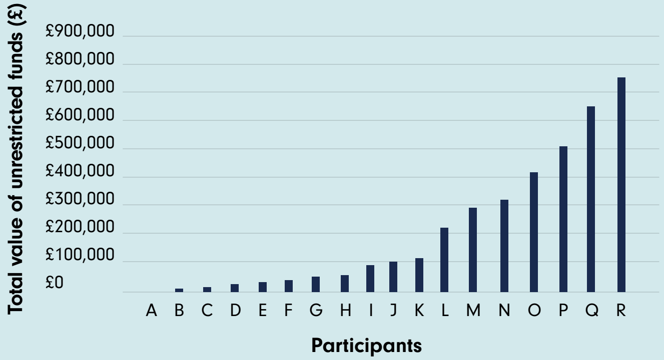
Total fixed assets held by the charities range from £0 (four organisations) to £850,000, with an average of £253,000. The charities fall into three categories: those that own minimal amounts of furniture and fittings; those that own some plant, machinery, vehicles, fixtures and fittings; and those that own land and buildings, in part through social investment.

Figure 3: Range of 'net assets' held by the participating organisations



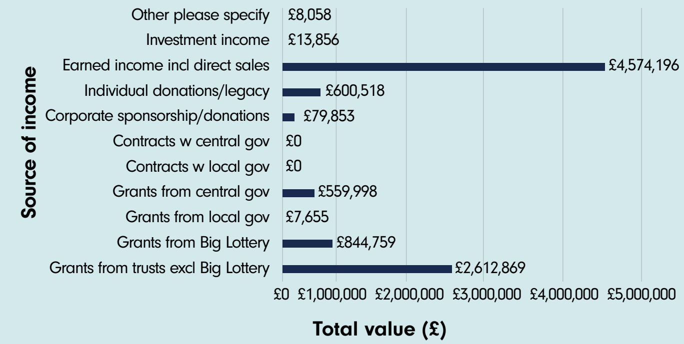
Net assets ranged from £2,500 to £860,000, with an average of £296,000.

Figure 4: Range of 'unrestricted funds' held by the participating organisations



Unrestricted funds ranged from £2,500 to £750,000, averaging £207,000.

Figure 5: Aggregate value (£) each income source received by all of participating organisations



Earned income was by far the largest source of income received (income generated in exchange for goods and services through trading. Source: NCVO Civil Society Almanac Glossary 2012), followed by grants from trusts and foundations (excluding the Big Lottery Fund), followed by Big Lottery Fund grants (see Figure 5 above). Individual donations and legacies and central government grants were also significant sources of income.

Figure 6: Range of net income of participating organisations

The income-expenditure balance produced an average of net incoming resources of just over £20,000. Six of the organisations saw deficits of up to £55,000.

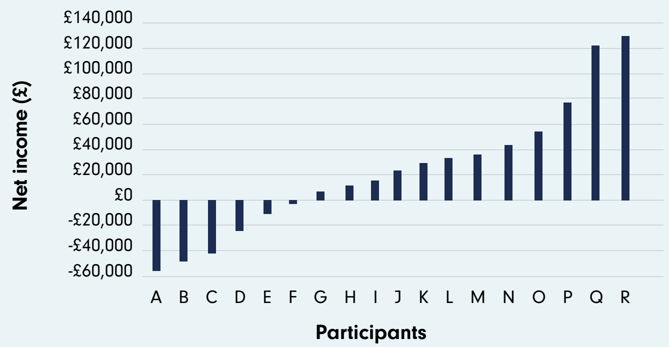
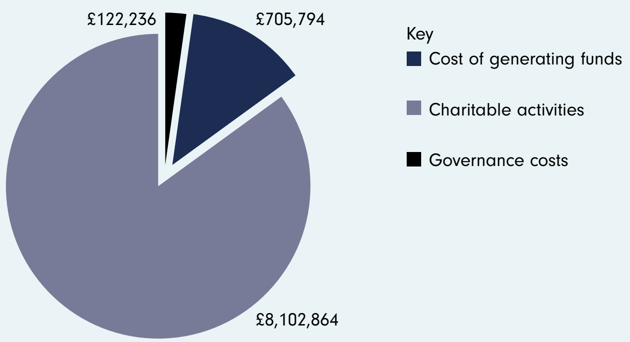


Figure 7: Total resources expended on cost of generating funds, charitable activities and governance costs



Total resources expended were almost entirely devoted to charitable activities.

In summary, the data shows that the sample includes organisations of various sizes within the small and medium income bracket, all of whom prioritise spending on their charitable activities. On average, the net incoming resource is fairly low across the sample (an average of £20,000), showing that these organisations do not have large amounts of resources that they can use flexibly.

3. Three kinds of journey

By describing and explaining these different organisational journeys, we hope to provide investors with a useful picture of how charities experience social investment processes so that they can use it to adapt their practice.

We identified three kinds of organisational journey among the 25 charities that we interviewed.

A highly stressful journey

– Unfamiliar and difficult process
– Urgent need for funds
– Overwhelmed by the decision
– Sometimes poor CEO/Chair relationship

A journey made with confidence

– Access to an accountant
– Robust financial systems
– Confident Board
– Good CEO/Chair relationship

Charities that chose to walk away from the journey

– Investor lacks understanding of charitable purpose and obligations
– Unfamiliar and poorly explained processes
– Perceived weaknesses in own organisation especially governance and financial systems

3.1 A highly stressful journey

These charities had little or no prior knowledge and experience of any form of charity finance other than grants, donations and local authority contracts. Every aspect of the social investment experience was unfamiliar and so, essentially, they were piloting social investment for their own organisation. The application process was difficult to handle not only because charities did not know how it worked but also because lenders did not explain it well: *'It [application process] took over my entire life'*. Many of these were stretched, busy service-delivery charities handling social investment '*off the side of the desk*'.

Trustees and officers alike felt overwhelmed by the magnitude of the decision: *'This was the biggest decision the Board had ever taken'*. In many cases, the level of stress that social investment caused was compounded by poor relationships between Chairs and CEOs.

These charities had not entered into social investment in a planned way; a loan was the only finance available at a time of urgent need: *'They [trustees] understood that was it, they had to take the risk'* or close. The impact of the loan had been similar to having an unrestricted grant in that it provided the organisation with breathing space and the flexibility to spend the funds where it was urgently required. Charities who had found social investment a stressful experience did not see it as being a new way to finance their work but instead had focused back on identifying independent funders for new grants. As one Treasurer put it, for his Board *'it would be difficult to brave it [social investment] again'*.

Many of these were stretched, busy service-delivery charities handling social investment 'off the side of the desk'.

3.2 A journey made with confidence

Not everyone struggled with the social investment process. For some trustees, although they did not take the decision to seek investment lightly: *'We went into everything, we weren't blinded'*, it was on a par with other major decisions that they had taken in the past such as entering a contract, or merger. The experience may still have been stressful at times but it was manageable. For several of these charities, the prospect of needing to generate an income and/or purchasing and managing property was not new to them and although they were far from complacent about these undertakings, their track record gave them a degree of confidence: *'We don't quite wash our face but we're getting close to it'.*

Where social investment and associated tasks were new to the organisation, critical factors in assuring a 'confident journey' were a confident Board that worked well together, access to a skilled accountant (either in the role of Treasurer or as a pro bono or paid advisor) and robust financial systems. In these charities, responsibility for investigating, championing and applying for investment was shared between at least one senior officer and one trustee, who appeared to have a good relationship and a common understanding of the organisation's direction. One charity that we interviewed might have been described as being on a 'stressful journey' in the past, but now appeared to be coping well with investment and associated property management challenges. The Chair explained that the charity had introduced a more formal style of supervision and reporting to the Board for the CEO and that this has had a beneficial impact on the CEO's stress and the Board's confidence in him.

A minority of the charities we interviewed said that they expected to take on further investment in the future. Most of them said that while they would not rule it out altogether, there would need to be a strong business case for doing so and the finance would need to be for something that the charity really needed to do.

3.3 Charities that chose to walk away

Like most of the charities in this study, these charities looked into the possibility of social investment because a trusted funder or advisor suggested investment in order to diversify income. They withdrew from the process for a number of reasons that fall into three main groupings, the first one being dominant across all of the charities:

- **Lack of alignment**
  Charities said that investors did not understand and failed to take account of their social focus. They described investors as 'well-meaning' but lacking understanding of charities, charitable purpose and the idea of public benefit, as well as the nature of governance and leadership in small and medium-sized charities. This had led trustees to question the rationale for social investment: *'If the social investment is not really about social mission then why not go to Barclays?'*

- **Opaque processes**
  Charities were honest about their own inexperience and some said that probably had not helped, but they nonetheless felt investors could do a lot more to explain their due diligence processes and were somewhat sceptical about some intermediary bodies who, they felt, appeared to be taking *'a big cut'* without giving much back and lacked transparency.

- **Organisation**
  Some of the charities walked away because of a perceived weakness in their finances, their financial processes, governance or leadership. Examples of this include: not having a physical asset; having a weak balance sheet; and having a Board that is *'scared'* to make decisions that they feel could put the future of the organisation at risk.

> *'First, you need to be able to create a return and that's fine. But then you're required to also show and measure your social return. And yes we have a social mission. But that kind of measurement is expensive and the work isn't well understood. The partners [investors] didn't seem to take into account the social focus.'*

Not all the charities we spoke to had turned their backs on social investment. Sometimes the timing had not been right – one charity said that they were *'starting to get our heads around it'* now; while another charity had stepped back while it coped with a change in Chair and CEO. Overall, any remaining appetite for investment was for blended finance provided by investors with a genuine commitment, knowledge and understanding of charity, particularly the realities of operating smaller, local charities.

4. Operating environment

In the introduction to this report we described the broad policy and funding context in which small and medium-sized charities operate; and we provided some background on the social investment market from the research. Here we discuss our findings from the charities that we interviewed about how they see the current operating environment insofar as it relates to their finances in general and social investment in particular.

We identify four features of the operating environment and then briefly discuss what has or could help in the future.

Local authority contracts and working capital

The charities we spoke to had lost contracts due to reductions in public expenditure, where services had been removed altogether or where smaller contracts had been combined into one large contract and awarded to a larger provider. Where they continued to provide services, some charities found themselves at the end of long supply chains making it hard to predict when they would be paid and leading to delays in payment for completed work. They had been required to move to payment in arrears and to pay up front for the resources they needed to deliver the contract. One charity had been required to pay up front for a new electronic monitoring system that they were required to introduce as part of the contract.

These charities had a genuine need for working capital without which they would have had to eat into carefully accumulated reserves, which are there to protect the organisation.

Income diversification

This was firmly on the radar of all the charities we worked with as an aspiration, mainly to move away from reliance on local authority contracts and to adjust the ratio of grants to contracts overall: *'We've been in that little boat riding around in local authority water. And it's time to take control'.* Most of the charities found it tough going putting together packages of development finance to support property acquisition or other major projects. Not only were they coping with unfamiliar processes to do with the property, but they were also juggling loans, multiple grants and contracts all with different timings and funding limits.

Property investment

Most of the loans we looked at were part of a bigger capital and revenue funding package, which the charities had assembled themselves; these comprised not only loans, but also multiple grants and contracts. In many cases, the loans and other kinds of finance were interdependent, leading to a race to secure the loan in order to not lose a grant or vice versa. We were not convinced in every case that either the charity or its investors had sufficiently interrogated the wisdom of purchasing a property or taking on debt to redevelop it. One incoming CEO described *'the burden of inheriting the debt'.*

In addition to identifying the likely journey a charity may face, investors and charities may find it helpful to specify the nature of the charity's property ownership. Earlier research has identified three kinds of ownership: stewards, community developers and entrepreneurs.[22] Most of the charities we spoke to were 'stewards' of buildings that they saw as inextricably linked to their mission to support the community (providing a place and a space for local people) or community developers. A minority were entrepreneurs and using the investment in a planned way to support their strategy.

Enterprise

Most of the charities, with some exceptions, were sanguine about the extent to which they would be able to generate an income from the kinds of activities that support their mission. Rental income was modest, unpredictable and no basis for expansion. One charity that had taken a loan to purchase their property said that at most 15 per cent of income might come from room rentals but that this fluctuated and that pressure on businesses and incomes had caused this to drop. One charity said that their advisor had reassured them that *'It's tough everywhere'* and there was no longer the demand they had anticipated. The business of childcare has changed since austerity hit: unemployment has risen sharply and demand for childcare has gone down.

A minority of the charities we spoke to saw enterprise or entrepreneurialism as a philosophy because it had enabled them to move away from a service delivery model and adopt an approach where residents or volunteers were part of operating the charity. How this worked varied: running a shop or café, building resources for sale or operating a small-scale business from the site. However, these enterprises did not make a great deal of money and in any case were only partially focused on achieving this:

> *What's distinctive about what we do is that we are generating income to provide this holistic approach and not just to pay for services or to maintain the building.'*

[22] Aiken, M. et al (2011) *Community organisations controlling assets: a better understanding*, York: Joseph Rowntree Foundation.

What can help?

We noticed that several of the charities appeared to have been supported through their social investment experience or cushioned from it by one large donation (usually a legacy), a major Big Lottery Fund grant over at least three years, or an important partnership that brought both income and commitment to their survival. Notably some of these partnerships were with regeneration organisations in the north of England, such as Coalfields Regeneration Trust, which grasped the way local economies worked and understood the social investments as playing a supportive role. Early adopters had become advisors to charities that were newer to the idea and there was a sense of regional self-help.

Many charities had worked really hard to accumulate reserves, in some cases having been forced to run them down and then build them up again: one charity had seen reserves dwindle to £5,000 but they were now back at £35,000. Some investors did not fully understand how to read a charity's accounts and therefore how to interpret the presence of reserves in the accounts. Charities needed investors and also local authority commissioners to understand the distinction between reserves and working capital. One of the conclusions of this study is that there is a need for charities to be able to access working capital at an affordable rate if they are to continue to deliver public services locally.

Charities need investors and local authority commissioners to understand the distinction between, and the need for, both reserves and working capital.

5. Motivation

Having examined the operating environment in which charities had considered social investment, we now look at what their key drivers were.

In every case, the charity's application for social investment was mission-driven: they wanted to set up or maintain something that was central to their ability to fulfil their mission. However, despite being mission-driven, some applications for social investment were not well thought through and this left some charities in difficulty:

> *'You must live by the ethos that brought you into this. You've got to meet your charitable aims. After that it's got to be a business case.'*

Where difficulties had arisen, charities said it was often because the decision to seek investment was mission-driven to the exclusion of financial considerations; such charities had *'followed their heart not their head'*. This was often linked to decisions being pushed through by 'heroic' founders because of the 'wow' factor of an exciting new opportunity; as one senior officer admitted: *'There was [the founder]'s own personality of wanting to build things and "wow" we could have our own building. It was short-sighted, [but] when you're founder led, you go with it'*. The better approach was to use their mission to enable them to make good decisions about what they do, without ignoring the need to make financial assessments of potential decisions.

Charities came across social investment as an option by chance, because a trustee or senior officer heard about it at a conference or other event; it was suggested to them by a trusted funder or partner; or they were approached directly by a lender. Later in the report, we discuss how charities appeared not to have considered a range of finance options.

Motivation for social investment among the charities that we spoke to was split roughly 50:50 between strategic opportunities and necessity or crisis.

Strategic opportunities

These charities took social investment in a planned way as part of their strategy to develop their organisation and/or protect themselves against changes in the operating environment, especially cuts to and reorganisation of local authority contracting. A small number saw this as being explicitly about becoming independent, buying time to restructure or review their strategy, and highlighted the value of having unrestricted finance in the form of the loan.

Some of these charities had taken several loans and each one had been used in a planned way to support their organisation's development. These charities said that they only took loans if it would help to develop the organisation as a whole:

> *'We only take funding if it will develop the company or if the definite outcome will be for the kids. We generate our income for overheads'.*

Necessity or crisis

Many of the charities needed funding fast in order to cope with a cash flow problem created by their lack of working capital, the sudden need to move premises and/or to buy their own building because it was put up for sale. Some felt pushed into the decision because they had to buy or lose their premises or had exhausted all other options. One charity was short of the total funds required to redevelop a building and was at risk of losing a grant they had already secured for the work if they could not find the rest of the money: *'We fell into it really. It was all or nothing'*; *'[It was] the necessity and the immediacy of that necessity'*.

For most of these charities, a loan was the only type of finance they could obtain at the time; they would have preferred a grant: *'It [a loan] was completely against the culture [of the organisation]. But they accepted the necessity'*. For these charities, speed of turnaround of their loan application was essential:

> *'It's about understanding [that] we, as small organisations don't have the cash flow or reserves to wait a year for funding'.*

6. Decision-making and the role of trustees

We wanted to understand the role of trustee Boards in the decisions charities make to seek and take up social investment. We were interested in how they weigh decisions and whether their views change after having successfully managed an investment.

Trustees' role in assessment

All formal decisions to seek and take investment were made by trustees, but their role in assessment of options was limited, as few options were considered. In most cases, CEOs (perhaps supported by Finance Officers) discussed the borrowing proposal in advance with the Chair and/or a committee of the Board and then presented it to the full Board for decision.

Who led the decision-making?

In some cases, the decision was strongly led by the CEO, a single trustee or a small group of trustees. In other organisations, the CEO liaised with a Board sub-committee that then reported to the Board, or the CEO liaised with the Chair and then took the proposal to the Board: *'It was an iterative process. We were authorising this properly'.*

In most cases, trustees took the decision very seriously and brought in external advisors (accountants and solicitors). Having someone on the Board, or available to trustees, capable of making *'sound financial judgments'* was important to trustees who perceived a need for a bridge between the charity and the finance provider.

Trustees' role and attitude

Most trustees took their role in agreeing social investment seriously and were thorough in their review process. Some CEOs and trustees thought that trustees with business or finance experience were more comfortable with the prospect of a loan. In a small number of cases, trustees either opposed taking loans on 'moral' grounds, or felt that borrowing indicated that the charity was not a going concern, or were very anxious about liability and local reputation. In cases where the charity had borrowed for 'necessity', trustees were thought to be concerned that that would set a precedent and would not be willing to countenance a second loan for the same purpose.

Board strength

We found that the charities we spoke to were divided fairly evenly between those that regarded their Board as reasonably strong and those that thought their Board was somewhat weak. In the latter case, social investors often suggested or insisted on new trustees with particular skills, especially Treasurers with finance experience. A number of CEOs said that the process of applying for social finance or engaging in the investment project highlighted Board and organisational weaknesses which were then addressed. One CEO said how stressful the process had been at the time but that *'the Board is much stronger now and [she finds herself] using tools and procedures all the time'* that were learned through the social investment process.

Comparison with other decisions

For most organisations, the decision to take social investment was regarded by CEOs and trustees as being on a par with other major decisions and challenges, such as organisational turnaround, restructuring and redundancy and safeguarding young people. However, for some organisations, with CEOs and trustees who were less experienced in financial management, it was a *'massive decision'.*

Engagement with later stages of process

A small number of trustees were engaged in the later stages of the investment process, generally the Treasurer and Chair. Issues that arose tended to relate to property law. There was often significant time pressure from outside agencies to complete the deal, which meant that there was no time to challenge or seek renegotiation of terms and conditions.

Attitude to social investment now

Those who borrowed from necessity are wary of borrowing again for the same purpose. There was a strong sentiment that the organisation would need to have moved on and strengthened its financial position. Furthermore, some organisations are very focused on paying down the loan and getting out of debt.

> *'Everything is temporary and a loan is so permanent.'*

Organisations that have a working business model that requires further investment were more enthusiastic. One such organisation that had had multiple loans uses a hierarchy of tests to help them decide whether to take a loan starting with: does it meet charitable aims; then is it an opportunity for profit or profile; followed by strategic fit; and finally, interestingly, *'is there the desire to do it'* among staff and trustees.

7. Application process

In this section we set out the application process as it was experienced by the charities we interviewed and note what helped them through the process.

Who did charities approach to borrow?

The majority of newly-borrowing charities only approached one social investor and they were referred by one trusted advisor, mainly external to, but supportive of, the charity. One charity approached two social investors and three contacted three potential lenders. There was little scoping or review of the market, which charities found to be opaque and confusing. They did not compare average loan sizes, interest rates, loan terms, lender experience in their sub-sector or track records of successful investing. Instead, they relied on their trusted advisors to direct them to the most appropriate lender for their purpose.

Independent advice

Independent advice was rarely sought on the investment proposal. Where it was used, it was provided by the charities' solicitors and/or accountants and involved reviewing risk, the legal implications of the loan and affordability and sustainability. Less experienced organisations at the beginning of the social investment journey would have welcomed very early stage support *'where Boards are struggling to understand charity finance, including investment'*. They valued advice being provided by *'people who can look at your business and spot opportunities and ideas'*.

Support with the application

The need for support with the application process depended on the capacity of the organisation, previous experience of the trustees and staff and the extent to which they understood the stages and requirements of the lending process. One charity suggested that an *'organisational health check'* (such as Big Potential's online diagnostic tool) before making the application would help them *'get their house in order'*. Support on business planning, trustee facilitation and legal processes would have been welcomed by the less experienced charities. Most of them were able to complete the application requirements in full, with staff producing the documentation with support from trustees, professional advisors and other supporters. Some organisations struggled and found the process difficult and overwhelming: *'I stopped doing other stuff. It took over my work for a number of weeks'*.

Due diligence

Due diligence is *'an investigation or audit of a potential investment. Due diligence serves to confirm all material facts in regards to a sale. Generally, due diligence refers to the care a reasonable person should take before entering into an agreement or a transaction with another party'*.[23] Social investors comply with due diligence requirements by reviewing and checking governance, management, finances, legal requirements, risk management, information systems and production/service delivery and by evidencing their conclusions.

To some extent, the term 'due diligence' has become shorthand for the whole assessment process. However, the assessment process also includes a focus on mission, governance, public benefit, non-financial risks and community engagement and empowerment. It might be helpful if the social investment sector explained the application, due diligence and assessment processes clearly, so that charities could understand both what information is required and how it will be interpreted. Charities may never have had explained to them the shift in understanding from deficit-based funding to asset-based support that is integral to the change from grant assessment to social investment analysis. Smaller charities may make many applications to a wide range of small and large grant funders, on the basis of an identified need or deficit in their community or community of interest. They may not have been questioned about their strategy for sustainability, the long-term viability of their charity or their capacity to trade and generate surpluses. This highlights the need for care in listening to potential borrowers and communicating how and why the process works, in terms that make sense to smaller charities.

For most charities, the due diligence processes were much as expected. In some cases, external timing pressures required very fast turnaround and the charities were grateful for the social investors' efforts in meeting those constraints. However, for less experienced organisations, the process was difficult and stressful, because they did not understand what information and documentation they were being asked to supply and how the data would be used to make a decision on their application. One charity remarked on how helpful a trustee, who was also an accountant, was in interpreting between the charity and the social investor: *'He speaks bank'*.

Similarly, charities divided into those that were not required to provide extra information after the application was accepted and those where the social investor came back, sometimes with query after query: *'Once we'd filled in the forms and sent them back, they changed the loan to value offer ... the goalposts moved and we didn't understand why'*. Some legal difficulties also arose in relation to property transactions, which were not the responsibility of the social investor but where communication could have been improved. Those charities that returned for second or subsequent loans found that they had developed a relationship with the lenders, which speeded up and eased the process.

Terms and conditions

The social investment terms and conditions were generally seen as fair and reasonable, with 'no nasty surprises'. Some of these conditions (such as valuations, proof of other funds, construction completion certificates, insurance and safeguarding policies and the appointment of an accountant as Treasurer) were seen as useful checks that the charity was managing risks effectively. In some cases, more experienced and repeat borrowers managed to negotiate on interest rates and repayment holidays. Others, especially those borrowing to meet an external deadline, felt that they did not have that opportunity. However, some conditions such as the requirement to keep a certain amount of cash available as reserves, or the specification of social impact indicators without consultation, were resented. In most cases, clearer explanation of the reasons for the requirements might have eased tensions.

[23] Taken from http://www.investopedia.com/terms/d/duediligence.asp [Last accessed October 2016]

8. Using and managing the loan

The charities we interviewed were at different stages in their experience of social investment. In this section we offer a snapshot of how they fared overall in using and managing the investment before analysing strengths and weaknesses, relationships with investors and financial impact.

What went well and what difficulties were encountered?

Most charities that received a social investment took a secured loan to buy, redevelop or build a property. These organisations had not encountered difficulties in making repayments and were conscious of the advantages of moving from paying rent to purchasing an asset. They were very positive about the outcomes.

Some other charities had borrowed, more recently, for working capital. While it was too early to say if the experience would be positive in the long term, one CEO identified immediate impact:

> *'Everything we are doing now comes from [the social investment]. That's the impact, because without it we wouldn't have survived.'*

Some charities welcomed non-financial support, receiving, for example, independent support to redevelop management accounts and on legal structure. A number of charities noted that the process had encouraged strengthening of Boards, bringing on finance and legal professionals.

However, a third of charities experienced difficulties or constraints following social investment. At the lowest level, these included awareness that the need to make loan repayments prevented the expansion of staff and services. Other organisations' expansion or diversification plans failed, required renegotiation of loan repayments or a request for interest-only or repayment holidays. In some cases, repeated refinancing and top-up loans have left charities in strategic, geographical or financial difficulties:

> *'As an investor, you end up focusing on what will get that investment across the line, which can mean that you don't do the stuff that will strengthen the organisation over time.'*

> *'It's how do you strengthen and capacity-build the organisations to be able to cope in this new environment, and how do we help them with the tools and expertise and skills. So it's almost like using it as a learning tool; how do they have to look at their balance sheets differently, how do they have to look at their cash flows differently, how do they have to look at their business planning differently, their impact differently, and by us giving them the loan or giving them a bit of grant and loan we're helping them on that journey.'*

What charities said about the outcomes and benefits of purchasing an asset:

'Now the building is watertight and secure.'

'Gave us confidence that we can run this type of project and to further develop.'

'Clients have a sense of ownership and place.'

'Definitely feel that having the building as an asset is a help. [The organisation is] financially stronger and more resilient.'

'More space, better conditions, more security for the future.'

'The biggest threat to our sustainability is our accommodation, so social investment saved the organisation repeatedly.'

'Generating income to provide a holistic approach [for beneficiaries] and not just to pay for services or to maintain the building.'

Strengths and weaknesses

Stronger Boards, with new skills – particularly financial, legal and commercial – were identified as organisational strengths by many charities, with a small number identifying dysfunctional Boards as a weakness. Owning a building as an asset makes the organisation more resilient. Increased capacity to scale up and deliver services is a strength 'allowing the CEO to stop working IN the business and start working ON the business'. Strong community support and diversified funding were also mentioned as strengths. Having trading experience and a flexible business model were thought to be helpful.

Managing cash flow, working capital and dealing with the situation as a sub-contractor for public sector contracts were identified as key weaknesses. The CEO of a charity that bought a building felt that they had underestimated the costs of owning their own building and the need for physical improvements.

Relationship between repeat borrowers and their investor

Some organisations have borrowed repeatedly from one lender and value the relationship with a *'critical friend'*, also noting that: *'we saw a real person, who is approachable'*. One noted the investor's empathy and *'a commitment that we won't close you down'*. Charity borrowers respect the long-term relationship and advice and guidance provided. The annual review process is now carried out by some organisations by phone rather than face-to-face, but was still appreciated. They have been happy to be used as case studies and to help to explain and promote social investment. In a nice combination of solidarity and practicality, one borrower said they went with a social lender *'who we knew, rather than squeeze 1% out of another lender. It saves time and money'*. Most importantly, charities felt that there is an identity of values *('a profound social conscience')* and that their commitment to mission was shared with the lenders.

Financial impact

Appendix B shows financial information from twelve of the charities that took revenue or capital loans and participated in our study.[24] The information comes from published accounts for the years 2011 (earliest available on Charity Commission website), 2014 and 2015 (where available). The earliest loans taken by interviewees were in 2004 and the latest in 2015, so a full picture of the change in their finances is not available. However, the data gives an indication of some of the opportunities and challenges for borrower charities and social investors. These merit further investigation through tracking and analysing charities' financial performance before and after social investment.

[24] The remaining organisations either did not take a social investment or received it too recently for any impact to be seen in their accounts.

The key points are:

- The data we have indicates that working capital or business development loans may have little or no impact on the capitalisation of charities. Capital loans do impact directly on the value of fixed assets because they are used to purchase, renovate or build capital assets. However, it appears that there is a tendency to run down the value of the assets over time, through lack of ongoing investment.

- More charities in receipt of capital loans saw their net assets increase over the period, but more in receipt of working capital or business development loans experienced a decrease in net assets. This may indicate a more strategic impact from capital investment than from the provision of working capital or business development loans.

- A similar picture emerges with unrestricted reserves, with most who took a capital loan seeing an increase and most revenue borrowers seeing a decrease.

- Over half of the organisations saw an increase in total resources expended over the four-year period, which is an indicator of increased activity and, potentially, impact. Further financial investigation could assess in more detail whether, and what type of, social investment had a positive effect on turnover, scale of operation and social impact.

Part 3:
Conclusions and implications

Conclusions and implications

In the final part of this report we draw together our conclusions from the study and suggest where they may have implications for charities and investors. The conclusion is in five parts:

—The social investment road and the journey
—Mission first
—Building good relationships
—Governance
—Markets and working capital

The social investment road and the journey

One way of considering the experience of the two parties is to see social investors as building and equipping the social investment 'road', while charities take a 'journey' along that road.

The social investment road consists of:

- **Outreach and marketing to explain social investment options**
- **Capacity-building and investment readiness support to get the charities on the road**
- **Application, assessment and due diligence processes**
- **The investment offer, terms and conditions**
- **Eventual take-up and use of social investment**
- **Loan repayment (includes testing financial assumptions about revenue)**

Our research identified three experiences of that journey, and most charities under £1million appear to fall into one of these:

- **A stressful journey**
- **A journey made with confidence**
- **Charities that chose to walk away from the journey**

Drivers or 'starting points' for these journeys fell into two broad categories: 'necessity' (embarking on the journey because of cash flow or a sudden need to move or purchase premises); or 'strategy' (embarking on the journey in a planned way to help develop their organisation or protect it from the impact of changes in the funding and commissioning environment).

Where charities were seeking investment out of necessity, they entered this social investment market in a fairly unplanned way and were forced to move quickly to the due diligence stage of the process.

Understanding the social investment journey both from a charity and from an investor perspective could alleviate some of the difficulties that both parties have experienced in working together. Many of the problems that arise can be addressed. First, given that most charities have never been through the process before and are essentially piloting it for their own organisation, there is a need for significantly improved communication about the key components and requirements. This would go some way to addressing some of the concerns highlighted in our study. For example, most charities that we have interviewed had either missed the outreach and marketing or found it hard to understand; few of them had availed themselves of investment readiness support; and those who were stressed by the journey did not understand the assessment and due diligence processes.

Critically, by making visible the social investment journey, investors and charities can identify organisations that are likely to struggle early on and adjust the way they explain the process as well as make available support through peers, trusted advisors and so on.

Second, there is a need for deeper understanding of the drivers for charities to engage with social investment and the way charities experience investment.

It is important to note that we see a social investment journey as including, but not being limited to, the due diligence stage in the wider process of thinking about, applying for, securing and then managing investment. Typically (with exceptions), charities are more comfortable with the 'thinking about' stage in this process sometimes called 'assessment' in grant-making, whereas due diligence is less or entirely unfamiliar. Guidance on social investment tends to focus on investment readiness of the applicant, but is lacking on what happens once an application is submitted to a social investor. The assessment and due diligence processes are very familiar to the social investors, but are a mystery to some potential borrowers. Mapping the full social investment journey would enable both parties to see where each charity is on this journey.

By making visible all elements of the social investment road, investors and charities can work out where, and what kind of, advice, support and information is needed. Some of this support will focus on legal and financial issues but a critical friend/mentor can offer a different perspective[25] and help a charity to think through the prospect of social investment thoroughly.

Factors that charities may want to think through need to include the following which are roughly sequential:

- **Degree of consensus among trustees and trustee confidence in the executive team**
- **If the journey is likely to be 'stressful': Have alternatives been exhausted first?**
- **If the journey is likely to be 'confident': Can the charity afford this, can it generate income?[26]**
- **For all journeys: Does the charity need this finance in order to fulfil its mission and therefore does the charity have to find the money somewhere?**

[25] Charities Aid Foundation (2010) *Financing the Big Society: Why social investment matters,* London: CAF.
[26] The ability and confidence to generate a surplus can act as a significant barrier to seeking and securing social investment, See Gregory, D., Hill, K., Joy, I. and Keen, S. (2012) *Investment readiness in the UK,* London: ClearlySo/London: New Philanthropy Capital; and Charities Aid Foundation (2014), *In Demand: The changing need for repayable finance in the charity sector,* London: CAF.

Mission first

All of the applications for social investment that we looked at were mission-driven: the charity wanted to set up or maintain something that they perceived as central to their ability to fulfil their mission. However, despite being mission-driven, some social investment purposes were not well thought through and led the charities into difficulties.

The aim of all social investments should be to leave an organisation in a stronger position not only financially but also in relation to its ability to pursue its mission.

To do that, drawing on our findings, requires:

— **Broad assessments including, but not limited to, due diligence**
Thorough assessment will enable investors to understand the social and financial potential of the charity applicants, including the role they play in their communities and the capacity of investment to strengthen resilience and impact.

— **A willingness to engage with inexperienced charities to help them survive**
This could lead to an investor choosing to support an application for social investment driven by necessity in a charity that is likely to struggle with the application process, but where investment will enable that charity to survive. The social impact would be 'survival' (in other words no change, status quo) and the investor would need to provide considerable support possibly with a blend of grant, loan and mentoring. The point is that the investor and charity alike would embark on the journey with their eyes wide open to the challenges that lie ahead.

— **Alignment of mission and values**
It was important to charities that their commitment to mission and values was both understood and shared by their lenders. Charities thought that this played out in lenders' practice, commenting in one case that a long-term relationship was likely, as the social investor possessed *'a profound social conscience'*. It meant that charities felt confident in sharing and discussing financial challenges in the context of what was right for the organisation's mission and beneficiaries, rather than what was most profitable. For their part, it is commitment to mission and values that pull charities through this challenging experience. This is consistent with our 2013 study where we found that securing social investment requires commitment and persistence, time and a willingness to acquire new skills, all underpinned by devotion to the organisation's mission and its beneficiaries.[27]

— **Financial products and associated outreach and marketing are tailored to charity need**
We were conscious that the social investment field was not stationary while we were carrying out our research. Nonetheless, as we complete the research, one key message from our 2013 research appears still relevant: that financial products need to be tailored to what charities need in order to fulfil their mission rather than investor market-building.[28]

— **Recognition that not all social investment is impact investment**
Sometimes charities require the supply of a range of financial products and services similar to those provided by banks and other financial intermediaries to small businesses; overdrafts; working capital; leasing; factoring; commercial mortgages, etc. While the charities are delivering charitable benefits, no bank is going to tie the provision of simple finance products to their impact.

— **Critical evaluation of property transactions**
Most social investments taken by small and medium-sized charities are property-related. Often the property is hard to disentangle from mission because the property itself is more than just a venue from which to deliver services, facilities and activities; it provides a space and a focus for community life itself. We found that these charities did not separate out the mission and the financial implications of decisions about social investment. We came across examples of charities that were able to use property purchase or development to strengthen their public benefit and also where it had failed. In the latter cases, charities found themselves with depreciating and inappropriate assets, in some cases in the wrong places or with the wrong facilities, hampering their capacity to deliver on their mission while drawing resources out of the organisation in loan repayments. Robust challenges by experienced social investors as to whether particular property investments were the best option (along with examples of what worked and what did not), could help relatively inexperienced charities to make better strategic decisions.

[27] Baker, L. and Goggin, N. (2013) *Charities and social investment: A study for the Charity Commission*, London: IVAR.
[28] ibid

Building good relationships

Most investors wanted to have a good relationship with the charities they supported. This meant good interpersonal contact, being interested in charities' mission and activities, and being supportive and helpful around organisational capacity and capabilities. Charities welcomed this but made two points about areas for improvement.

- **Lack of familiarity with charities**
  Positive relationships could be undermined by lenders who quickly became anxious about charity finances, often unnecessarily, because they were unfamiliar with the state of uncertainty that is a daily reality for many small, local charities: *'I want to say trust us we'll find a solution and if we're really in crisis we'll tell you'.* While we found a general lack of understanding about charity approaches to reserves, some charities felt that their lender had a good grasp: *'They understand that we, as small organisations don't have the cash flow or reserves to wait [for funding]'.* It takes experience for grant makers and lenders to be able to judge whether a charity is on the right side of financial uncertainty, given that most charities are living with a degree of instability in this respect in an operating environment that is continuing to change.

- **Distinction between good transactions and good relationships**
  Some investors concentrated on good transactions: they built supportive, interested relationships around their social investment transactions over the short term. What charities mean by 'good relationships' is an investor that understands and supports their social purpose and wants a long-term relationship that will focus on delivering on mission as well as financial viability. As one charity that holds such a relationship with an investor put it: *'Whatever we do, we always talk it through with them'.* If a charity that was important to the welfare of its community was threatened with closure, the investors that understood this distinction and had built good 'relationships' (not just transactions) would see themselves as having a place around the table to work out what could be done. Having an ongoing relationship with a social investor means that the charity can move fast if they need further investment. Charities thought that this was important given the number that had needed investment fast because of a cash flow or property crisis. Having the support of an institution long-term was more important to the charities than having the same person to deal with during the transaction (although the latter was appreciated where it had occurred). The more transactional approach may be reinforced by the kinds of short-term funding opportunities that are typical in the newer segments of the social investment market with funds tending to open and close rapidly.

Governance

Governance is critical to the social investment journey, whether that's a confident journey, handling a stressful one or making the decision to walk away. It is the trustee Board that takes the decision to seek social investment and with which the formal transaction between charity and investor takes place.

Central to this is the relationship between a charity's Chair and CEO. Where they work well together and have a shared vision for the organisation's direction, as well as mutual trust and confidence, then the charity is more likely to experience a confident journey. This is echoed in other research by Big Society Capital on the trustee perspective.[29] In our study, where we found that the relationship between Chair and CEO was poor, often it was one 'heroic' trustee or founder pushing through the investment with little challenge from other Board members.

Several of the charities that we worked with do not have a Treasurer. The critical issue was having access to an accountant who might hold the role of Treasurer but might also be a local accountant providing pro bono or affordable advice on a regular basis. Charity CEOs that felt well supported in this respect typically said that they and the accountant (or similar) *'sit down together'* every month or even fortnightly. Third party paid advisors were generally said to 'muddle things' and some charities felt that they had been overcharged.

In this study we found that investors were beginning to perceive a need for a direct relationship with trustees who are, of course, responsible for taking the decision to seek investment. How, practically, investors will organise themselves so that they can form this direct relationship with Boards of trustees who typically meet outside office hours, remains to be seen. Place-based investors may be better positioned to achieve this.

The social investment process had given some charities the impetus to strengthen their Boards by refreshing membership where meetings had become stale and unproductive. They also looked at how the charity had changed and identified the kinds of new skills needed, particularly financial, legal and commercial. Critically, Boards of trustees needed to be able to weigh risk. Some of the conditions attached to loans were seen as useful checks that a charity was managing risk effectively. If these conditions were communicated better and early on (see the Social investment journey above) then trustees could use them positively and proactively as part for their own assessment of the social investment proposition. Some of the conditions included: valuations, proof of other funds, construction completion certificates, insurance and safeguarding policies and the appointment of an accountant as Treasurer.

[29] Big Society Capital (2016) *Social Investment Insights Series: Governance and Social Investment*, London: BSC.

Markets and working capital

Within the literature there is a strong sense that there is a mismatch between the supply of, and predicted demand for, social investment. It is argued that the segmentation of the market in terms of the need for different products based on organisations' size, asset base and stage of development has played a part in the disconnect.[30] Put another way, there is a lack of market segmentation to reflect the distinction between the relatively few large and major organisations in the voluntary sector as compared with the relatively greater number of small and medium-sized ones.[31]

This research has been about the specific social investment experience of small and medium-sized charities and argues that this experience is different and distinct from that of larger charities with incomes of £1million or more. Our findings suggest that the social investment sector does not function as a market with charities under £1million.

The social investment offer is opaque. Charities do not know, and it remains difficult to find out the range and type of finance different lenders provide and therefore which to approach for particular needs and in particular circumstances (albeit noting the role of Access in supporting collaboration between social investment finance intermediaries). Other research confirms this lack of awareness of social investment options[32] and also the challenge for smaller organisations of dedicating the time and resources needed to navigate the market.[33] Marketing and promotion by social investors is broad in its scope and makes it difficult for those approaching the market for the first time to differentiate between lenders, products and offers of support. One new and scalable charity approached 40 social investors before finally receiving social investment from charitable trusts.

Our research also sheds light on an emerging issue which may be affecting the way small and medium-sized charities use social investment. Many organisations have seen reduced local and central government funding and a switch to commissioning/output related funding. They are unlikely to be prime contractors, instead they are often at the end of a long supply chain, which adds an extra level of risk to their funding. In the past, grant funding was often provided upfront which removed the necessity for working capital. Now, organisations need to build both reserves and working capital – if they are using reserves for working capital, they are no longer available in the case of internal or external shocks. Our findings are reflected in research across the wider voluntary and social enterprise sectors – both this research and a recent members' survey carried out by Social Enterprise UK[34] seem to indicate an increase in charity and social enterprise organisations needing to borrow for working capital, as a result of sub-contract work for the public sector. In the words of one respondent, this means that organisations need *'full, FULL cost recovery'*, covering not just direct and indirect costs, but the requirement to produce unrestricted surpluses to finance reserves, working capital and funds for innovation and development. Most organisations are also attempting to diversify income by targeting major donors, trusts and foundations, a strategy that cannot work for all of them.

[30] Floyd, D., Gregory, D. and Wilson, N. (2015), *After the Gold Rush: The Report of the Alternative Commission on Social Investment*, Available at http://socinvalternativecommission.org.uk/ [DW note: Add Last accessed?]
[31] NCVO (2016) *UK Civil Society Almanac 2016*, London: NCVO
[32] See Charities Aid Foundation (2014), *In Demand: The changing need for repayable finance in the charity sector*, London: CAF; and Gregory, D., Hill, K., Joy, I. and Keen, S. (2012) *Investment readiness in the UK*, London: ClearlySo/London: New Philanthropy Capital.
[33] Ronicle, J. and Fox, T. (2015) *In Pursuit of Readiness: Evaluation of the Investment and Contract Readiness Fund*, Birmingham: Ecorys.
[34] Social Enterprise UK (2016) *Prospecting the future: social enterprise and finance data from 2011–2015*, London: SEUK

Concluding remarks

This research draws attention to a range of common challenges for small and medium-sized charities seeking to address mainly social welfare needs in communities of geography or communities of interest. Some are deeply familiar – governance, for example, while others are not exactly new but more sharply drawn because of the financial and policy pressures that charities currently face. These include the need for working capital because of long delays or, for example, being forced to accept payments significantly in arrears when delivering public sector contracts.

Few charities see social investment alone as a way forward for them to continue to fulfil their mission and charitable objects. However, some can conceive a time where loans might form one plank of a diversified funding portfolio alongside grants and donations. There is a need for significantly improved communication of the key components and requirements of the social investment process.

Social investors interested in forming long-term relationships with charities and their trustees, who understand the realities, uncertainties and style of entrepreneurialism that have characterised the charity sector for many years, and who are willing to simultaneously champion and challenge charities and their trustees, may be best placed to achieve this.

Appendix A

List of participants

We do not name the 25 charities that took part in the research.
Below we have listed the individuals in national bodies who gave formal interviews about our research.

The acknowledgements at the front of this report list others who also freely gave their time to help with the research.

Caroline Forster	Social Investment Business
Caroline Mason	Esmée Fairbairn Foundation
Caroline Sims	Charity Bank
Charlotte Ravenscroft	National Council for Voluntary Organisations
Danyal Sattar	Joseph Rowntree Foundation
Eric Munro	RBS NatWest
Geetha Rabindrakumar	Big Society Capital
Hugh Rollo	Locality/Key Fund
Megan Peat	RBS NatWest
Nicola Steuer	School for Social Entrepreneurs
Peter Holbrook	Social Enterprise UK

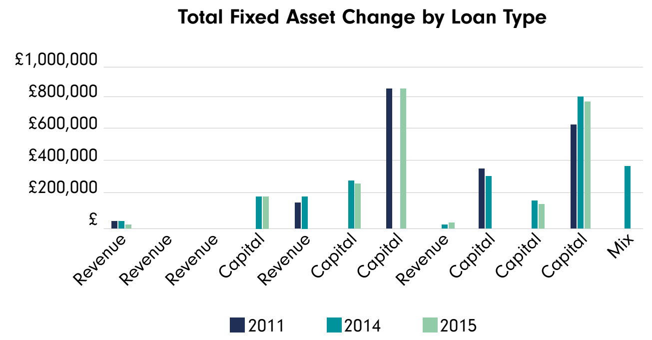
And members of the Social Impact Investors Group

Appendix B

Analysis of financial information from charities in the sample

The graphs below show financial information from twelve[35] of the charities that took revenue or capital loans and participated in our study. The information comes from published accounts for the years 2011 (earliest available on Charity Commission website), 2014 and 2015 (where available). The earliest loans taken by interviewees were in 2004 and the latest in 2015, so a full picture of the change in their finances is not available. The data gives an indication of some of the opportunities and challenges for borrower charities and social investors. Further and more detailed financial investigation could assess whether and what type of social investment had a positive effect on turnover, scale of operation and social impact.

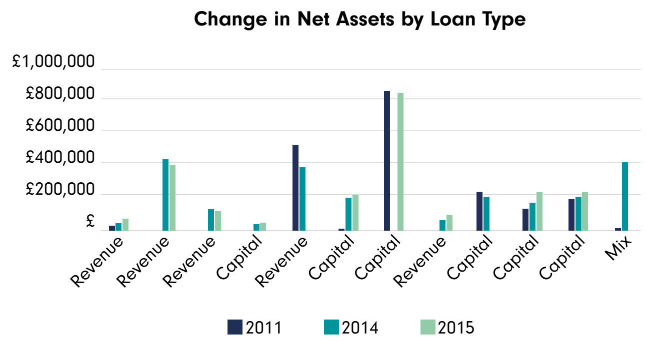
Table B1: Total fixed asset change by loan type



The data indicates that working capital or development loans may have little or no impact on the capitalisation of charities. Capital loans do impact directly on the value of fixed assets, because they are used to purchase, renovate or build capital assets. However, it appears that there is a tendency to run down the value of the assets over time, through lack of ongoing investment.

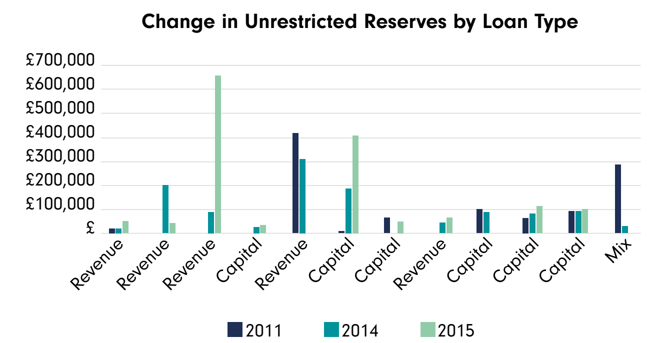
[35] The remaining organisations either did not take a social investment or received it too recently for any impact to be seen in their accounts.

Table B2: Change in net assets by loan type



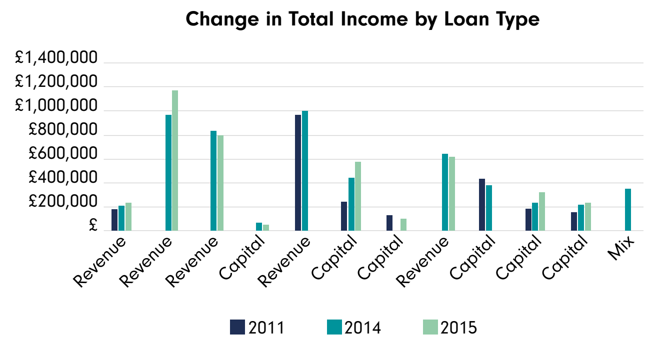
The picture of net asset change is varied. More charities in receipt of capital loans saw their net assets increase, but more in receipt of working capital or development loans experienced a decrease in net assets. This may indicate more strategic impact from capital investment than from the provision of working capital or business development loans.

Table B3: Change in unrestricted reserves by loan type



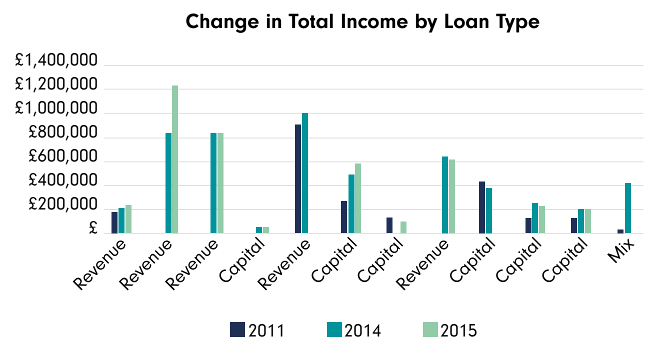
Most charities in receipt of capital loans saw their unrestricted reserves increase, while most who received revenue grants experienced a decrease. It is noteworthy that one organisation, which has had steady access to working capital loans, saw a very substantial increase in its unrestricted reserves.

Table B4: Change in total income by loan type



The balance between increased or decreased total income by loan type is fairly even, with capital loans more associated with an increase. It would be worth further investigation as to why some loans (both revenue and capital) saw steady increase in total income, while others saw total income fall.

Table B5: Change in total resources by loan type



Most organisations saw an increase in total resources expended over the four-year period, which is an indicator of increased activity and, potentially, impact.

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