Social Finance in the UK: The Story So Far…

A detailed look at the loan portfolios of Futurebuilders England, CAF Venturesome and The Key Fund between 2002 and 2014

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Abstract

While much has been written about the size, characteristics and growth of the UK social investment market, up to now there has not been any publicly available data on actual transactions. The publication by EngagedX of data on a sample of over 400 loans made over a twelve year period to 2014 by Futurebuilders England, CAF Venturesome and the Key Fund has filled an important gap and, we hope, started a new era of greater transparency in social finance. This paper provides our analysis of the EngagedX data set. It shows that, with the exception of loans outstanding for less than 12 months, the provision of social finance has not been a comfortable experience in most cases either for the borrower or the lender. Interest rates charged appear to have been higher than social organisations could afford, requiring renegotiation of terms which produced lower rates than originally expected by the lenders. Write-off ratios were very high, suggesting that debt funding is not a suitable method for funding much of the social sector and raising questions about the long-term viability of the business models of some of the providers of funds, particularly when ongoing management costs are also taken into consideration. We conclude by offering some suggestions about changes that may help to ensure the development of a healthy and sustainable social investment market.

Acknowledgements

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"CAF Venturesome, the Key Fund and the Social Investment Business have led the way in openly sharing social investment performance data. The EngagedX data set marks an important first step in driving up transparency in social investment, and we are committed to contributing more data and greater insights from the experience of our loan portfolios to continue improving learning. We welcome this report's contribution to the debate on how we move discussion on social investment from perception to evidence based reality, and we hope that other social investors follow our example by supporting greater transparency in social investment."

We are grateful to Engaged X for granting us consent to publish our derivative work using their data.

About the authors:

Robbie Davison is the Director of Can Cook CIC.

Robbie started his social enterprise work in the 1980s. A founder member of the Furniture Resource Centre, he spent 7 years developing various aspects of that model.

In career moves that were both in the Third and Public Sector his roles have always specialized in creating and/or leading initiatives that were wholly focused on treating the problems associated with inner city deprivation.

He has raised £millions to facilitate social programmes/enterprise, accessing money from European & Central Government, regional, sub-regional, charitable and private sources.

In 2007 he created Can Cook, an enterprise established from work with a Sure Start programme and dedicated to changing food behaviours of people through cookery and training. Can Cook has since trained over 11,000 people and has had its social impact independently measured by City University, London. Can Cook also has an incubator kitchen, a street food wagon, caters in a nursing home, campaigns on the issue for food poverty and is in the process of setting up *COOKED* - a fresh meal delivery service for adults and children in their homes or in care settings.

Directly related to this work, Robbie has an MA (DIST) Social Enterprise.

Helen Heap is an independent social investment analyst and the founder of Seebohm Hill Ltd.

Helen spent more than 2 decades working in the financial services industry as an analyst, equity salesperson and investor, mostly in Japanese equities. Her career started at Abbey Life where she analysed companies and managed equity portfolios, including one of the very first socially responsible investment funds, The Ethical Trust. While working at Goldman Sachs, in both London and New York, Helen was involved in selling Japanese shares to institutional investors around the world. At Sloane Robinson she was responsible for selecting stocks for Japanese portfolios and was Head of Sector Research. Seeking a change in direction, Helen spent 2011 working with a number of social enterprises, social investors and the Cabinet Office in roles involving the measurement and reporting of social value.

In 2012 she joined employment charity Tomorrow's People as Social Investment Manager. It was in this role that she met Robbie Davison and together they have co-authored two papers and a book on social finance.

Helen went freelance in July 2013 and established Seebohm Hill later that year.

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Introduction

In June 2015 the Social Investment Research Council and RBS Group sponsored the publication of a report, The Social Investment Market Through a Data Lens – Revealing the costs and opportunities of financing the 'unbankable'[1]. This was the result of a project undertaken by EngagedX which set out to publish anonymised performance data to reveal the financial characteristics, risk and return profiles of a sample of loans provided by three Social Investment Financial Intermediaries (SIFIs) over a twelve year period ending in 2014.

The report is described as the first ever independent data centric study into a key segment of the UK social investment market. We welcome the fact that CAF Venturesome, Key Fund and Social Investment Business were willing to provide the underlying raw data on these transactions. We also welcome the work that EngagedX has done to structure and publish that data in a way that enables further detailed analysis to be undertaken. Both steps are important in improving transparency and developing a better understanding of what does and does not work when it comes to funding social organisations.

The report itself provides a useful description of the background to the project, the data used, comparisons with other markets, and comments from the participating SIFIs. It also provided a list of key lessons and reflections. The information provided by EngagedX is a rich data set which enables a detailed analysis to be performed and useful insights to be gleaned. What follows is our own analysis of the data provided, some questions we think are raised from it and some comparisons that may be made between this data set and current conditions in the social finance market.

Why are we doing this? Since 2013 the two of us have been using our knowledge, skills and experience as a social entrepreneur and professional investor to try to find the most effective ways of funding those social enterprises which have innovative solutions to meeting social need. This analysis is a further step in a journey which has seen us collaborate to write a number of papers[2] and a book[3] as we studied the market for social finance in an effort to understand why so much of the money being offered does not get to where it is needed. We believe that most social enterprises are too small and not sufficiently established within their markets to be able to support the types of funding that are available from social finance providers. We have reached this conclusion based on our own data gathering and research but that has been a lonely and difficult undertaking in the absence of quality information. It is therefore extremely helpful to have such a large and important data set made publicly available.

[1] Social Investment Research Council. The Social Investment Market Through A Data Lens, June 2015
[2] Does Social Finance Understand Social Need? Robbie Davison, Jan 2013. Can Social Finance Meet Social Need? Robbie Davison & Helen Heap, June 2013.
[3] The Investable Social Entrepreneur – Introducing Builder Capital. Robbie Davison & Helen Heap, Mar 2014

We hope that this paper will contribute to a better understanding of what has actually been happening in the provision of social finance over the period examined, as well as contributing to the wider debate about what 'appropriate capital' for social organisations needs to look like. Analysis of real data on completed transactions improves understanding of what works (and what doesn't) and increases the chances both of the right sort of money reaching social organisations and of the social investment market developing in a balanced, sustainable way. Only when both sides (demand and supply) are in good shape will we have a fully functioning and effective social investment market place. That is a goal worth aiming for and we look forward to working with others in social enterprise and social finance to achieve it.

In this paper we will start by providing some context about the social finance market. After describing our methodology we go on to summarise the key points of what we found in the data. That is followed by a discussion section where we raise some important issues and, finally, some concluding remarks.

Contextualising the social finance market

There is now an extensive body of research which aims to provide insight into the size, characteristics and growth of the UK social investment market. It is not intended here to provide a detailed literature review but rather to provide a flavour of the information available and to provide context regarding the current social finance landscape.

For convenience, we have split the available research into three categories:

1) That produced or commissioned by those who are seeking to promote growth of the social investment market (focus on the supply side).
2) Information provided by those who are trying to understand the funding needs of social organisations (focus on the demand side).
3) Evaluations and data analysis of current or past funds.

Most of the available research on social finance in the UK comes from the first category. Publications such as that from HM Government in 2011 – Growing the Social Investment Market: A Vision and Strategy[4] were explicit in their objectives (the title says it all) and set the tone for much of what was to follow. This report introduced Big Society Capital (BSC) as a wholesale provider of funds to the sector and the principal investor in the UK social finance market. It was followed in subsequent years by annual updates on progress from HM Government.

[4] Growing the Social Investment Market: A vision and strategy. Cabinet Office, Feb 2011

Following the launch of Big Society Capital in 2012 we saw reports that were almost breathless in their sense of excitement as to the growth potential of this new market. Another report whose title said it all, The First Billion - A forecast of social investment demand[5], was sponsored by Big Society Capital, published in Sept 2012 and predicted that demand for social investment in the UK could reach £750mn by 2015 and £1bn in the following year. For reference, according to Big Society Capital's Annual Report for 2014 the amount of money from BSC and their co-investors that had actually reached charities and social enterprises by Dec 2014 was £104mn. This is not an apples to apples comparison but it gives an idea of the actual rate of progress.

A detailed review of UK social investment conducted in 2013, which looked at the key players, the investments made and the economic impact of them, assessed the total size of the market then at £202mn, up from £165mn in 2010/11.[6] This report, in turn, referenced an estimate from the CDFA and RBS Group of a potential funding gap for social ventures of between £1.3bn and £2.1bn per annum. [7] In their 2014 publication, "In Demand"[8], CAF Venturesome estimated average annual demand for repayable charity finance of £765mn over the following five years. 70% of this is expected to come from charities with annual turnover of £1mn or more.

With such a big potential market opportunity having been identified for providers of social finance it was no surprise to see publications that sought to understand exactly what needed to be done to start to fill those gaps. The Analysis of Evidence for Local Impact Funds from the Social Investment Business (SIB) is one example which combined an analysis of actual previous investments made by SIB and a survey of financing and support needs conducted among existing investees. One of the key conclusions from the survey in this report, cited in support of the proposed establishment of a range of Local Impact Funds, is that

"*There is an existing demand for smaller loans of less than £250,000, with 74% of respondents indicating they are seeking loans of less than £500,000 out of which 53% indicated they sought for a loan of less than £100,000.*" [9]

Survey data was also the methodology used in what has become a key benchmark study on the demand side of the market. Social Enterprise UK's the State of Social Enterprise Survey 2013[10] is claimed to be the largest survey of social enterprises in the UK with results taken from 878 telephone and online interviews with senior figures in social enterprises. This report

[5] The First Billion - A forecast of social investment demand. Boston Consulting Group, Sept 2012
[6] Growing the social investment market: the landscape and economic impact, prepared for the City of London, Big Lottery Fund, Big Society Capital, and Her Majesty's Government by ICF GHK in association with BMG Research July 2013
[7] CDFA & RBS Group (2013) Mind the finance gap: evidencing demand for community finance, ICF GHK
[8] In Demand: the changing need for repayable finance in the charity sector. CAF Venturesome, March 2014
[9] Analysis of Evidence for Local Impact Funds. Social Investment Business, Feb 2015.
[10] Social Enterprise UK. The People's Business – The State of Social Enterprise Survey 2013.

shows the median turnover of social enterprises in 2013 at £187,000 and the median amount of loan finance applied for as £150,000. While both these values may be an accurate reflection of the survey responses received by SEUK, great care must be taken in interpreting this information. At face value this would suggest a loan to turnover ratio of 80% which seems extremely high and not one that most lenders would be comfortable with (for example within the Futurebuilders portfolio, the ratio of loan size to recipient annual revenue was 54% among the loans which were written off vs 19% for the rest of the closed portfolio[11]).

A detailed analysis of the SEUK survey data was conducted by Fergus Lyon and Rob Baldock in 2013[12]. They showed that 65% of the social enterprises surveyed were not interested in seeking social finance. This study also highlighted a need for further research to properly understand the ability of the 21% of social enterprises who were considered "nascent borrowers" to actually be able to take on repayable finance.

Our own work has shown that the potential for most social enterprises to be able to service debt finance is very poor. We were extremely sceptical about the value of survey data on social finance related issues, especially when questions are asked without reference to expected repayment terms. We therefore took a different approach to gathering evidence by conducting studies of financial data reported to Companies House by over 1300 social enterprises operating in north-west England and Swansea. Our research has consistently found that the average annual turnover of social organisations is less than £50,000 with net asset values of well below £10,000[13]. That is considerably smaller than the £187,000 turnover figure often cited from the 2013 SEUK survey and leads us to believe that many of the decisions being made on the size of the social sector and it's capabilities to take on repayable finance are based on inaccurate assumptions rather than fact. Our data shows that these are not organisations that have the capability to take on even relatively modest amounts of debt.

The third category of research – evaluations and data analysis – is relatively recent and includes the study which is the subject of this report. Given the figures quoted above for the total size of the social investment market it can be seen that the £117mn of loan capital which was disbursed by Futurebuilders England from 2004 to 2010 represented a significant part of the social finance landscape. As was the associated £28mn of grant funding which was also part of the Futurebuilders funding package. It is therefore useful and important to now have data and evaluations available[14] [15] to show how that money was used, how successful (or not) it was in achieving its objectives and for lessons to be learned.

[11] A Tale of Two Funds The management and performance of Futurebuilders England, Boston Consulting Group, July 2015
[12] Third Sector Research Centre. Financing social ventures and the demand for social investment, June 2014
[13] Seebohm Hill Ltd. Financial Analysis of Social Enterprises in the North West, April 2014.
[14] A Tale of Two Funds The management and performance of Futurebuilders England, Boston Consulting Group, July 2015
[15] Social Investment Research Council. The Social Investment Market Through A Data Lens, June 2015

Methodology

Much of the data used to make important decisions in the social sector, including about funding and the provision of repayable finance, is taken from surveys. These are often poorly constructed, have low response rates and can cover a very wide range of different organisational forms, size, age and social impact area. This is an unsatisfactory method of gathering vital information which can lead to a reliance on supposition and generalisation, resulting in inappropriate solutions to important problems. Only when we ask the right questions based on accurate information about what is actually happening in specific areas will we be able to properly understand what works well, what needs to change and how. The availability of the EngagedX dataset is a significant step forward in improving the quality of information in the social finance sector.

We have adopted the same methodology in this paper as we have elsewhere in our work developing the Builder Capital Model – using reported financial data to analyse the facts, identify key trends and uncover important gaps in the social finance market.

This analysis uses data provided by EngagedX based on information on closed investment deals in the UK between 2002 and 2014 made by CAF Venturesome, The Key Fund and Social Investment Business. This is the first time that social investment transactions from multiple investors have been combined into a single, comparable dataset.

EngagedX included data on 426 completed investments with total capital draw down of £42mn. These comprised both equity and debt transactions (secured and unsecured) but excluded any grant elements.

The data file is published on the Government's open data portal as a CSV file. For the purposes of this analysis, each individual entry was manually input in XLS format to allow sorting of the data. The CSV data can be found here: EngagedX Dataset

For some entries, no record was found of any capital write off having been made against a particular loan even though the total payments actually made were less than the total draw down. In order to capture all incidences where original draw down was not fully repaid, regardless of whether or not this was registered as a write off by the SIFI, all write off data shown in this analysis is based on calculated data where the calculation takes the Total Draw Down column minus the Total Capital Payments column. There were 21 entries (out of 426) where the calculated figure for write offs was higher than that shown in the original data. As a result, calculated write offs are £8,475,998 vs stated write offs at £8,250,713 (2.7% higher).[16]

[16] We have confirmed with Engaged X that there were a few inconsistencies in some of the source data in terms of how write offs were treated. These resulted in variances when comparing capital drawn down versus capital repaid and stated write offs. For example, if some of the investment was 'converted to grant' without declaring it as a write off then there would be a negative variance (capital unaccounted). If some of the write off had been recovered without reducing the write off amount then it would appear that additional capital was

Other than the manual conversion from text to number format and the use of calculated write offs no other changes were made. The data was sorted in an Excel spreadsheet using various criteria in order to reveal key trends.

The accompanying spreadsheet is available on request from helen.heap@seebohmhill.co.uk

What the data reveals

In the sections that follow we provide a summary of the key points from our analysis of the data. This is not intended to be a detailed line by line review but rather to highlight particular areas of interest and significant trends.

What the data reveals: by size of loan

When sorted by loan size the following becomes clear:

Volume of loans.

The largest number of loans falls in the range of £10K to £74K. Around two thirds of the entire portfolio comes within these categories but on a value basis the proportion is much lower at around 20% of total draw down. Around 85% of the volume of loans are of £150K or below; by value this category accounts for just under 40% of the total.

Value of loans.

The largest 34 loans, in the categories of £250K and up to £1mn+, accounted for just under half of the total value of the portfolio but were only 8% of the total number.

Annualised returns.

Loans in the largest five categories (£100K upwards) achieved average annualised returns that were higher (or less negative; around -3%) than those in the smallest categories (£99K and below) where achieved annualised rates came in closer to -10% across the total portfolio.

However, once write-offs were excluded the picture on returns reversed. Average returns on the £100K+ loans in the performing part of the book were just under 5%. Those on loans of less than £100K were just under 6% on average.

Duration of loans. The larger loans, on average, tended to be outstanding for longer than those in the smaller categories – just over 38 months on the £100K+ loans; approximately 25 months for those below that size. There was no material difference in the duration profile of the loan book after write-offs were excluded.

repaid. In equity deals, there may have been capital appreciation which would also show in the data as a variance. This issue highlights the value of industry-wide reporting standards to deal with such scenarios during the reporting and data recording process in order to ensure more consistency in the reported data.

Write offs. The value of write offs (partial and full) for the overall portfolio was £8.5mn, 24% of the total. These were spread fairly uniformly across the various size categories, with the exception of the largest loans (over £1mn) where write offs amounted to 9% of the total draw down, and the very smallest (under £10K) with over 30% written off.

What the data reveals: write offs

An analysis of the data sorted by size of write offs shows a more detailed picture:

Overall portfolio write offs.

There were 140 loans out of the total portfolio of 426 which recorded either a full or partial write off. This amounted to a total value of write off of £8.5mn, which was 24% of the overall portfolio value. The amount drawn down on the loans which experienced any write downs was £11.1mn, which gave a write off ratio on these loans of 73%.

While a simple calculation would suggest an annual write off ratio over the 12 years covered by the data of 2%, a closer examination of the data shows that the underlying trend is actually around 4% per annum.

Size of write off.

The two single largest write offs were of £842K and £625K respectively and, while only representing 1% of the overall number of loans, they accounted for 17% of the value of total amount written off. The £842K was the portion unrecoverable from an original draw down of £1.4mn, representing a write off ratio of 62%. The £625K write off was a 100% loss on a loan which remained outstanding for over 5 years, one of the longer durations in the portfolio.

There were 5 loans in the size category £250K to £499K which were total write offs, i.e. with a 100% loss ratio. The data show that where things went wrong on the larger loans in the portfolio they tended to do so in a very meaningful way: the loss ratio for the 50 loans that were written off in the 4 largest categories of write off (£50K up to over £500K) was 87%. By contrast, write offs of less than £50K on average represented around half of the original amount drawn down. As a result, over 80% of all write downs in the portfolio came from just 12% of the total number of loans made and 19% of the total value of the overall loan book.

Percentage write off.

29% of the overall number of loans which were affected by write offs experienced total write offs (100% loss ratio), while over half had loss ratios of 85% or higher. Only 30 of the 140 loans affected by write offs had loss ratios of less than 50%.

Duration of loans.

The simple average duration of loans over the 140 that had full or partial write offs was 32 months (weighted average 39 months). However, these averages hide a clear difference in

loan period between those parts of the portfolio where substantial write offs were made and those where write offs were less severe: there was an average duration of 26 months for loan write offs of 85% or more; where write offs were 60% or less, average loan duration was 43 months.

What the data reveals: returns

The information on returns is shown only for that portion of the loan book which is not affected by write offs: 286 loans with total draw down value of £31mn.

Due to the weaknesses of the Internal Rate of Return measure, as noted in the SIRC report, all return data analysed here uses the Annualised Annual Return %, defined as the total return on investment divided by the number of years the investment was outstanding.

It is important to note that the EngagedX data does not include transaction costs or other management costs. All return data is shown gross and not net of costs. This is an important factor which will be addressed in the Discussion section of this paper.

Overall portfolio

The simple average annualised return on the performing part of the loan book (286 loans where there were no partial or full write offs) was 5.7%. When returns are weighted according to the % share of draw down, the average annualised return for the whole of the performing loan book is slightly lower at 5.3%.

Given that each of the contributing SIFIs to the dataset have a stated minimum interest rate of 6% (Futurebuilders; CAF Venturesome up to late 2011) or 6.5% (CAF Venturesome from end 2011 and Key Fund), it is interesting to find that the average return on the overall portfolio was less than 6%. In fact, only 40% of the number of loans, and 20% of the total draw down of the fully-performing part of the portfolio actually achieved annualised returns of 6% or higher.

The largest segment of the portfolio (76 loans; 27% by number; 53% by value) delivered annualised returns of between 4% and 6%. The average size of these loans was around twice that of the average for the overall portfolio excluding write offs (draw down of £215K vs £108K).

Highest returns

The 36 best performing loans represented £2.5mn of draw down (8% of the performing book; 6% of the total book including write offs) and all achieved annualised returns in excess of 10%. The weighted average return for this portion of the portfolio was 15%. Average value of draw down for these loans was lower than the average for the performing portion of the loan book at £72K.

Lowest returns

The 34 loans which delivered the lowest positive annualised returns (of less than 1%) accounted for £3.4mn of draw down (11% of the performing book; 8% of the total loan book) and produced an average return of 0.1%.

Duration of loans

The data seem to show a loose inverse correlation between the annualised return achieved and the duration of the loan: those loans delivering returns in excess of 10% had a weighted average duration of 7.9 months; the loans with returns in the range of 6% to 10% were on average 17 months; between 4% and 6% the average period was 32 months; and loans with returns of between 1% and 4% were outstanding for an average 40 months. Only the lowest performing loans bucked the trend a little with those delivering returns of less than 1% at 30 months duration.

What the data reveals: duration of loan

Less than 12 months

Around one quarter of the number of loans outstanding were for 12 months or less. The proportion was lower on a value basis – 12% of draw down for the total book; 15% of draw down when write offs are excluded.

These loans were smaller than the average (£70K weighted average for the performing portion of the book vs £108K overall) and also generated the highest returns at just over 10% on a weighted average basis.

Despite the short duration of these loans they were still subject to some write offs with almost £600K losses incurred (7% of all write offs).

Weighted average annualised return 10.6%

1 to 2 years

This is the portion of the loan book which incurred a disproportionate share of write offs – 22% of all losses came from loans with duration of 1 – 2 years even though they only accounted for 17% of the total draw down (27% share of the number of loans).

Once write offs are excluded, this group of loans performed closest to the objectives of the SIFIs with a **weighted average annualised return of 5.5%.**

Once again, average loan size in this segment was smaller than the overall average at £80K (performing portion of the loan book).

2 to 3 years

These loans were around a quarter of the total across all measures – number, value and write offs.

Average size of loan slightly above that for the portfolio as a whole at £124K.

Weighted average returns at 4.9%

Over 3 years

This is the largest segment of the loan book by value (44%) and share of write offs (43%) but around one quarter by number.

Average loan size is considerably larger than the average at £190K (excluding write offs).

Weighted average returns are 3.8%, maintaining the trend of lower achieved interest rates as loan duration lengthens.

What the data reveals: start year of loan

2002 to 2004 – the run-up to Futurebuilders

Just 8 loans were made during this period: 7 were £100K or below, of which one £50K loan was written off in its entirety; the eighth loan was for £1.4mn, of which £841K would be written off and £200K of interest payments made over the 35 months the loan was outstanding. This was presumably one of the very earliest Futurebuilders loans.

2005 to 2011 – mostly Futurebuilders

This is the period when Futurebuilders was active with over 80% of the loans in the portfolio disbursed during these years. 66% of the loans by value of draw down were made in the four years 2008 to 2011.

Loans which were started in 2005 resulted in the largest proportion of value written off with 36% of the total draw down for that year lost. 2006 originated deals saw write offs at 27% albeit on only around half the volume of loans made in the previous year (24 loans made in 2006; 47 in 2005).

2008 was a year of transition for Futurebuilders as a new fund manager was appointed in April that year. Perhaps unsurprisingly this was another year of high write offs at 26% of draw down.

Applications for Futurebuilders closed in January 2010 but loans were still being disbursed through 2011. In fact, 2011 saw the highest volume of loans at 89 and the highest value at just under £8mn, including two of the six loans of over £1mn which were made (one of which, at £2.7mn was the largest in the entire portfolio). 50 of the 89 transactions done in this year were of £50K or less, suggesting that this was probably a very active year for Key Fund and CAF Venturesome too.

2012 to 2014 – Post-Futurebuilders

From 2012 onwards there has been a clear reduction in the average size of draw down made, a reduction in the amount of write offs, and an improvement in annualised returns. It is not clear yet whether this is due to better underlying performance or merely the fact that these loans have not been outstanding as long as the rest of the portfolio.

Once write offs are excluded, it can be seen that annualised returns improved considerably, from less than 5% for most of the period (2007 the honourable exception at 6.4%) to over 6% since 2011.

Discussion

Interest rates – proactive social discount or brutal reality?

In their report, EngagedX highlighted some key insights which they took from the data. Two of them are reproduced in full here:

*"**Risk and pricing** - The data sample analysed relates to a high-risk portion of the market by definition. Many of the SIFIs implemented a policy for only considering investment applications for organisations that had been refused finance from mainstream or retail providers. Capital pricing was often on an affordability basis and not always adjusted to the inherent risk of the deal. The combination of these two aspects means that although on aggregate the SIFIs did have a strong appetite for taking on risk, and this is evidenced in a concomitant capital loss rate, however the SIFIs were not able to recoup all of these losses from surpluses on successful deals as is the case in, for example, the traditional venture capital market.*

***Blended return and Implied Impact** - a principal objective of the SIFIs was to focus on deploying repayable capital that created positive social impact. Although the social impact performance has not been analysed as part of this project, it is evident that this investment strategy resulted at times in below market rates of financial return. EngagedX refers to this fade off from market rate returns as the Implied Impact of social investments, this is to differentiate merely poor financial performance from intentional lower financial performance when combined with the intentional creation of social impact. In other words, the Implied Impact is the capital pricing discount that investors are prepared to accept in exchange for*

positive social impact. Implied Impact is not a measure of social impact per se. It is recommended that the extent of the Implied Impact should infer the level of rigour that might be applied to evidencing social impact so that it can be articulated as a bona fide return on investment as part of a blended return investment model."[17]

The weighted average annualised return (weighted by share of draw down) on the total portfolio was -4.7%. For the loans that were not affected by write offs (the performing part of the portfolio) the weighted average return was 5.3%. Given the relative shares of Futurebuilders (charging 6% interest rate)[18] and CAF Venturesome/Key Fund (at 6.5%)[1920] we would expect to see achieved annualised returns of around 6.2% if everything was performing in line with plan.

Disregarding the write offs, this would imply that the performing part of the portfolio was subject to a "fade off from market return" or social discount of 0.9% (6.2% - 5.3%). The highest implied social discount applied for loans in the £500K to £1mn category where the average annualised return was 2.5%, meaning a social discount of 3.7%.

While it is seductive to think of these achieved rates, after the event, as being the deliberate intention of social investors who were making loan pricing decisions on the basis of the social impact that they were observing directly as a result of the funds they had provided, we wonder if this is really what happened. It is entirely possible that the largest loans were responsible for creating the most social impact and hence might be expected to attract commensurately high social discounts. But if that were the case loans in the £1mn+ category would be expected to have the highest social discount and that was not what the data shows (weighted average returns in this category were 5.3%, in line with the overall portfolio).

It seems that in the case of Futurebuilders there was no intention to make any explicit link between the rate of interest charged and social impact delivered:

"Given the significant uncertainties of lending to a largely unknown market, the management team decided not to charge variable interest rates but rather offer a standard rate of 6% on all loans. Whether or not this reflected the true risk of the loans was impossible to determine but it was hoped that the simplicity and clarity of the model would benefit applicants and fund administrator alike."[21]

Social impact was not included in the EngagedX data so it is not possible to say what the relationship is between that and loan pricing. However, knowing the realities of operating a social organisation with all the difficulties that entails in terms of meeting day-to-day costs

[17] Social Investment Research Council. The Social Investment Market Through A Data Lens, June 2015
[18] A Tale of Two Funds The management and performance of Futurebuilders England, Boston Consulting Group, July 2015
[19] https://www.cafonline.org/charity-finance--fundraising/borrowing/tools-and-guides/our-criteria

[20] http://thekeyfund.co.uk/investment/our-investments/geographical/north-west-fund/

[21] A Tale of Two Funds The management and performance of Futurebuilders England, Boston Consulting Group, July 2015

and the constant hunt for income, we surmise that the reason that achieved annualised interest rates came in lower than the stated minimum rates was because those were the interest rates that the investees were able to afford to pay at the time. Lenders were taking pragmatic decisions on how best to protect their capital and recoup their investment and were adjusting their terms accordingly as they went along. There's nothing wrong with that – SIFIs need to think about the health and sustainability of their businesses just the same as social organisations do – but let's be honest about it if that is what is really happening.

If a thriving social investment marketplace is to develop it will be based on supply of and demand for capital that meets the needs of both social organisations and SIFIs and which is available on terms which make sense to each of them. If, as the EngagedX data shows, the true market price for loans is 5.3% (or was in the period 2002 to 2014) then that is the rate that providers need to work back from when looking at their cost structures and product offerings. Actually, given the deterioration in economic circumstances for social organisations which has taken place in more recent times it is extremely unlikely that even 5.3% would be achieved so this interest rate almost certainly needs adjusting downwards. In any event, doing things the other way round – setting rates based on the costs that SIFIs need to cover and hoping that these will be achieved (perhaps with the use of some investment and contract readiness support?) is not the path to a sustainable market.

That was then, this is now

Looking at the number of loans made in the EngagedX dataset, the vast majority (85%) were for amounts of £150K or below; two thirds of the total were for less than £75K. Interesting to note that the Access Foundation has been established by the Cabinet Office, Big Society Capital and Big Lottery Fund specifically to fill a "financing gap" for the provision of funds of up to £150K.

Access has established a £45mn Growth Fund which will provide grant and loan funding to enable SIFIs to plug this gap. This is what they say[22]:

What is the problem that the Growth Fund is trying to solve?

The Growth Fund aims to tackle the reasons for this financing gap, namely:

- the shortage of unsecured, lower value flexible finance for charities and social enterprises that are seeking finance to test their model, survive and grow
- the high costs for social lenders to deliver this type of finance, which restricts supply
- the lack of track record and often the perception of risk which prices the cost of finance out of reach for social enterprises and charities.

[22] http://access-socialinvestment.org.uk/growth-fund/what-is-the-growth-fund/

The EngagedX data shows that historically there does not appear to have been an issue regarding the supply of funds in this part of the market. In terms of track record, while it is true that loans originally offered in the past at 6% or 6.5% actually only achieved annualised rates on average of 5.7% for loan sizes of £150K or below, that was no worse a performance than for larger loans, suggesting that smaller social organisations fared no worse than their larger counterparts when it came to ability to meet repayment terms.

As noted earlier, austerity conditions have caused a deterioration in the economic operating environment for most social organisations, while demand for their services has simultaneously been increasing, placing tremendous strain on their ability to meet even the most generous funding terms. The recent demise of Kids Company is a very high profile example of the difficulties caused by high growth in social need at a time of cuts in funding for services. These conditions will undoubtedly hit smaller social organisations harder than the larger ones. Analysis conducted by Seebohm Hill on the social economies of north-west England and Swansea shows that the average turnover of social enterprises in those locations is less than £50K and net assets are below £10K – neither of which provide any resilience in the face of a serious downturn in operating conditions nor the capacity to take on repayable finance.

At the same time, the terms on which the social finance market is offering funds are getting more difficult. While Key Fund and CAF Venturesome continue to offer their loans at 6.5%, more recent entrants into the market are charging higher rates (for example, Liverpool Local Impact Fund states rates of 6% to 12%). Fund launches during 2014 by Social and Sustainable Capital and FSE Group among others have also tended to offer large amounts with minimum loan sizes of £200K upwards. We wonder what evidence is being used to make these decisions; the EngagedX data would suggest that SIFIs are not sufficiently in touch with current real market requirements.

The EngagedX data shows a clear difference in achieved annualised interest rates for loans originated between 2005 and 2010 (weighted average of 4.6%) and those originating between 2011 and 2013 (weighted average of 8.0%). There is also a marked reduction in the average size of draw down shown in the data from 2012 (£44K) vs the six years to 2011 (£124K). This shows the impact of Futurebuilders on the cost of funds available from the social finance market and the amount of capital offered at the time it was operating (interest rates charged were very low; size of loans high).

The published data shows that loans made since 2012 have been of smaller size, in fewer numbers and at higher interest rates than those made during the core operating period for Futurebuilders (2005 to 2011). It is impossible to say definitively if this was due to lack of supply of funds or lower demand. However, given the return profile and write-off experience that has been revealed by the EngagedX data set, and the significant deterioration in operating conditions faced by the social sector in recent years, we would surmise that SIFIs who are currently offering loans at interest rates of 8% to 12% will struggle to find a viable market. Similarly, even if demand apparently exists for loans of £200K+, SIFIs should take note

of the write off experiences faced by the earlier large loans in this sample. If the lessons from this dataset are that the social finance market was tough during the period under review, it most certainly has not got any easier since. This data shows that if the funding provided is not a good fit for what is required it can cause damage, both for the social organisation and for the SIFI providing it. SIFIs and social organisations should work together more effectively as partners, with maximum transparency and honesty in order to ensure that only the right money is provided on terms that make sense for both parties. Imposing the wrong money is not a neutral act; it causes harm and hinders the development of a healthy market.

Management costs matter and need to be included

Even with the best will in the world, any funds reaching front line social organisations from Access Foundation's The Growth Fund are going to struggle to offer terms that are substantially more favourable than the rest of the market, even taking into account the subsidy from Big Lottery, given Big Society Capital's requirement for a 5% return on their portion of the money provided and the need for SIFIs to cover their costs as well.

It is important to note that the EngagedX data set does not include transaction costs. The only publicly available information we have been able to find on the cost of managing these portfolios comes from a report published by the National Audit Office which showed total fund management costs for the Futurebuilders Funds of £26.6mn. Assuming this amount is spread over 7 years would mean annual management costs of £3.8mn, or 2.6% of the total capital invested (loans and grant). By way of comparison, consumer rights campaigner Which quotes a figure of 0.75% as the typical annual management charge for actively managed funds in the UK investment market, and hedge funds or venture capitalists offering a more bespoke portfolio management service are known for their 2 and 20 fee structure (2% annual management charge and 20% share of any gains made).

Without an accurate understanding of the true cost of providing these funds it is impossible to know whether current social finance models are sustainable or not. What we can say, now that we have the EngagedX data, is:

- even without write-offs, average returns to SIFIs of around 5% are only just going to be sufficient to meet the basic cost of funds (if Big Society Capital's expectation of 5% per annum is typical)
- if the Futurebuilders annual management costs of 2.6% are representative then SIFIs will need to charge 7.6% just to break even (again ignoring write-offs). Even if the social finance market were to bring costs down in line with current fund management industry averages (0.75%), they would still struggle to do anything other than break even if cost of funds stays at 5% and actual returns manage to achieve historical averages.
- write offs cannot be ignored and need to come in at much lower levels than has been the case historically if there is to be any hope of sustainable social finance models developing.

While all this may appear to be mostly an issue for the supply side of the market – Big Society Capital and the SIFIs – actually it is just as important that any front line social organisation thinking of taking on social finance is aware of the financial viability of those providing them with funding. Conditions are hard enough for service providers without them suddenly having to deal with a funder that is struggling to maintain its own business model. The difficulties of the Cooperative Bank in 2013-14 may be fresh in the memories of many in the sector and will serve as a useful reminder of the importance of viable and strong financial intermediaries.

Capacity Building

The data shows a picture of lower annualised returns as the length of time the loan is outstanding (duration) increases: 10.6% for loans of less than 12 months, 5.5% for 1-2 years, 4.9% for 2-3 years, 3.8% for loans of 3 years or longer. Given that the majority of funds provided in this data set (by Futurebuilders) were designed to build capacity of third sector organisations, this is a surprising and disappointing result. If the capabilities of the sector had been improved, and thus the ability of recipient organisations to use repayable finance as a sustainable source of funding increased, it would be expected that the need for payment holidays, reduction in interest rates or other adjustments to terms would reduce over time. This data shows the opposite – the longer loans remained outstanding the more difficult repayments became, resulting in lower achieved interest rates for the longer duration loans.

Social organisations in receipt of funds from Futurebuilders could use them either for capital investments or for improving capability and skills[23]. In the market research we have undertaken, as part of our work in developing the Builder Capital model, it is clear that in order to be successful in improving the financial sustainability of any social organisation cash invested is a necessary but not sufficient condition. Money, if it is in the right form, can provide the essential first step and may facilitate much needed opportunity for growth. But that impetus needs to be caught in a much broader way, by investing in skill-sets which bring commercial acumen in to the organisation in order to fully capitalize on that improved capacity.

An evaluation of Futurebuilders conducted in 2010[24] found that in the first full year following investment the income growth of investees fell behind that of two matched comparator groups, while expenditure continued to increase at a faster rate. At the time, the authors of the study noted that

"the continued growth in expenditure is likely to reflect the investees spending funds received through their Futurebuilders loan and investing in greater service delivery capacity, but the reduced income growth requires further exploration. It could be due to organisational pressure

[23] A Tale of Two Funds The management and performance of Futurebuilders England, Boston Consulting Group, July 2015
[24] Futurebuilders Evaluation: Final Report. Centre for Regional Economic and Social Research Sheffield Hallam University, March 2010

related to the delivery of the Futurebuilders funded activity: there is some evidence from the case studies to suggest that small and medium sized organisations can struggle with capacity issues in the short term following receipt of Futurebuilders investments."

This raises questions about the organisational and financial capabilities of the social organisations receiving funds and, more generally, whether loans are the most appropriate way of funding capacity building. On the first of these, publication of a full list of investees and details of the amount and form of money provided to them by Futurebuilders would enable such an analysis to be undertaken, as well as to augment the initial analysis done in the 2010 evaluation with a longer-term view of income and expenditure trends following investment. This would be a further step forward in improving transparency on this important issue.

On the issue of the suitability of loan finance in funding capacity building, the EngagedX data provides two pieces of evidence that it was not in the case of this sample:

1) The fact that achieved interest rates fell across the portfolio as loan duration increased suggests that the need for organisations to negotiate less onerous (or more favourable) terms on their repayments rose as time went on following the initial investment. So, either the benefit provided by the investment was very short-lived, or other factors subsequently came into play which more than offset it; possibly both. In any event, this does not suggest a long-lasting improvement in organisational capacity.
2) The write off ratio for the portfolio is high at 24% of the total, or around 4% per annum on an underlying basis. In a properly functioning banking system this ratio is typically in the very low single digits (1% to 3%). The write off ratio shown in this dataset raises questions about the appropriateness of the funds being provided. Write offs of 30% in the under £10K loan category suggest there is a particular problem here.

Analysis of the write offs shows that when things went wrong they did so in a big way: over half of the loans that were affected by write offs had loss ratios of 85% or higher; the loss ratio was 73% across all loans that incurred full or partial write offs.

Also, when things went wrong it tended to happen quite quickly: those loans with a loss ratio of 85% or more were outstanding on average for only 2 years, whereas those losing less than 60% of their value ran for around 3.5 years. That compares with a weighted average loan duration of just under 3 years for the performing part of the loan book (the 286 loans that were unaffected by any write offs).

It is not possible to say from this data what the reasons were for these defaults. However, a separate study on the closed portion of the Futurebuilders portfolio by Boston Consulting Group, which did include a detailed review of the defaults, noted:

"This suggests that most defaults were caused by a lack of financial stability and the bankruptcies of recipient organisations rather than a longer-term performance issue." [25]

[25] A Tale of Two Funds The management and performance of Futurebuilders England, Boston Consulting Group, July 2015

Our analysis of the EngagedX data and other research that we have undertaken leads us to strongly conclude not only that loans are not a sensible way to fund organisational development and capacity building, but that they can actually push social organisations into financial distress and, in some cases, bankruptcy. Again, publication of a full list of Futurebuilders investees with the amount and type of capital provided would enable further analysis to be done on this important issue.

The loans that worked best

The most successful loans (from the point of view of the lenders) – those where all the original capital was repaid in full and where the interest rates achieved were at or above the minimum requirement – were those in the categories £150K to £249K, £75K to £99K and £10K to £24K. In total, these loans accounted for less than one quarter of the overall portfolio, delivered average annualised interest rates of 6.5% to 6.6% and were of shorter duration than the portfolio average (weighted average duration of 30 months for the £150K to £249K loans; 22 months or less for the other two categories; overall portfolio duration was 35 months).

Once again, without detailed information available on specific loans it is impossible to explain exactly what is going on here but the fact that these loans tend to be shorter term ones may suggest that they are being used to provide working capital or other short term cash flow needs rather than fund longer term development opportunities. Of course, there is nothing wrong with that but it still leaves open the question of what is the best way to provide social investment for the longer term if, as suggested by this data, loans are only really suitable to meet very short term funding needs?

Our work on development of the Builder Capital Model shows that there is an important distinction to be made between two very different types of funding:

- Short term finance to meet working capital and immediate cash flow needs. This may be provided via loans where there is sufficient income available to cover capital repayments and interest. We characterize this short term funding as social finance.
- The kind of long term risk capital capable of absorbing the costs and losses incurred by social organisations as they develop their business models to financial sustainability. During this stage of their development organisations may have to fund up-front costs such as additional staff, R&D, and market testing while income levels remain insufficient to meet them. Only those enterprises who can access suitable funding will be able to realise the growth and social impact opportunities that are available. We characterize this long term funding as social investment.

Our research suggests that there is a substantial need for the kind of social investment we describe above, which is currently not being met. If we are to achieve a more balanced and sustainable funding model for social organisations then we argue that we need more social investment and less emphasis on the provision of social finance.

Conclusion

The availability of the EngagedX dataset on the closed loan portfolios of Futurebuilders England, CAF Venturesome and the Key Fund has improved significantly the amount of information in the public domain on the characteristics of the social finance market. We welcome the publication of the data and we hope that it represents the first step in more detail being made available in the future. In particular, we would encourage publication of a full list of Futurebuilders' investees along with the date, amount and type of investment.

Now that we have data available for analysis we can see that, with the exception of loans outstanding for less than a year, the provision of social finance has not been a comfortable endeavour in most cases, either for the borrower or the lender. The fact that average achieved annualised interest rates of the portfolio have been below the stated minimum rates of the SIFIs raises questions about the ability of social organisations to be able to afford the funding which is being offered. High write off ratios across the portfolio also suggest that debt funding is not a suitable way of funding much of the social sector and leads us to question the long-term viability of SIFIs if the business models which applied over the period of this study are not adapted in a significant way. This data provides evidence that debt can be damaging if it is used in the wrong circumstances.

For us, the analysis we have been able to undertake using the EngagedX data raises a few key issues:

First of all, it is clear that not enough is known about the true size of the social sector, the characteristics and diversity of the organisations that operate within it, what their funding needs are, and what capacity they have to take on repayable finance. Efforts to show that the UK has a large and rapidly growing social investment market have taken precedence over the need to accurately assess exactly what is required. These have led to an overreliance on survey data and not enough analysis of the actual evidence that is available. This has no doubt partly (but not entirely) due to a lack of high quality data. The publication of the EngagedX data set is a welcome contribution to improving the information available within the sector.

What is required now is a further commitment to transparency and ongoing publication of data plus honesty by everyone concerned in making accurate, evidence-based assessments of what is needed.

Once we have a better understanding of what appropriate capital for social organisations looks like then a thriving and sustainable social investment market requires the right mix of funding to be made available on terms that make sense for both social organisations and the SIFIs. That means an ecosystem comprised of different types of capital provided by a range of different providers who themselves will draw on their own sources of funding. It will not be achieved if the market is overly reliant on repayable finance whose terms are solely or largely determined by a single wholesale provider, such as Big Society Capital, unless those terms can

be varied to suit individual circumstances to a much greater degree than appears to be the case at the moment.

The EngagedX data shows that there is clearly a place for the provision of short term loans to meet immediate working capital and cash flow needs – this is the one part of the social finance market which does appear to be fit for purpose and is (or was in 2002 -2014) working well. There may also be an important market for longer-term loans at genuinely social rates (less than 5% based on analysis of the EngagedX data; probably substantially below 5% after adjusting for current austerity conditions) for those social organisations which are able to support the repayments. Our own work in devising the Builder Capital Model has identified a real need for long term patient risk capital – equity not debt – a part of the market which is so far almost entirely absent.

Providing the right sort of money in the right amounts at the right time requires a much better understanding by both SIFIs and social organisations about the realities of running and funding the provision of services to meet social need. Social entrepreneurs and practitioners need to get smarter at understanding what is required and negotiating with SIFIs for what they need, rather than trying to fit what they do to the money that happens to be available at the time. This is the true meaning of capacity building in the context of social investment. It means equipping social organisations with the commercial acumen, knowledge of finance and language that they need to be able to access and negotiate sensible terms for the funding they require. It is about much more than the use of grant to provide temporary subsidies for loan costs or to pay for operating costs of SIFIs who themselves do not have a sustainable business model.

Equally, the EngagedX dataset has highlighted the important questions that SIFIs need to answer if they are to be able to participate in a healthy market for social finance:

i. What is an acceptable level of write offs?
ii. What is a sustainable level for management costs?
iii. What level of social discount is required in order for funds to be provided to social organisations on terms which are sustainable?
iv. Can funds be sourced at a cost of capital which makes sense given the answers to i) to iii)?

Our work on the Builder Capital Model is explicitly aimed at investors who are looking to provide social equity capital in order to meet the need for long term risk capital among social organisations. Builder Capital investors are not looking to maximise financial returns nor achieve short term capital gains. Rather, they are investors who are proactively seeking to make positive social change and are prepared to take on the risks that come with genuine innovation. They are ultra-patient and willing to support the enterprise as it battles through market dysfunction on the way to a viable business model. The social entrepreneurs they support are looking to build effective organisations that can sustain themselves in the long run and to repay investors once the enterprise has achieved self-sufficiency. Both investors and entrepreneurs are committed to delivering high social impact from the outset and

financial returns that are directly related to the success of the enterprise once sustainability is achieved.

Builder Capital is just one example of a different type of funding model which will very soon enter the social investment ecosystem. We look forward to the development of many others and hope that together we can help to create and sustain a thriving market for social investment.

Helen Heap & Robbie Davison

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