

## CAPITAL, CAPACITY BUILDING AND IMPACT

This paper begins by repeating the argument of many others that building organisational capacity in the social sector is critical to increasing social impact in the long term. It develops this in the context of the need for a better capitalised social sector, arguing that in order to achieve more impact we need to focus on how financial capital can build organisational capacity.

The paper suggests that raising money solely on commercial or near commercial terms is a threat to a large proportion of the activities undertaken in the social sector as it extracts funds. Therefore, new and increased sources of philanthropic capital need to be deployed and the existing capital of the social sector needs to be better utilised. The tools of investment need to be practiced by all those seeking to build capacity to achieve impact – and this should be called Social Investment.

## CONNECTING CAPACITY AND IMPACT – ORGANISATIONS ARE CRITICAL

What is the purpose of the social sector? The answer is probably immensely complex. But let us agree that, in the most general terms, it is to make positive changes to society – to achieve social impact.

Each social sector organisation – be it a charities, social enterprises, social purpose businesses or co-operative expresses its purpose differently but with a focus on the change it wishes to bring about. Charitable, mutual or community purpose is an incredible advantage to organisations because of the motivation it gives to people to be committed and supportive – whether they be staff members, volunteers, donors, customers, or beneficiaries.

Financial resources are always tight because the scale of social need is high and ever changing, whilst goodwill is a resource in abundance. The combination of money and goodwill is the magic of the sector - the passion and commitment to purpose of people in the social sector often squeezes extra benefit out of resources that might otherwise have been considered spent.

People and money are important, but we need these resources to be collected and grown through organisations. Strong organisations are critical to delivering social impact. Organisations can have a lifecycle much longer than a particular source of funding, or the career stage of a particular person. Organisations not only channel resources to where they are needed but retain the learning gained through doing so. However, too often in seeking to achieve impact we ignore the value of organisations. We increasingly focus on doing more for beneficiaries now, rather than building the capacity of an organisation to deliver impact in the medium to long term. This applies to both funders and those directly delivering impact.

So what do we mean by capacity? An organisation has the capacity to do something when:

- it has access to people, equipment and processes capable of delivering the required output, “capability”
- it can fund that capability
- it can turn capability into action and output at the right time.

Organisations need capacity to deliver their current activities, to respond to the unexpected and to deliver in the future.

Organisations need the capacity to deliver their current activities, and this is often the predominant focus in the social sector. They need to recruit and retain people with the right skills and experience to deliver current activities, and to manage the overall organisation including its finances. Suitable premises and equipment need to be available at the right time (but not necessarily owned). Revenue sources are needed that cover the full cost of delivery and give some margin for contingency or reserves. Those revenue sources need to be diversified sufficiently such that capacity would not irreparably damaged should one revenue line be lost. Working capital is needed to manage differences in the timing of income and expenditure.

Organisations also need the capacity to respond to the unexpected – for example a surge in demand for their services or the sudden loss of a key contract. This is organisational resilience, and this capacity is about being flexible and able to adapt. This maybe flexibility in working practices, access to additional staff and premises, flexibility in expenditure contracts (e.g. break clauses in a lease on office space). It may also be achieved through diversity in revenue sources or through building the strength of relationships with funders and suppliers. Capacity in this form comes also through holding cash reserves and having underwriting agreements and insurance policies to protect against risks. So a key part of ensuring an organisation has the capacity to respond to the unexpected is to adopt a formal process to identify and address potential risks. A key consequence of having this capacity is that organisations can take a positive approach to managing risk i.e. they pursue their strategy aware of the risks it poses rather than reining in their strategy through fear of the consequences of risk. No activity is risk free, after all.

Organisations need the capacity to deliver impact in the future. The activities they deliver today may not be the ones they should deliver in the future – because the needs of their beneficiaries may change; or because more effective approaches are developed. Without the capacity to deliver in the future organisations become focused on producing the outputs of their current activities, not on delivering impact in the most efficient and effective way. The capacity to deliver in the future requires:

- horizon scanning – a vision and roadmap for how the needs of beneficiaries may change
- awareness of context – who is a competitor or collaborator in delivering impact? what economic, social trends, political trends will affect the issue and the organisations working on it
- capability to innovate – designing new approaches, testing and evaluating prototypes, being able to take successful prototypes to a larger scale of impact
- development capital – funding to risk on: achieving greater scale and developing more effective approaches.

Building the capacity of an organisation in these three ways sets up the organisation to be focused on creating long term impact over just delivering its current services. But building the capacity of one organisation does not *guarantee* more long term impact. There is risk - a chance of not achieving impact - involved at two levels: any one organisation may not be ultimately effective in achieving impact; and any one intervention that seeks to build capacity may not do so.

---

## THE ROLE OF FINANCIAL CAPITAL

Building capacity is therefore an investment activity – resource needs to be employed speculatively to build capacity but without the certainty it will be achieved.

The primary resource needed to build capacity is money which can be used to acquire the necessary capacity:

- through hiring people with skills and experience
- through purchasing access to premises and equipment
- through funding research and development.

And money is also needed as money – for working capital and to provide cash reserves. But other capacity-building interventions may be more difficult to buy. For example:

- the commitment of employees to the mission of the organisation, the development of a strong organisational culture and the retention of experienced staff;
- networks of contacts providing opportunities for new business or influence over public policy;
- reputation for quality of output, innovation or long term impact.

Acting as a capital investor to build capacity requires the disciplines of investment activity to be employed so as to manage the risk and maximise returns (impact). Investors should:

- build a diversified portfolio
- set measures of performance that indicate organisational capacity is being built (rather than outputs produced)
- engage closely with investees, and understand how plans adapt as they are implemented, but keep the focus on building capacity
- utilise networks to add capacity that cannot easily be bought.

We need more capacity to achieve long term impact in the social sector. In order for this capacity to be built, a greater supply of financial capital is required, and more organisations and individuals deploying capital are needed. Those seeking to build capacity need to adopt investment disciplines which recognise the inherent risk in making these investments - capacity may not be built and social impact may not increase in the long term.

Across a portfolio that is appropriately supported and monitored, financial capital will build capacity and see greater impact achieved in the long term.

## SO MORE MONEY IS NEEDED... BUT THE COMMERCIAL WORLD ISN'T THE ANSWER

The argument that the social sector needs more money is an all too familiar one. There isn't enough money to go round, and there are probably too many charities. The need for capital is acute because it constrains capacity and impact, but should capital be raised at commercial prices?

One consequence of the never ending demands for more funding of the social sector are the calls to "be more efficient" or "be more like the private sector" or "stop asking for handouts and start trading". Private sector experience is increasingly being drawn on: better understanding of the economies of scale has driven growth and some consolidation; more corporate approaches to decision making are in evidence; as are robust approaches to target setting and performance measurement. Furthermore, people are increasingly drawn in from the private sector as their skills in driving economic growth and profitability are seen as important to the social sector's performance – especially where social sector organisations find themselves in direct competition with private sector organisations.

Commercial capital is also increasingly looked to. It is plentiful and investment opportunities are sought out because there is greater balance between demand and supply. Philanthropic capital is harder to access not least because demand far out-strips the supply and rationing is effectively in operation. Commercial capital can therefore seem attractive where commercial terms can be serviced.

The increasing supply of commercial finance and in-flux of commercial activities and approaches needed to service it is driving a corporatisation of the social sector (referred to as "tescoisation" by one commentator). But commercial investors are interested in financial returns first. Impact is a nice to have, and has reputational benefits but impact is secondary. Furthermore commercial management understands best a working culture of

competition, protection of intellectual property, growth in turnover – not impact maximisation at all costs, for example closing your business down because your competitor could deliver a better service for less money or giving away your intellectual property so that charities across the country can adopt your good practice.

But it must be understood that, within the structure of the economy in 2010, the majority of social sector activity delivers impact to the detriment of paying financial returns on capital. This is because social sector organisations have not demonstrated they can achieve a price for their products and services which covers both operational costs and the commercial costs of capital – we are only just moving beyond full [operating] cost recovery.

This does not mean commercial capital should be ignored. Commercial approaches may be well suited to financial models where impact and financial returns go hand in hand and so there is no conflict of objectives between investor and investee e.g. delivering a public service at a fair price – one that makes it possible to deliver a profit – and then growing that business; or running a renewable energy business.

The trend for introducing commercial capital into the social sector represents a fork in the road for the structure of the sector, a split that has arisen because of a lack of capital that is motivated by the achievement of social impact first. There is a very significant debate to be had now about the capital structure of the social sector we wish to see, and how we get there.

One model is to recognise two sectors, united by the motivation to achieve impact but distinguished by the financial model employed and the financial returns on capital generated.

Those activities where the financial model is such that impact and financial return can be achieved with positive correlation might move closer and closer to the commercial sector, raising fully commercial capital. Parts of the commercial world might join this sector too - getting even more into the delivery of social and public benefit. This commercial-social sector would be a good thing if it is genuinely achieved with financial returns paid without detriment to impact. Seldom do “social enterprises” or “social purpose businesses” achieve this currently, but the political trend of outsourcing public services continues to represent the richest source of opportunity to do so albeit ultimately funded by the tax payer.

The rest of the social sector (a catchier name is required) – representing the majority of existing organisations – need an increased and resilient supply of capital that is philanthropic in its overall cost and motivated by building the capacity to deliver impact over all else. This doesn't mean just giving more grants and raising more donations. It means:

- building on the emerging new approaches for deploying philanthropic capital including the venture philanthropy funds, work around programme related investment, and work on community bond and share issues;
- ensuring that although the objective is not financial return, management is motivated to use capital efficiently as capital, not cunningly disguised revenue funding; and
- raising substantially more philanthropic capital funds.

Commercial capital does have a role in this part of the social sector. There isn't sufficient philanthropic capital to fund the current demand for capital, and so where the costs of commercial capital are affordable (e.g. in low risk applications such as acquiring premises) it should be used in order to release philanthropic capital for high risk needs. Across an organisation's balance sheet its cost of capital remains sub-commercial, philanthropic.

More controversially, in an environment where there is insufficient philanthropic capital the social sector needs to consider what appetite it has for using philanthropy to subsidise commercial returns. We are beginning to see philanthropic capital invested alongside commercial capital. In some circumstances commercial capital is called on to give a scale and timeliness not delivered by the philanthropy sector whilst philanthropic capital is required to subsidise the financial returns to the commercial investors in the interests of seeing impact happen faster or bigger. This logic appears sound on the surface – but ultimately money is being withdrawn from the social sector and from organisations which we have distinguished as being ones where there is no correlation between financial returns and impact. So theoretically those withdrawn funds could have been used to achieve more impact.

More philanthropic capital is needed by organisations motivated by, and capable of, delivering impact. This requires:

- those that can service commercial capital to use it; and this may require withdrawal of philanthropic funds to drive the use of commercial money.
- the philanthropic capital already in the social sector to be used efficiently to build capacity for impact.
- a campaign to attract philanthropic capital as well as revenue, connecting capital, with investment in organisational capacity and therefore impact.
- commercial capital to be drawn on only where the impact benefits (through scale or timing) exceed the costs to the social sector of a withdrawal of funds.

## WHAT SOCIAL INVESTMENT SHOULD REALLY MEAN TO THE SOCIAL SECTOR

The essence of the argument set out above is this:

- money is needed by social sector organisations to achieve social impact
- organisations need revenue and capital, but capital should be used to build capacity to achieve social impact
- building capacity is not a certain process, there is risk involved
- investment seeks potential upside (returns) as well as recognising downside (risk)
- the social sector needs investment in capacity with social impact as the primary objective for return and investment discipline in managing the risks of achieving this.

This process should be called social investment – investing capital with the primary purpose of building capacity and achieve impact.

---

## THREE STEPS TO BUILD SOCIAL INVESTMENT

1. Recognise that social impact isn't homogenous, so promote thematic funding  
Investing for impact will mean different things to different people. Attempts at seeking to find a unifying currency for social impact should be abandoned. Organisations and individuals with social investment capital to deploy should be helped to build investment communities of interest / concern which aggregate their funds into thematic funds. These communities of interest should include grant givers, individual donors, public funders and the major resource concentrated charities
2. Establish in the social sector the fundamental connection between building capacity and investment, by forming a group of funders who describe themselves as investors for capacity and impact

When funders are clear that building capacity is uncertain but important, they will want and need to adopt the risk management tools of investment. The venture philanthropy community should be brought closer to the mainstream of charitable funding, because they are the pioneers of these approaches.

3. Hijack the Programme Related Investment agenda amongst charitable foundations and redefine it as being CCI – capital, capacity and impact.

Foundations should be leading the way in differentiating their funding between revenue and capital (not just buildings!) Capital funding should be referred to as investment, with financial returns between minus 100% (a grant) through to plus 5% or 10% i.e. just sub-commercial. All charitable grant giving institutions should be required by the charity commission to have a policy on capital funding setting out how it seeks to build capacity and impact, and how the inherent risk in such funding is being managed.

Joe Ludlow  
April 2010