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CAPITALISING  
THE  
VOLUNTARY  
AND  
COMMUNITY  
SECTOR:  
A REVIEW

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For the NCVO  
Funding  
Commission

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## ABOUT THE AUTHOR

Joe Ludlow is a Fellow of the Clore Social Leadership Programme, working on new approaches to social investment. Prior to his Fellowship, Joe worked for Venturesome as Senior Investment Manager. Whilst there he was responsible for making over £4m of investment into a range of charities and social enterprises – mostly organisations with a turnover under £5m. He began his career with the TeachFirst programme, teaching in a secondary school in the London Borough of Hackney. Joe is a Trustee of two charities: GVEP International and Gemin-i.org. Joe holds a MEng from Cambridge University and an MA from the Royal College of Art and Imperial College London.

## ABOUT THE NCVO FUNDING COMMISSION

In February 2009, NCVO launched a Funding Commission to respond to the Sector's concerns and uncertainty about funding over the next ten years and to take responsibility for setting a new funding agenda.

The Commission will look ten years into the future and ask, what are the opportunities and challenges for Voluntary and Community Organisations (VCOs) in relation to their funding.

Its objectives are:

- To set a new agenda for the funding of VCOs in the next decade by publishing a report outlining the key issues and making a set of practical recommendations;
- To raise awareness and understanding of the future funding issues facing civil society among VCOs;
- To engage with funders and policy-makers to ensure they understand and are supportive of its findings.

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## EXECUTIVE SUMMARY

The VCS exists to deliver impact, and does so through a range of activities which have distinct financial models – including grant funding, earned income from charitable activities, social purpose trading and fundraising.

The concept of appropriate funding should be adopted to ensure that revenue funding is differentiated from capital investment, and that financial instruments are employed which are appropriate to

- the financial model of the activity i.e. to what extent can surpluses be achieved?
- the specific uses of capital by the activity and organisation
- the stage of development of the activity or organisation e.g. start up, growing fast, mature
- the appetite for risk and return of the investor and investee.

Data on demand and supply of capital in the VCS is thin, but there is evidence of capital investment not keeping pace with the growth in turnover of the sector. Furthermore, there is evidence which suggests VCOs struggle to access capital when they recognise their need for it. There is little evidence demonstrating the consequences for impact of better capitalisation.

Demand for capital is latent, and not clearly articulated. Low levels of financial literacy and financial conservatism are significant factors in this. Low risk needs for capital such as premises and equipment are reasonably well served by commercial finance and philanthropic sources. Development capital has been prioritised in recent years, and is well supported by grants and social investment. The need for working capital and reserves to give organisational resilience is often overlooked (the money is “spent”) yet is an overwhelming need. As the diversity of financial models employed in the VCS increases, the consequences for capital requirements must not be overlooked, for example contracts and trading have greater need for working capital.

The pricing of capital in the VCS is an area requiring careful consideration. Investors are attracted by apparent win-wins of financial returns and social impact, but opportunities to achieve this are limited. The majority of VCOs need capital which is philanthropic i.e. is expected to deliver social impact over financial returns.

A resilient supply of capital which is sub-commercial and independent of Government policy is needed. This supply will need to draw on the assets within the VCS already – in grant making institutions and major charities and draw on the individual giving market. The tools of investment need to be employed in investing capital whether in the form of grants or repayable finance.

A discernible social capital market has grown up in the UK over the last decade, with an ever-widening range of investors, funds, advisors and most importantly VCOs participating. We should aim for a robust social capital market where access to capital is no longer a constraint on the delivery of impact by VCOs.

# WHY DOES THE VOLUNTARY AND COMMUNITY SECTOR NEED CAPITAL?

The Voluntary and Community Sector (VCS) exists to improve quality of life for people and the planet. VCS organisations deliver on-going services, identify unmet or ill served needs and advocate change. More funding is always asked for, because the challenges faced are large.

VCOs adopt a range of financial models in undertaking their activities, reflecting factors such as the competitive market they are operating in, the purpose of the activity (to generate funds or directly achieve impact), and the requirements of funders. Figure 1 illustrates this, and emphasises that many VCOs operate more than one financial model within their organisation.

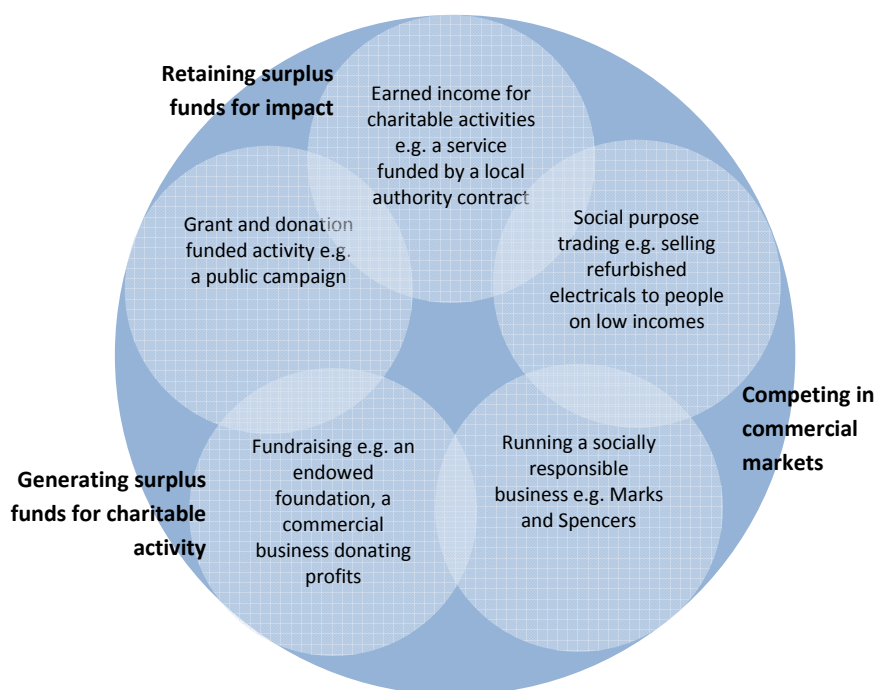


FIGURE 1: FINANCIAL MODELS FOR CHARITABLE ACTIVITY

Grant and donation funded activity is typically tied to specific project work or to a budget of costs. In recent years a trend towards funding *outputs* and *outcomes* of activity has been observed, as has the provision of *unrestricted funding* or *core costs*. Surplus generation in grant funded activity is difficult.

Earned income for charitable activities is usually in the form of contracts to deliver services which may come from public, private or charitable sources.

Social purpose trading involves the selling of a product or service to multiple customers to deliver an impact, and surpluses may be achievable and may reach near commercial levels.

Socially responsible business involves activities whose primary purpose is profit generation, but where the activity is constrained by standards of social and ethical responsibility.

Fundraising involves activities whose primary purpose is profit generation but where the intention is to donate a proportion or all of those profits to grant funded activity.

## APPROPRIATE FUNDING

Charitable activities need more than just funding, they require funding in an appropriate form for the financial model employed. Appropriate funding differentiates between revenue funding and capital investment, and selects the financial instruments used to match the financial model of the activity. This concept was originally explored in 'Grant Making Tango' (Unwin 2004).

For example:

- a charity which needs to secure its premises as the only suitable location in the area might use a mixture of capital grant funding and a commercial mortgage to acquire the building. The mortgage payments might be broadly similar to the costs of its existing rent.
- a public campaign to raise awareness of women's issues amongst the political parties would be funded by revenue grants and donations.

This paper explores the demand and supply of capital to the VCS through a framework for *appropriate funding* which considers:

- the financial model of the activity i.e. to what extent can surpluses be achieved?
- the specific uses of capital by the activity and organisation
- the stage of development of the activity or organisation e.g. start up, growing fast, mature
- the appetite for risk and return of the investor and investee.

## DEFINING CAPITAL AND THE USES OF IT

Economists define capital as being a factor of production or service delivery which is not wanted for itself but for its ability *to enable* the delivery of services or production of goods.

All organisations need capital – whether in the commercial, public or social sectors. Forum for the Future suggests that there are five types of sustainable capital (The Five Capitals Model – a framework for sustainability 2007).

- Natural Capital is any stock or flow of energy and material that produces goods and services.
- Human Capital consists of people's health, knowledge, skills and motivation needed for productive work.
- Social Capital concerns the institutions that help us maintain and develop human capital in partnership with others; e.g. families, communities, businesses, trade unions, schools, and voluntary organisations.
- Manufactured Capital comprises material goods or fixed assets which contribute to the production process rather than being the output itself – e.g. tools, machines and buildings.

- Financial Capital enables the other types of capital to be owned and traded.

The availability of capital gives an organisation the *capacity* to produce returns. In the VCS, returns on capital may be financial, social, environmental or cultural. Overall the role of capital in a VCO is to give the organisation the capacity to deliver impact.

The VCS uses *financial capital* to build capacity in one of four ways:

- To acquire the *fixed assets* necessary to deliver on-going services, projects and activities;
- As *working capital* to manage timing differences between spending money and receiving it (cashflow) thereby enabling on-going activity;
- As *development capital* to fund the costs of:
  - growing existing services and projects
  - developing the infrastructure of the organisation e.g. through IT, or financial systems, or marketing
  - innovation in new products, processes and services;
- As *reserves* or *insurance* to give resilience, protecting the organisation and its activities against the unexpected happening.

#### APPROPRIATE FUNDING AND THE OBJECTIVES OF FUNDERS

Differentiating capital investment from revenue funding is important to ensure appropriate funding mechanisms are put in place.

Revenue funders provide money to produce specific outputs or outcomes (or to fund specific costs). They are concerned with quality of outcome, value for money and risk minimisation. The instruments of effective revenue funding (be it restricted grant funding, contracting, commissioning, tendering etc) are designed to achieve this. These instruments are different from those used for capital investment.

The providers of capital to an organisation are *investors* who seek to build the capacity of the organisation to achieve its mission in the longer term. Investors accept that there is risk that the organisation will not achieve their desired returns on capital, whilst also believing there is the opportunity to exceed their desired returns. Investors employ tools to manage this risk such as conducting detailed organisational analysis, portfolio diversification, close supervision and frequent reporting.

However, revenue funding and a charity's need for capital are closely linked and this is further explored later in the paper.

#### APPROPRIATE FUNDING AND A DIVERSITY OF FINANCIAL INSTRUMENTS

The supply of capital to the social sector is often described as *social investment*. But this term has many interpretations – from general grant making, loan finance for charities, through to commercial investment with social and ethical credentials.

This report is concerned with the demand for and supply of financial capital in a wide variety of forms with the primary objective of building the capacity of an organisation to achieve social, environmental or cultural impact. Table 1 lists the range of financial instruments at work in the VCS.

VCOs seek capital to build their capacity to achieve impact, but investors (suppliers of capital) may be motivated by achieving financial returns or impact or a blend of both. So there is a role for (i) commercial bank loans to VCOs which may well build the capacity of the VCO but from the bank's perspective are an opportunity to deliver financial returns; (ii) loans from social investors and community development finance institutions at a discount to commercial rates.

But access to capital is about building a diverse range of financial instruments available to VCOs and in ensuring an appropriate match between the need for capital and the form it is supplied in.

**TABLE 1: FINANCIAL INSTRUMENTS AT WORK IN THE VCS (ADAPTED FROM FINANCING CIVIL SOCIETY, VENTURESOME 2008)**

<b>Instrument</b>	<b>Financial risk to supplier</b>	<b>Repayment risk to VCS</b>	<b>Examples of suppliers</b>
Grant	Complete – no repayment	None – no repayment	Baring Foundation, Esmée Fairbairn
Equity (shares)	Very high (potential reward also very high)	Low (as linked to success)	Triodos Opportunities Fund, Bridges Ventures
Quasi-equity (royalties)	Very high (substitute for equity)	Low (as linked to success)	Bridges Ventures, Venturesome
Patient capital (long-term loans)	High – but repayment expected	Low/medium	Adventure Capital Fund, Venturesome
Unsecured loans	Medium	Medium (1-5 year repayment)	Social Investment Business, Charity Bank
Overdraft / Standby facility	Medium / Low – short term cash flow cover	High	Barclays, Natwest
Secured loan (mortgage)	Very low –asset backed	High	Banks

## BROAD EVIDENCE OF THE NEED FOR CAPITAL

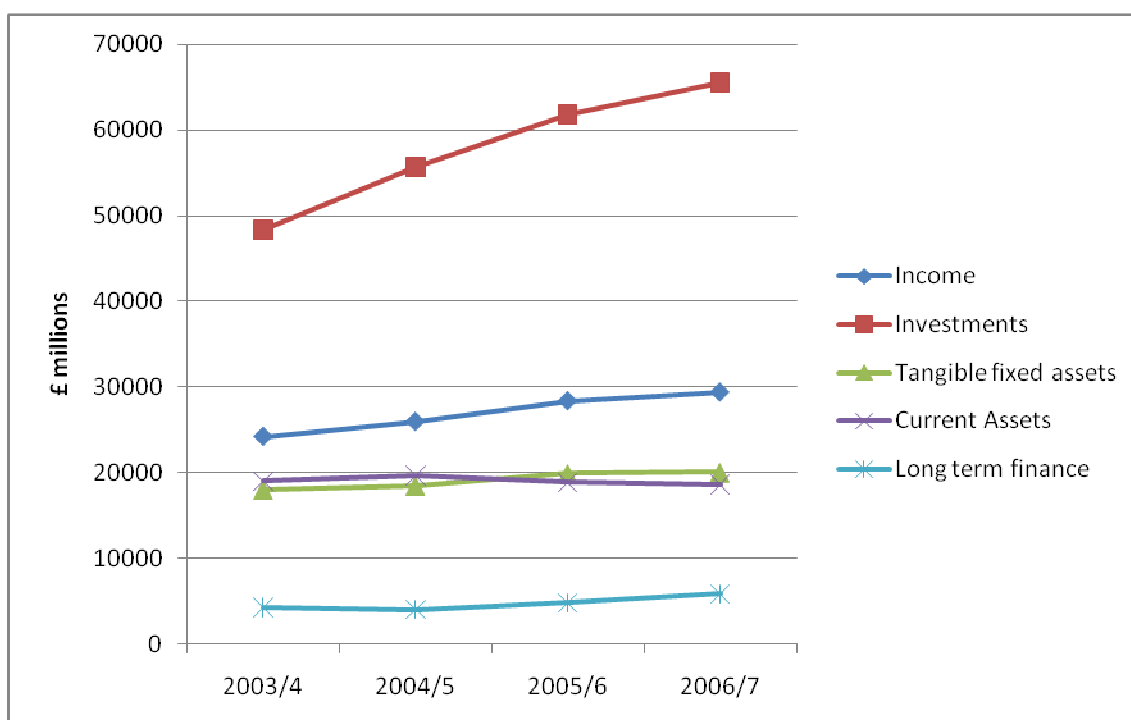
70% of VCOs state that funding has restricted their activities in the past year (Green 2009), despite the income of the sector growing over the past five years at 5% pa. This section explores what broad evidence there is for access to capital being a restraint on activities and impact.

### *EVIDENCE FROM SECTOR WIDE DATA*

The total gross assets of the VCS in 2007/8 were c£104 billion, but the distribution of these assets across organisations was far from uniform – one third of the assets were held by 54 organisations, and within this one fifth of the assets held by just four organisations. Grant making foundations and medical research organisations whose primary activity is grant-making can be argued to control 50% of the sector’s assets (The UK Civil Society Almanac 2009).

In the period 2003 to 2007, the income of the VCS grew at an average annualised rate of 5%. Figure 2 shows that, with the exclusion of investment assets (majority controlled by grant makers), the sector’s asset base has not kept pace with income (fixed asset growth 3% pa, current assets -1% pa). Access to long term finance has improved however, with a growth rate of 8% pa over the period – latest data for 2007/8 suggests c£2.9bn of long term loan finance in use. The impact of the recession on this data is not yet known.

FIGURE 2: TRENDS IN INCOME AND CAPITAL 2003 - 2007 (SOURCE NCVO)



The data in Table 2 adopts the UK Civil Society Almanac’s categorisation of organisations by size<sup>1</sup>. The ratio of net current assets to turnover suggests that smaller organisations have a better working capital position than larger organisations, but that larger organisations are better able to access external financing. It must be noted that these are average values which mask the substantial variation in balance sheet positions within categories.

TABLE 2: ANALYSIS OF ACCESS TO CAPITAL BY SIZE OF VCO (SOURCE NCVO)

	Number of organisations	Average turnover £000s	Average net current assets £000s	Average long term finance £000s	Ratio of net current assets to turnover	Ratio of long term finance to income
Medium	20664	305.2	172.0	26.8	56%	9%
Large	3963	2677.5	827.9	493.6	31%	18%
Major	413	34358.4	5293.0	7864.4	15%	23%

### *EVIDENCE OF DIFFICULTIES ACCESSING CAPITAL*

Several reports have found some evidence of VCOs experiencing difficulty in accessing capital (Bank of England 2003) (SQW Ltd 2007). One indicator of the need for additional capital is the extent to which charities have had to take on revenue funding outside of core mission to maintain turnover and capacity. The SQW study found

*‘The evidence from the study illustrates that the majority of [third sector organisations] are in the position of focusing continually on organisational survival, sometimes necessitating some mission drift, and certainly in many cases at the expense of concentrating on the future development of the organisation.’*

This indicates a lack of free reserves and working capital. These simple needs for capital are often overlooked as an organisation doesn’t necessarily need to spend money on anything specific e.g. Government rules on the use of the Community Builders fund require money to be disbursed rather simply committed.

It is the knowledge of having *access to capital* that can have a substantial material effect on the capacity and management decision making of a charity (Venturesome 2005), rather than having actual cash in the bank. For example a charity with a lumpy pattern of grant funding with either (i) several months expenditure in free reserves; or (ii) access to an overdraft facility of a similar value will have the confidence to pursue its strategy and not make redundancies ahead of seeing the results of its grant applications. A charity without such access to capital would need to make cuts and then may find itself needing to add back capacity to deliver on newly won funding.

### *EVIDENCE OF THE CONNECTION BETWEEN BETTER ACCESS TO CAPITAL AND MORE IMPACT*

It is logical to infer that supplying capital to VCOs should build capacity in an organisation, and there is qualitative evidence support this (Abdy and Bolton 2007). It follows that organisations with more capacity should then deliver more impact, but there is little data on this and no broad quantitative studies of the connection between capitalisation and effectiveness or impact.

<sup>1</sup> Micro, income under £10,000; Small, income between £10k and £100k; Medium, £100k to £1m, Large, £1m to £10m; Major £10m+

## THE NEED AND DEMAND FOR CAPITAL IN THE VCS

The level and type of demand for capital is not well documented or quantified (Nicholls and Pharaoh 2008). Whilst supply of capital from social investment funds can be evidence of demand, the supply of capital as grants and from commercial sources is difficult to quantify and interpret as demand. Anecdote suggests the need for capital may be significantly greater than the number of applications for capital funding across all forms and sources.

However, proxy indicators can be drawn upon to surmise a picture of the capitalisation across the VCS within the framework for appropriate funding (uses, stage of development, financial model, pricing).

### DEVELOPING DEMAND

Before looking at the need for capital in terms of use, organisational stage, financial model and pricing the distinction must be made between need (or “latent demand”) from demand which is evident and articulated (Goodall and Kingston 2009).

There would be substantial merit in VCOs expressing the need for capital themselves. However, the recent consultation on the creation of a Social Investment Wholesale Bank (Office of The Third Sector 2009), gathered evidence to suggest that the need for capital existed but demand was immature and not articulated. This was felt to be because:

- a poor level of financial understanding can inhibit VCOs ability to differentiate and explain their need for capital;
- VCOs prioritise the raising of additional revenue;
- A culture of financial conservatism exists whereby protection of the organisation is prioritised over building capacity using loans and equity-like funding.

### *THE IMPORTANCE OF FINANCIAL LITERACY*

A VCS with high levels of financial literacy is a critical factor in achieving a well capitalised sector. Organisations with a strong comprehension of their financial model, financial position and the sources of funding available to them are able to:

- Accurately budget and forecast, giving more robust income and expenditure accounts and potentially surpluses;
- Link finance and the need for capital to strategy and business planning
- Appear credible and confident when seeking investment
- Understands the needs and objectives of providers of capital and therefore tailoring their communication of the need for capital to this.

Financial literacy has received some support – notably from NCVO’s Sustainable Funding Project – and marketing from social banks and social investment funds e.g Charity Bank and Social Investment Business have also raised levels of understanding of the role of finance. The ChangeUp programme sought to address financial literacy through the Finance Hub in 2007-8.

## *FINANCIAL CONSERVATISM AND ATTITUDES TO RISK*

Raising capital – particular development capital – involves stepping outside business as usual and taking on some risk both of non-delivery of impact and financially. Where the financial instrument used is not a grant, the financial risk is in stark focus.

For many Trustees, governing a financially prudent organisation is a primary concern and ensuring the organisation continues to be able to deliver its current services to beneficiaries is essential.

This approach priorities a Trustee's duty to ensure an appropriate financial situation over a Trustee's duty to see public benefit is delivered.

## *INVESTMENT READINESS - WHY IS IT NEEDED?*

When seeking capital investment, all organisations need to be able to articulate their financial position and need, and be able to demonstrate they are organised so as to deliver the returns on capital they forecast. *Investment readiness* services exist to support organisations in doing this and seeking investment.

The support provided may include:

- management consultancy to prepare organisations for growth, including writing business plans, improving operational efficiency, strengthening governance;
- financial consultancy, providing interpretation or development of business plans and evolving financial models into a form that meets the requirements of investors
- brokerage / fundraising consultancy– providing introductions to investors and managing the structuring of funding packages from multiple investors (*co-investment*).

Investment readiness has been identified as one potential means of improving or accelerating access to capital for the VCS by both VCOs seeking capital and funders who wish to deal with applications for support in an efficient manner. Significant investment readiness programmes have been funded by NESTA, Capacitybuilders and Communitybuilders. Organisations such as UnLtd Advantage are testing specialist models of investment readiness support for the wide social sector including approaches to funding. Consultancy firms and accountants are also well placed to do this work as they do in the commercial world.

For organisations seeking to raise very large sums of capital, Social Finance has pioneered services in this area.

## LOOKING AT THE USES OF CAPITAL

### *ACQUIRING FIXED ASSETS – PROPERTY AND EQUIPMENT*

Securing appropriate premises is often essential to the delivery of charitable services. The need for plant and machinery is less significant, with the exception of I.T. equipment. Fixed assets usually retain a realisable financial value after their acquisition and represent low financial risk<sup>2</sup> investment for both VCO and an investor.

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<sup>2</sup> Defining financial risk as the probability of repayment in full of the capital invested

There is strong evidence of demand from the VCS for financial capital to support the acquisition of fixed assets. 67% (£70m late 2008) of the Futurebuilders Fund has been used for property investments (National Audit Office 2009); the majority (81%, £22m in 2008) of Charity Bank's loans are long-term (over five years to maturity) and are usually secured against fixed assets (Charity Bank Ltd 2008). Whilst it is not surprising that the VCS has a substantial need for premises and equipment to support the delivery of its work, demand for fixed asset finance has been supported by features of the market such as:

- the rise of commercial property prices over the period 2002 – 2007 encouraging VCOs to acquire property as a financial investment
- the growing supply of finance for fixed asset acquisition from: grant funders (e.g. Capacity Builders, Community Builders); social investment funds and social banks e.g. Futurebuilders, Charity Bank; commercial lenders e.g. Unity Trust Bank.
- the propensity of donors to meet tangible requests for funds has made fundraising for fixed assets substantially easier than fundraising for other capital requirements such as working capital. The combination of this feature with the perception amongst VCOs that property assets can be readily refinanced with secured lending has seen demand for fixed assets in some cases being driven by their use as a financial reserve in lieu of cash.

The impact on fixed asset acquisition of the recession, falling commercial property prices and reduced commercial lending is not yet quantified, but there is emerging evidence from specialist banks such as Triodos (Triodos Bank announces 73% growth in lending and commitments in 2009) and Charity Bank of increased demand (Charity Bank announces positive mid year results 2009).

#### *WORKING CAPITAL – MANAGING THE TIMING OF INCOME AND EXPENDITURE*

Working capital is needed by VCOs for broadly two purposes, often described as cashflow issues. The first purpose is to finance contracted or invoiced income paid in arrears to enable work to be delivered in advance of payment – this timing issue is broadly a low risk financial need. The second purpose is to give the capacity to pay on-going regular expenditure e.g. salaries, rent whilst income may be irregular e.g. from grants, fundraising events, seasonal sales patterns – this need has more risk to it due to the uncertainty of income flows.

Evidence of demand for working capital is mainly qualitative. Around two-thirds of demand for Venturesome's support in its first five years of operation was for working capital or reserves capital (Bolton, Kingston and Ludlow, The Venturesome Model 2007). One-third of respondents to a Charity Commission survey (Charity Reserves 2003) had used their reserves to fund working capital. Evidence of how this demand is being financed is also weak. However:

- more than 50% of social enterprises had sought overdraft finance (Bank of England 2003).
- a qualitative study of VCOs and social enterprises found the predominant need for finance to be for working capital (SQW Ltd 2007)

Many commercial and social investment institutions provide working capital to the VCS as secured and unsecured loans. Grant funded activities often benefit from payments in advance to provide working capital.

## *DEVELOPMENT CAPITAL – GROWING ACTIVITIES, BUILDING INFRASTRUCTURE, INNOVATING*

The VCS' need for development capital has been frequently described e.g. Bank of England 2003, Bridges Ventures, National Audit Office 2009, SQW Ltd 2007. Investment ahead of income generation and evidence of profitability is high financial risk.

The relative dilution of small and medium sized charities and concentration of major charities (The UK Civil Society Almanac 2009) suggests a need for support for VCOs to reach greater scale and potentially achieve more impact and greater economies. Substantial steps have been made to supply development capital to VCOs, including:

- Government funds – Adventure Capital Fund (£14m), Futurebuilders Fund (£215m), Health Social Enterprise Investment Fund (£100m), Community Builders (£70m), Risk capital for social enterprise (£10m)
- Support for early stage social entrepreneurs through UnLtd
- The development of specialist 'social venture funds' including Bridges Ventures Social Entrepreneurs Fund, Triodos Social Entrepreneurs Fund, Big Issue Invest, Venturesome.

There is evidence of good take up of some of this funding e.g. the recent closure of Futurebuilders, but equally anecdotal evidence that some social venture capital offers are not appealing to VCOs because of pricing and the perceived risk to the charity of such funding.

Much of the publicity and promotion around development capital investment has related to loans and more exotic financing (e.g. *quasi-equity, social loans, revenue participation*). But the most significant source of development capital in the VCS continues to be grants. Grant makers do not typically express their funding as meeting the need for development capital. More often funding is described as being for:

- innovation and new approaches; or
- core funding and infrastructure; and sometimes
- capacity building.

Venture philanthropy, and other approaches to grant making that engage closely with an organization, explicitly take an investment approach to the supply of development capital through grants. Funding is often used to prepare business plans; strengthen management and governance; and develop systems and processes to build the capacity of the charity to achieve impact.

## *RESERVE CAPITAL AND INSURANCE – GIVING CHARITIES RESILIENCE*

The need for charities to hold reserves is well recognised from the perspective of financial prudence and solvency. Increasing numbers of charities have reserves policies and fulfil them, but there has been public suspicion that charities hoard reserves and prioritise reserve building over meeting the needs of current beneficiaries (Charity Commission 2006).

It is important to clarify that when looking at a charity's balance sheet it will hold unrestricted and restricted funds to meet its needs for all uses of capital (fixed assets, working capital, development capital and reserves). Reserve capital is best thought of as insurance – money which the charity could call upon in the event that the unlikely happens. For example:

- a key member of staff may leave or be taken ill, affecting project delivery or fundraising

- a long standing contract may not be renewed, and the costs of making redundancies and exiting leases needs to be covered
- the success rate of a fundraising pipeline may suddenly dip below its long term average, creating a deficit.

Reserve capital fills two roles: firstly it provides funds to meet the financial costs should the unexpected happen, mitigating risk; but secondly its existence helps management decision making to be longer term, maintaining organisational capacity and being less reactive to short term fluctuations in performance: reserve capital gives charities *resilience*.

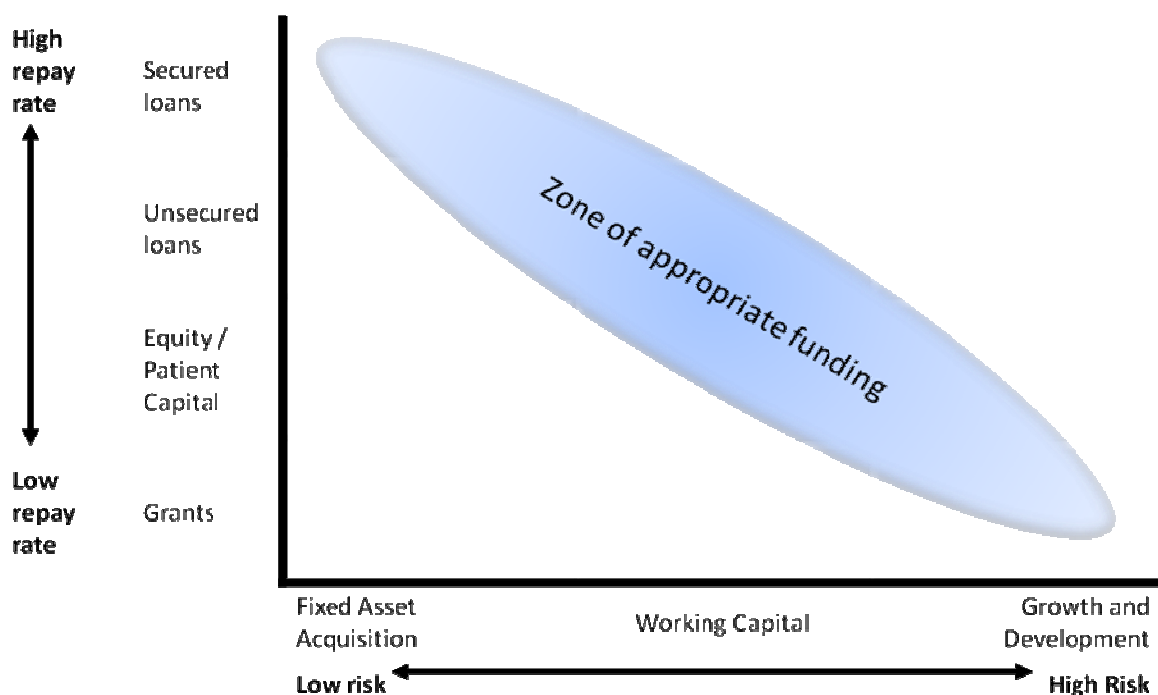
Reserve capital may be held by charities as part of their unrestricted funds, but reserve capital can also be provided in the form of underwriting (Venturesome 2005) and there may be a role for the wider use of insurance instruments to provide resilience.

### *MATCHING USE OF FUNDS TO FINANCIAL INSTRUMENT*

Figure 3 illustrates the principle of matching the risk of the use of capital to the financial instrument used to supply funds. For example:

- purchasing a building is low risk because there is a reasonable chance that the building can be resold for near to the value it was acquired for. It is therefore reasonable to finance the purchase of the building using a secured loan where there is a certain obligation to repay the funding with interest
- spending money on direct mail for a fundraising campaign aims to generate a greater level of donations in the long term, but the campaign's success cannot be guaranteed. This investment needs to be funded using an instrument that acknowledges funds may not be repaid such as equity investment or grants.

FIGURE 3: MATCHING USE OF FUNDS AND FINANCIAL INSTRUMENT, ADAPTED FROM 'FINANCING CIVIL SOCIETY', VENTURESOME, 2008

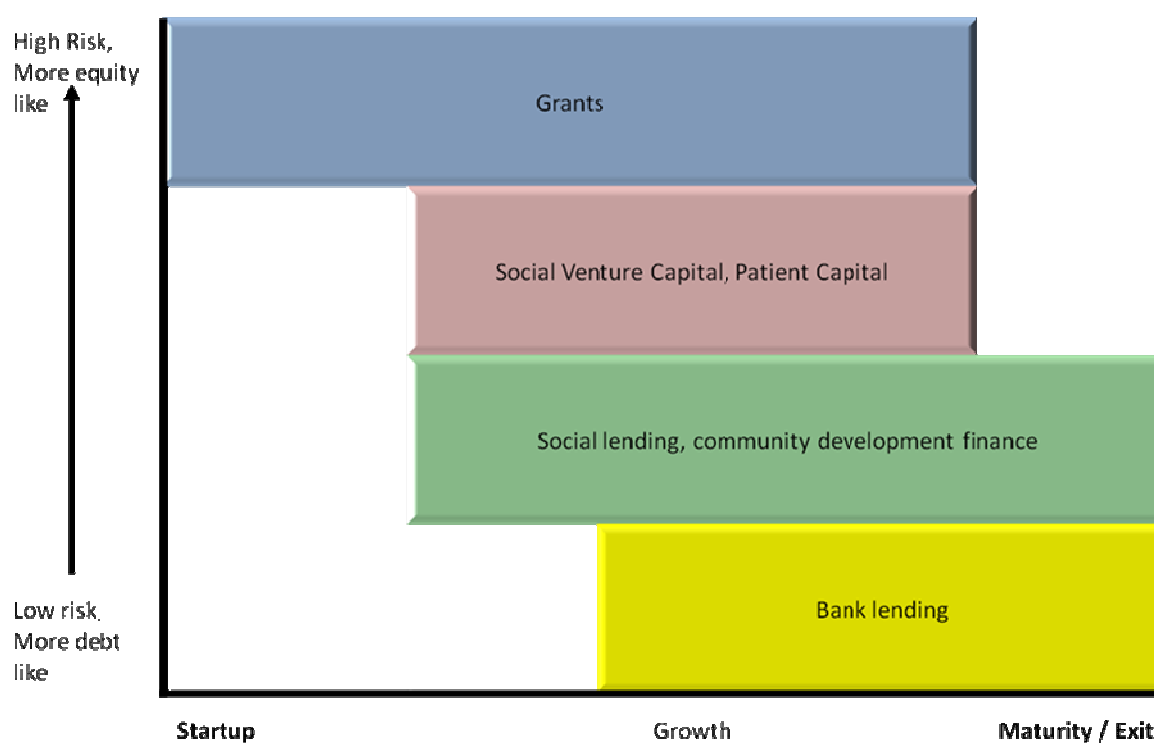


## LOOKING AT THE NEED FOR CAPITAL BY STAGE OF ORGANISATIONAL DEVELOPMENT

Figure 4 plots appropriate forms of capital by the stage of development of an organisation. It describes a general correlation between risk and maturity, early stages being high risk than more mature organisations.

When an activity and / or organisation is first established its success is uncertain. Will it raise the funding needed to do the activity? Will it achieve its hoped for outputs and outcomes? Will it manage to deliver within the budget and timeframe? Start-up activity is high risk in terms of financial performance and impact. Financial capital is required for piloting and prototyping activities ahead of detailed knowledge of their likely costs and whether revenue will be attracted to them. At a very early stage there is little distinction between capital and revenue, other than the terms on which the funding is offered.

FIGURE 4: APPROPRIATE FUNDING BY LIFESTAGE, ADAPTED FROM NICHOLLS AND PHARAOH, 2008



Organisations with a track record of past delivery are of lower risk than startups because there is data against which they can justify their forecasts and need for funding. Capital is required to fund expansion (working capital and development capital). The aim is often to achieve through scale efficiencies and increased impact – opportunities to achieve returns on capital develop.

As an organisation matures, it needs to diversify revenue sources to manage risk, innovate new products, and ensure its infrastructure is robust and resilient. This too requires investment. In the commercial world, businesses at this stage have typically achieved operating profitability and can self-finance these needs. This is not always possible for charitable activities where the opportunities to make surpluses are limited (see below). Mature organisations often seek to expand into new geographic markets or diversify into new activities. This may be done through

internally or through acquisition, but development capital and working capital is typically required to achieve this.

#### LOOKING AT THE NEED FOR CAPITAL BY FINANCIAL MODEL OF THE ACTIVITY

As illustrated in Figure 1, the VCS undertakes activities and generates income through a range of financial models. These have significant consequences for demand and supply of capital and this is explored below.

##### *ACTIVITIES FUNDED BY GRANTS AND DONATIONS*

Grant funding is very important to VCOs, and the role of grants in providing development capital has already been discussed. Yet a culture has grown up which associates the concept of 'financial sustainability' with a move away from grant funding to other forms of revenue and capital. This is incorrect – a business reliant upon impulsive purchases could be exposed to more risk to its income than one in receipt of annual grant commitments. However, financial models based around grants and donations may show the following features, with associated consequences for the need for capital:

- grants may offer little or no capacity to generate a surplus on activities. This means the activity will not be able to fund its own capital needs, has no contingency for error, and cannot repay capital to external providers.
- lumpy income patterns give rise to highly variable cashflow where grant funding sources are not sufficiently diverse e.g. a major grant may be paid quarterly in arrears on 31 March, requiring the majority of the costs to be financed by the charity ahead of receiving income.
- lumpy income patterns and uncertainty around grant decision timescales puts risk into cashflow forecasts and a need for reserves / insurance.

40% of income in the VCS is in this form.

##### *EARNED INCOME FOR ON-MISSION ACTIVITIES*

The Civil Society Almanac data shows the prevalence of this financial model increasing, driven in the main by income from the state. This approach creates a number of distinct features around the need for capital:

- contracts based around the delivery of outputs or outcomes may offer the opportunities to generate surpluses. Funders and VCOs have been encouraged to employ the principles of Full Cost Recovery (ACEVO) but this approach makes no allowance for a VCO's need for capital. Providing revenue tied to the delivery of outputs and outcomes and awarding funds on a judgement of value not cost is gathering momentum with both grant makers and public service commissioners (Ellis 2009). This should allow more VCOs to make small surpluses on their work and in turn enables the development capital requirements of the activity to be financed with repayable funding – loans and equity-like instruments.
- contracts are often paid in arrears and this creates a need for working capital.
- contracts are increasingly seeking to share or transfer the risk around the delivery of outcomes to the charity e.g. in supporting the long-term unemployed, a charity may be compensated on its success for placing people into jobs and their retention in those jobs for six months. This requires a form of reserve capital to protect the organisation against the

risk of not achieving their targets. The proposed social impact bonds (Social Finance Ltd 2009) are a model of providing such capital.

- contract tendering processes create a need for development capital, the recovery of which needs to be priced into any resultant contract
- contract length can have a significant consequence for: the acquisition of fixed assets, where shorter contracts increase the demand for leasing arrangements; and for recruitment where charities need to balance their risk of permanent recruitment should the contract not be renewed versus the effect on recruitment of hiring on fixed term contracts. Reserves help mitigate risks around non-renewal of short contracts, and maintain capacity in an organisation.

### *SOCIAL PURPOSE TRADING*

Social purpose trading (social enterprise) approaches are well promoted by Government and others. Competing in a market is not unique to social purpose trading – after all VCOs find themselves competing for grant funding, competing for local authority contracts, competing for individual donors giving by direct debit. What distinguishes social purpose trading is the focus on selling predetermined (designed) products and services to multiple purchasers, in comparison to tailoring activities (projects) to the requirements of funders, be they grant funders or contracting bodies. This distinction has particular consequences for capital:

- investment in product development is required on the speculation of customers coming forward.
- development capital is required to fund people, stock, marketing, other running costs ahead of sales reaching the volume necessary to breakeven (“startup losses”).
- often the production of stock before sales are achieved needs to be financed.
- working capital is needed to fund variability in sales volumes from one month to the next, and to fund sales paid in arrears.

### *FUNDRAISING*

Most VCOs undertake fundraising activities, and for some organisations the primary activity is fundraising. The objective is to use capital to generate financial returns. It may be argued, therefore, that the fundraising financial model is a commercial one.

Development capital may be needed to startup and grow the activity, for example by hiring a fundraising manager or developing and testing a direct mail campaign. Fundraising is an activity with uncertain outputs and the tools of fundraising recognise the management of risk by building pipelines of opportunities, discounting opportunities based on past success rates etc.

When risking charitable capital for a fundraising activity a balance between the financial risk and likely financial benefit to the charity needs to be found. Where the fundraising activity involves trading commercially to generate profits, a charity needs to think carefully what its commercial advantage is over incumbents whose primary focus is profit maximisation for investors, and consider within this whether access to capital is an advantage or a barrier to success. For example, a private company may be more able to access development capital to grow to scale and maximum profits because its investors expect high financial returns, where a charity will necessarily divert some profit to its charitable activities.

## PRICING CAPITAL - LOOKING AT RISK AND RETURN FOR VCOs AND INVESTORS

As explored above, investing capital is undertaken in pursuit of returns which in the VCS may be financial or in impact. But the purpose of a VCO in seeking capital should always be to provide capacity to achieve impact, even if that is achieved through a fundraising activity.

Appropriate funding must seek to match the returns sought by an investor with the returns payable by the charity.

The pricing and affordability of capital for VCOs has broadly three factors involved:

- the level of financial return required by the investor and payable by the charity
- an assessment of the potential impact achieved through capitalising the activity
- an assessment of the risk – the chances of financial returns being paid and impact being achieved.

Figure 5 below illustrates the interplay between financial returns and impact and suggests that for the majority of the demand for capital in the VCS there is a trade-off between the two (Cheng and Ludlow 2008), as illustrated by the dashed line.

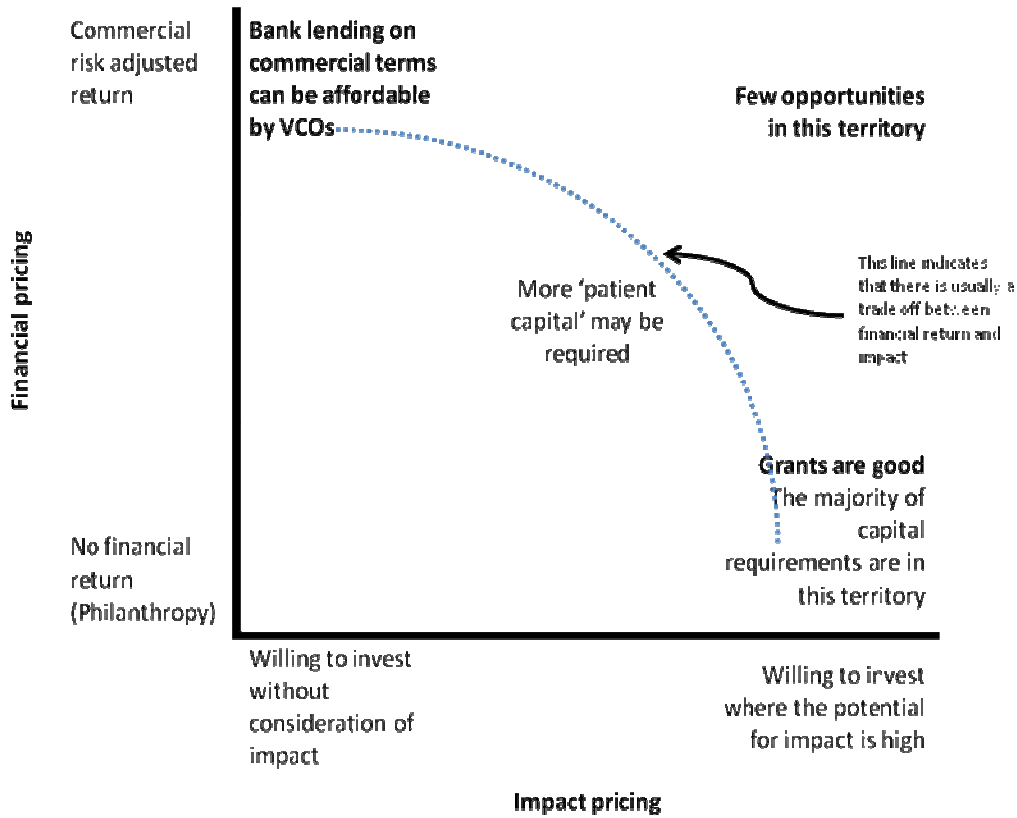
The risk of bank lending for fixed asset acquisition is relatively low, and the pricing therefore is accessible by charities. Commercial rates of return on development capital, for example from venture capital funds, are not generally affordable by VCOs and so sources of capital that are prepared to absorb high risk in exchange for potential impact are required – this is one reason why grants are such an important source of capital for charities.

The risks of reserve and working capital sit in a middle ground where, whilst commercial rates of return are usually unaffordable, capital can often be recycled – albeit on a patient basis. The experiences of the Adventure Capital Fund and Venturesome social investment portfolios demonstrate this approach. At a portfolio level the returns after losses may be negative, but capital is recycled and reinvested multiple times before it is lost entirely.

There has been significant growth in social venture capital funds, targeting in the main social purpose trading activity e.g. Bridges Ventures Social Entrepreneurs Fund, Triodos Social Entrepreneurs Funds, Big Issue Invest Social Enterprise Fund. These funds would appear to be targeting opportunities towards the upper left corner of the diagram in Figure 5. The need for capital of the majority of VCOs would not meet this price point.

FIGURE 5: PRICING CAPITAL FOR THE VCS

ADAPTED FROM - AMONGST OTHERS - ACUMEN FUND, "THE NATURE AND TYPE OF SOCIAL INVESTORS", APRIL 2009



### THE STATE OF NEED AND DEMAND

There is substantial under-capitalisation in the VCS, but this demand is not expressed. Financial conservatism continues to hinder demand for capital at the expense of impact.

The drive to adopt a range of financial models appropriate to the activity should be welcomed but the implications for the need for capital should be noted. Equally, the VCS must recognise that trading isn't always better than fundraising and grant funded activities.

The pricing of capital is an important topic to consider – the majority of the VCS cannot afford commercial prices for capital, especially for higher risk needs.

## THE SOURCES OF CAPITAL

The development of a robust social capital market and a well capitalised VCS is not purely a matter of making additional funds available. Informed demand needs to be met with appropriate funding from a resilient and diverse supply of capital.

The principle sources of capital for the VCS are: (i) the commercial capital markets; (ii) the public sector; (iii) grant making institutions; and (iv) individual donors. The VCS has faced barriers in accessing capital from each of these sources.

### DANCING WITH THE DEVIL? ACCESS TO COMMERCIAL CAPITAL

The commercial capital markets are an important source of capital investment in the VCS, despite there being obvious differences in the primary motivation of commercial investors (seeking maximum financial returns on capital) and VCOs as investees (seeking maximum social impact). The available capital in the commercial markets is enormous, and the infrastructure to support its deployment is sophisticated. However, the payment of financial returns to commercial investors is, of course, extracting funds from the VCS. So commercial funding is a helpful source of capital where:

- the amount of capital required could not be sourced solely from charitable sources; or
- the timing of the requirement is such that a commercial institution can react faster; or
- the commercial rate of return is bearable, and capital from charitable sources is limited and could be better used to meet needs which cannot be funded commercially.

However barriers to accessing commercial capital have, and still do, exist:

- commercial investors may perceive that VCOs represent higher financial risk than they actually do from a lack of specialist VCS knowledge e.g. the Charity Bank default rate is less than 0.5%<sup>3</sup>;
- there can be a fear of reputational damage if the investor is portrayed as 'closing down a poor charity' in the event of default or refusal to advance funds to a VCO;
- as discussed above, there is often a difference between the risk of a charities financial need and the financial returns it is able to pay an investor in comparison to commercial enterprises, especially in higher risk uses of funds such as development capital where commercial rates of return on, for example, venture capital are seldom affordable by VCOs.
- The scale of the VCS has been overlooked as a business opportunity.

Despite these barriers, the commercial markets have played an important role in financing VCOs – from providing many billions of pounds to finance housing associations, through the many thousands of charities with small overdraft facilities to the specialist charity and social enterprise departments of some clearing banks e.g. RBS / Natwest.

Following the recommendation of the Social Investment Taskforce (Enterprising Communities - Wealth Beyond Welfare 2000) there is an on-going lobby for the introduction of a 'Community Reinvestment Act' in the UK, similar to that in place in the USA which forces the disclosure of

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<sup>3</sup> See [http://www.charitybank.org/Saving/Protecting\\_your\\_Savings.aspx](http://www.charitybank.org/Saving/Protecting_your_Savings.aspx)

lending to people and organisations in deprived areas, and could highlight the extent to which commercial banks are financing the VCS.

Looking to the future, new models of utilising commercial capital alongside charitable capital are emerging. For example [Deutsche Bank Eye Fund; work of social finance]

Charitable funding is being used to leverage commercial money by (i) absorbing risk and therefore guaranteeing certain financial returns; and sometimes (ii) providing cash to fund returns. There is an important debate to be entered around this issue – how can a focus on capacity building and impact be assured in such models? How should we assess the merits and risks of charitable funds leveraging commercial capital in this way?

The commercial world also engages with the VCS through corporate philanthropy programmes. Corporate philanthropy often has objectives around: synergy with commercial activities; employee engagement with the activities and culture of the firm; customer engagement with brand and products; synergy with corporate mission, vision, values; and public reputation. There are few examples of corporate philanthropy explicitly supplying capital, outside of gifts for fixed asset acquisition because capital needs are often less tangible than revenue funding. However, venture philanthropy approaches have attracted some corporate funding e.g. Diageo Foundation and Shell Foundation.

## INDEPENDENCE AND RESILIENCE – WHAT ROLE FOR PUBLIC SECTOR CAPITAL FOR THE VCS?

Public funding represents 31% of income to the VCS, and government has played a substantial role in the supply of capital – both as a funder and in stimulating the social capital market.

Since 2002, Government has:

- provided c£450m to create a range of investment funds for the social sector (Adventure Capital Fund, Futurebuilders, Health Social Enterprise Investment Fund, Community Builders, Social Enterprise Equity Funds). A substantial amount of this funding has been in the form of loan finance.
- clarified the eligibility of charities and social enterprises for support from the small firms loans guarantee scheme.
- funded fixed asset acquisition and improvement through Capacity Builders
- supported work to increase the transfer of physical assets to community ownership via the Community Assets Programme.
- adopted and promoted the Compact as a code of best practice for Government engagement with the VCS – including improved practices on contracting which enable VCOs to seek finance against these contracts.
- Introduced Community Investment Tax Relief
- Acted as a market builder by commissioning research and undertaking consultations on a range of key social capital market issues e.g. Risk capital for social enterprises; the social investment wholesale bank.

Some commentators have expressed the view that the Government is too dominant in the funding of the VCS and especially in the provision of capital. One concern is that capital is being supplied attached to public policy objectives and that this damages the independence of the sector and its capacity to adapt to societies needs. A further concern, especially in the light of the current recession, is that the supply of capital from Government cannot be sustained at its current levels.

Government's promotion of loan finance has been particularly criticised both for not meeting a diverse range of capital needs appropriately, and also for damaging the existing market for loan finance for the VCS by creating a large single supplier in the Social Investment Business able to offer low cost finance.

#### THE ASSETS WITHIN THE SECTOR– THE IMPORTANCE OF GRANT-MAKING FOUNDATIONS IN ENABLING ACCESS TO CAPITAL

31% of the assets of the VCS are held by grant-making institutions, and grants made by these organisations represent 12% of VCS income (The UK Civil Society Almanac 2009).

Historically grant-making institutions have separated their investment activities from their grant-making practice; seeing investment as being about generating financial returns in order to fund grant-making. There has been substantial work undertaken in promoting the deployment of the financial capital held by grant making institutions in line with mission, for example, 'Mission Possible: Emerging opportunities for mission-connected investment, 2007'; 'Foundations and social investment', 2005. A small group of grant making institutions in the UK have pioneered both *Mission-Connected Investment* (investments made in line with charitable mission but with expectation of near commercial returns) and *Programme-Related Investment* (investments made below commercial rates into organisations who could have received grant funds but where repayment of the investment may be feasible and therefore a repayable investment is an efficient use of capital). A larger body of foundations in the USA practice *PRI* and *MCI* ([http://www.primakers.net/member\\_dir](http://www.primakers.net/member_dir)).

As already noted, grants are a highly significant source of capital for charities, especially in financing needs which are not easily met by commercial sources or more risk averse revenue funders.

However, significant historic barriers have constrained the availability of capital investment in VCOs by grant-makers including:

- A lack of clarity between the different approaches needed between capital investment and revenue funding
- Low levels of organisational capability to manage social investments including legal constraints, due diligence processes, monitoring and reporting.
- Some grant makers have a cultural discomfort with risk taking and not being able to specify the precise outputs expected from a grant.

Grant makers are adopting a range of strategies in supplying capital to VCOs. Some have continued to supply capital directly but broadened the range of financial instruments they use beyond grants – for example, the Esmée Fairbairn Finance Fund. Some grant makers have decided to treat capital investment as a specialist activity and placed funds with fund managers and intermediaries – for example, Tudor Trust has invested in funds including Charity Bank,

Venturesome and Triodos Social Entrepreneurs Fund. Co-investment is also being practiced with grant-makers collaborating to put in place a package of funding for a project.

## INDIVIDUAL GIVING AND CAPITAL

A small but growing number of wealthy philanthropists have actively engaged with the supply of capital to VCOs (Goodall and Kingston 2009). This has spanned the use of *Venture Philanthropy* approaches in some cases e.g. Impetus Trust (<http://www.impetus.org.uk/about/individual-donors>) through to social lending and social venture capital approaches e.g. Venturesome or Bridges Ventures Social Entrepreneurs Fund (<http://www.cafonline.org/default.aspx?page=15414>), (<http://www.bridgesventures.com/founding-partners>).

Large and major charities have been very successful in building regular individual giving typically as unrestricted funds. The use of these funds as revenue or as a source of capital clearly depends upon the financial model of the activities being undertaken, but this reliable flow of funds should be seen as an important, implicit source of capital.

However, little progress has been made in explicitly attracting capital funding from the mass market of individual donors (Goodall and Kingston 2009), particularly to smaller charities. This may be because of:

- Donors find requests for revenue more appealing and engaging with tangible outputs, and because a culture has grown up of not wishing to fund apparent overheads.
- Easy to understand offers and easy to access infrastructure to enable investment management is not in place.
- The case for building capacity and its connection to long term impact has not been clearly made.

## KEY ISSUES IN THE SUPPLY OF CAPITAL

The supply of capital to the VCS has increased in profile over the last ten years, but as we have seen from Figure 2 actual growth in capital has not kept pace with income, except in the form of loan finance.

There is a strong need for an on-going resilient supply of capital independent of public policy objectives. 50% of income in the VCS comes from individuals, and this constituency needs to be engaged with the need for capital more explicitly and at a much greater scale.

Whilst grants represent the major instrument used in the supply of capital, the need for capital has become broadly associated with an increase in loan finance. The sector needs a diverse range of financial instruments at work to ensure appropriate funding takes place (i.e. loans can't fund everything) but also to use the capital available to the sector as efficiently as possible i.e. where capital can be recycled through surplus generation or refinancing it should be – grants are precious and in short supply.

As the diversity of financial instruments at work has grown, the pricing of repayable capital has become an issue. Commercial rates of return on capital are seldom achievable by charitable activities, and so investors are required who are willing to trade-off financial returns and

impact. Of course the promise of near commercial returns and high impact is a 'no-brainer' – but very few charitable activities can deliver this – the VCS should exercise caution over funds which appear to promise this.

Financial institutions in the sector need to run viable businesses, and an indiscriminate supply of low-cost or free capital undermines the viability of specialist banks and community development finance institutions. The practice of appropriate funding extends to using appropriately priced finance - near commercial terms on debt for fixed asset acquisition and patient capital and grants for high risk development capital needs.

Finally, the scale of the need for greater supply cannot be ignored. Recent examples of substantial capital raising in the social sector e.g. Hackney Community Transport raising £5m (Guthrie 2010) indicate demand for large tranches of capital. There is insufficient supply of sub-commercial capital to meet this scale of need.

## ENSURING APPROPRIATE CAPITAL INVESTMENT FOR THE VCS

Having reviewed the need for capital and reflected how that translates into demand and supply, the concept of a capital market for the VCS should be explored.

A discernible social capital market has grown up in the UK over the last decade, with an ever-widening range of investors, funds, advisors and most importantly VCOs participating. The social capital market has at least three functions:

- to build the capacity of the wider social sector to achieve impact through the supply of financial capital
- to use financial capital efficiently within the social sector to build capacity, through a range of financial instruments recycling money to maximise the usage of the funds available.
- to increase access to capital for the social sector from all sources (commercial and charitable) and in many forms, not just loan finance.

A robust social capital market will exist when access to capital is no longer reported as a constraint on the delivery of impact by VCOs.

### APPROPRIATE FUNDING – MATCHING DEMAND AND SUPPLY IN THE REAL WORLD

In the illustrations earlier in the paper we have described appropriate capital funding as when

- the financial model of the activity is considered (Figure 1)
- the specific uses of capital are matched with an appropriate instrument (Figure 3)
- the stage of development of the activity is matched with an appropriate instrument (Figure 4)
- the appetite for risk and return of the investor and investee are in harmony (Figure 5).

In practice evaluating an organisation's needs for capital and making appropriate matches is not an exact science, rather a matter of judgement based upon experience. Differences in judgement of value create the conditions for a market, and a range of services is evolving to provide some infrastructure to the social capital market.

*Fund management intermediaries* have evolved to collect capital from a range of sources and invest them within specific mandates. More general approaches such as Venturesome [or one other] have been supplemented by specialist and thematic funds e.g. for social enterprise, for Community Land Trusts, for Youth.

*Advisory services* have been developed. Advisors work with those seeking capital: providing consultancy, investment readiness, and fundraising services. Advisors also work with investors developing investment strategy, identifying opportunities and undertaking *due diligence*.

*Information services* also have a role. New Philanthropy Capital's research is an example of a publicly available information service that investors can draw upon in evaluating funding opportunities.

*Transaction services* manage the mechanics of investing capital – agreeing terms, constructing legal agreements and managing co-investment packages. Distinct operators in this territory are yet to emerge

## THE AMOUNT OF CAPITAL AVAILABLE AND THE ROLE OF A WHOLESALE INVESTMENT BANK FOR THE VCS

*Wholesaling services* seek to raise large sums of capital with a specific mandate to then be allocated to particular fund managers to invest. The concept of a Social Investment Wholesale Bank for the social sector has grown out of the work of the independent Commission on Unclaimed Assets who recommended the use of funds held in dormant bank accounts to create a wholesaler. The Calvert Foundation has operated in this manner in the USA for over ten years.

## CONCLUSION - THE BURNING ISSUES FOR FURTHER ENQUIRY.

We need to develop a culture of funding in the VCS that adopts the principles of appropriate funding, differentiating between revenue and capital and considering

- the financial model of the activity i.e. to what extent can surpluses be achieved?
- the specific uses of capital by the activity and organisation
- the stage of development of the activity or organisation e.g. start up, growing fast, mature
- the appetite for risk and return of the investor and investee.

This culture will develop only if the financial literacy of the VCS is built – amongst both VCOs and funders. A substantial programme of financial literacy needs to be developed to this end.

The VCS also needs to address the culture of risk aversion and preservation of the status quo. Financial prudence is very important, especially for organisations whose beneficiaries and vulnerable and reliant upon them. However the VCS exists to achieve positive social change and organisations need to be primarily accountable for this, their impact. Alongside financial literacy, more exploration is needed around the connection between risk taking, capital and impact. This should include the approaches needed from funders to invest capital at risk to seek impact.

Data on the demand, supply and use of capital in the VCS is weak. This can be simply addressed and should be quickly to support the qualitative evidence from across the VCS of undercapitalisation. One specific problem in measuring capital flows in charities is the accounting practice of showing capital grants as unrestricted funds, mixing the money with revenue funding. The adoption of a form of accounting for grant capital outside of the income and expenditure account would aid financial literacy and boost demand for capital as well as giving better data.

Finally and most importantly a resilient supply of capital which prioritises impact over all else needs to develop, and so the role of:

- grant making institutions;
- major non-grant giving charities;
- individual donors; and
- commercial investors

in supplying capital needs consideration through this lens.

## GLOSSARY

*VCO* – voluntary or community organisation

*VCS* – voluntary and community sector

*Revenue* - the total amount of money received by the organisation for services provided during a certain time period i.e. revenue should at least cover on-going expenditure.

*Working Capital* – funding used to manage timing differences between spending money and receiving it (cashflow)

*Development Capital* – funding the costs of:

- growing existing services and projects
- developing the infrastructure of the organisation e.g. through IT
- innovation in new products, processes and services

*Mission-Connected Investment* - investments made by a grant making institution in line with charitable mission but with expectation of near commercial returns.

*Programme-Related Investment* - investments made by a grant making institution below commercial rates into organisations who could have received grant funds but where repayment of the investment may be feasible and therefore a repayable investment is an efficient use of capital.

*Full Cost Recovery* – a system of apportionment of overheads and management costs to project and service budgets to ensure VCOs apply for the full cost of delivering work rather than just the direct costs.

*Venture Philanthropy* - an approach to philanthropy which involves giving skills as well as money. It uses the principles of venture capital, with the investee organisation receiving management support, specialist expertise and financial resources. The aim is for a social, rather than financial, return.

*Unrestricted funds* – Money which may be spent by a charity on anything within its charitable objectives.

*Restricted funds* – Money which is constrained by a funder to be spent on a particular project or within a predetermined expenditure budget.

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