



Summary of financial products for the third sector

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Introduction

The purpose of this document is to provide a high level overview of the financial products that are currently being used, or developed for use, in the third sector, so that organisations operating in this arena are aware of the range of opportunities available to them, over and above traditional grant finance. It also sets out some options that are not currently available to the sector, but that could be useful if effectively adapted.

As there is already a significant amount of information available in this regard (notably in a number of publications produced by Venturesome and available on the CAF website) this document draws on the material already in existence (with appropriate cross reference) rather than re-invent the wheel.

Trustees and Executives considering the financing options available to them should bear in mind that, in many circumstances, the best opportunity for the organisation may take the form of a package of two or more financial products, tailored to meet its specific funding requirements.

Clearly, the tax and legal implications for both the investor and the organisation itself would need careful consideration before any form of financing is implemented.

Loan capital

A loan is borrowed money that has to be paid back to the lender over a fixed period, and typically with a fixed rate of interest. However, whilst the over-riding definition is simplistic, loans can take a number of forms, as outlined below.

Secured loan or a mortgage

Such loans are typically fixed period and interest bearing, and are secured against the assets of the organisation (for example, a property.) Whilst the rate of interest charged on such loans is typically lower than that charged on an unsecured loan (defined below) securing such loan finance often requires some level of due diligence by the lender, which can be costly.¹

Unsecured loan

As the name suggests, with an unsecured loan, the investor does not take security over the assets of an organisation. As a result, due to the higher level of risk borne by the investor, the interest charged on such a loan will usually be higher than that on a secured loan.

However, some organisations providing such loan capital to third sector organisations are prepared to do so on more favourable terms, as they appreciate the benefit of the social, as well as the financial, return. This sub-set of unsecured lending is often referred to as "patient capital." As well as lower interest rates, lenders of patient capital may be prepared to extend the term of the lending or to offer short term capital repayment holidays.²

¹ Venturesome 2008a, *Financing Civil Society: A Practitioners View of the UK Social Investment Market*, p12

² As above

Working capital facility

Short term cash facility available to an organisation to finance its day to day operations. Such a facility not only enables an organisation to manage short term operating liquidity but also to function whilst it may be waiting for an alternative form of long term funding.

Venturesome go further to sub-divide working capital into 'closed working capital' and 'open working capital.'

According to this definition:

- closed working capital refers to short term finance that is provided to an organisation to cover its cash flows through a period where they are waiting to receive an already committed grant.³
- open working capital refers to short term finance that is provided to an organisation to cover its cash flows in a period before it has raised all the money it requires to cover its costs.⁴

The HM Government paper 'Real Help for Communities,' published in February of this year, makes reference to the fact that third sector organisations cannot always access the finance they need. To quote direct from the publication:

"The Government welcomes this opportunity to make clear that its support for business is for all businesses regardless of their mission. This includes 'Real Help with Finance', the recent package of measures launched in January that are designed to address the cash flow, credit and investment needs of small and medium sized businesses. The Government is ensuring the package reaches out to all types of business and that the third sector benefits from this support in practice. This will be established by evaluating and monitoring the reported impact and take-up amongst social enterprises."⁵

Part of the proposed package of measures is 'The Working Capital Scheme,' which the Government states will secure £20 billion of working capital credit for companies *and the third sector*. In overview, this scheme involves the Government working with UK banks and the European Investment Bank to maintain existing lending and make funds available to small and medium firms. It is intended that business will benefit in two ways:

1. The guarantee will secure £20bn worth of working capital credit lines for companies – ensuring they are safe from reduction or withdrawal,
2. In addition, the guarantee will free up capital which the banks must use for new lending as a condition of this scheme. This is lending that would otherwise not have been provided.

³ Venturesome 2008a, Financing Civil Society: A Practitioners View of the UK Social Investment Market, p15

⁴ As above

⁵ HM Government, 2009. Real Help for Communities: Volunteers, Charities and Social Enterprises, pp24-25

Asset purchase arrangement

Under this form of financing, the organisation enters into a fixed rate hire purchase agreement in order to obtain funds to acquire capital assets such as a mini bus or a phone system. The most important feature of this sort of hire purchase arrangement is that the organisation ultimately takes ownership of the asset.

This form of financing is currently provided by Charity Bank and, in overview, is structured as follows:

- The customer chooses the equipment and supplier
- Charity Bank pays the supplier on their behalf
- The customer pays for the equipment (such as a vehicle) over a period matched to its working life
- Outright ownership passes to the customer at the end of the agreement on payment of the Option to Purchase Fee
- The asset appears on the customer's balance sheet.⁶

⁶ http://www.charitybank.org/Borrowing/About_our_Loans/What_we_offer/Asset_finance.aspx

Equity

Equity is often also referred to as share capital. An investor who has an equity stake in an organisation therefore has a stake in its ownership.

With the exception of certain preference shares⁷, there is no interest on equity and no fixed repayment periods. As such, equity investment is real "risk capital" for the investor, as they endeavour to achieve a return on their investment through:

- discretionary dividends paid from distributable profits, and / or
- capital gain on sale of the equity

The use of equity financing in the third sector is 'currently limited as the legal and ownership structures of many not for profit organisations restricts the ability to issue share capital.'⁸

However, the introduction of Community Interest Companies, that can issue share capital to raise investment, may result in equity capital being a more common place financing mechanism in the social arena.

One of the benefits of equity finance is that it can 'help to strengthen an organisations balance sheet by increasing the cushion that it can fall back on, should it be required. The increase capital base can also help an organisation when it is looking to secure additional loan finance in the future.'⁹

Key to the development of equity for social organisations is going to be the development of market liquidity such that investors can easily sell shares once they have bought them; for example, via the establishment of a Social Stock Exchange.

One of the measures put forward in the recently published HM Government paper "Real Help for Communities: Volunteers, Charities and Social Enterprises, is a £75 million 'Capital for Enterprise Fund' that will invest in small businesses which need equity and have exhausted traditional forms of finance. Social Enterprises will be able to access this fund.¹⁰

⁷ Where preference shares are shares which offer the owners priority over ordinary shareholders. Preference shareholders are often entitled to a fixed dividend (akin therefore to interest) even when ordinary shareholders do not receive a dividend

⁸ Financehub on-line reference material, 2008c. *Quasi-equity Finance*

⁹ Financehub on-line reference material, 2008a. *How Have VCO's Used Loans?*

¹⁰ HM Government, 2009. *Real Help for Communities: Volunteers, Charities and Social Enterprises*, p25

Community Bonds

With a Community Bond, the intention is to provide local, affordable finance to facilitate community based projects, whilst potentially providing a rate of return to investors.

Two specific examples help to illustrate how this is currently achieved in two different ways:

Example one:

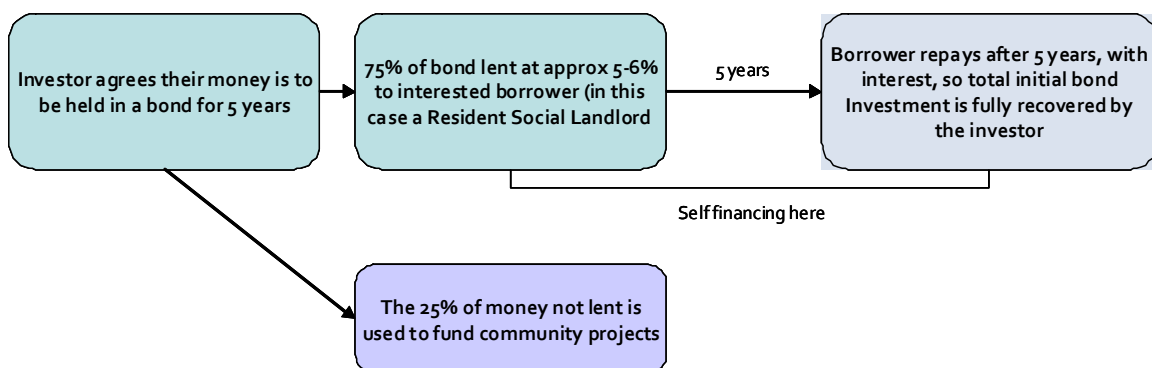
Community Bonds are currently being offered by a number of commercial banks as “standard” savings options (example here taken from Natwest). In this case, the intention is to help provide finance for local community projects around Britain, whilst the investor earns interest on their savings.¹¹

In this scenario, the investor is offered a guaranteed interest rate by the relevant bank. She then chooses how much of that interest she wants to receive personally and how much she wants to be paid to community projects: clearly, the lower the interest rate the investors choose to receive, the more money will be invested in community projects. Typically, the bank will have a number of projects which it is supporting and the investor can choose which one benefits from her “sacrificed interest.”

Example two:

Community Bonds are currently being issued by a number of other commercial organisations. Again, the intention is to provide finance for local communities. However, in this scenario, whilst the investor receives her capital back, she does not receive any interest thereon.

Take the example of the CambridgeHorizons Bond. In this case, a pot of money is collected from investors (typically individuals and businesses) who are uniting to realise a shared vision in the local community. Then, as illustrated diagrammatically below¹²:



As mentioned in the last Commission meeting, this second example has historically tended to need significant support from those already investing in the sector, thus the level of new money brought in is relatively modest.

¹¹ Taken from the Natwest online savings portal www.natwest.com

¹² Text in the diagram taken from www.cambridgehorizons.co.uk/our_challenge/funding/social-bonds

Quasi-equity finance

Quasi-equity finance is a category of debt taken on by a company that has some traits of equity.

This form of funding is potentially beneficial to third sector organisations because it provides a form of finance that is viable where:

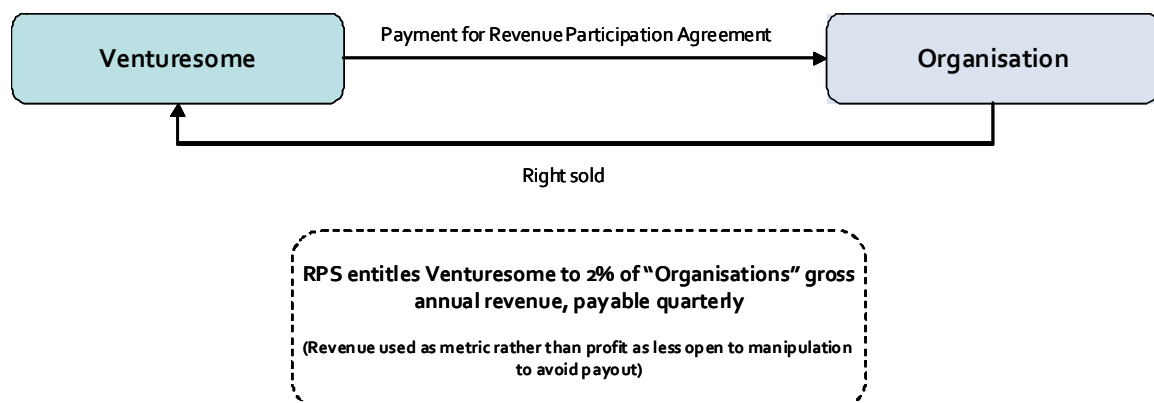
- Traditional equity finance is not an option (which, as noted in the equity section above, is typically the case for organisations in the third sector where the legal and organisational structure restricts the use of share capital), and
- Traditional loan finance is inappropriate as the ability to pay interest on loan financing is restricted in the start up phase due to financial losses.

Furthermore, an additional potential benefit of quasi-equity finance for the investee organisation is that the funding is “de-risked.” This is because the organisation makes payments to the investor based on its future revenue streams. As such, if no revenue is generated, no payments are made.¹³

Whilst conversely, the risk of such a nil return is a real *downside* of quasi-equity financial for the investor, the potential upside is also clear; if the investee organisation exceeds financial performance, the investor receives a higher return. In addition, it enables them to support organisations in a way that is more efficient than providing a grant, enabling both social impact and recycling of capital.

There are a number of variations and nuances of quasi-equity financing. However, the terms of the arrangement will typically be such that either:

- i. the investor is entitled to a specified percentage of annual revenue of the organisation over a certain, pre agreed level. If earnings are over the projected agreed levels, the investor achieves a better rate of return than it would on a traditional loan. However, if the charity does not generate the projected agreed income, it will not be required to make loan repayments.
- ii. the investor is entitled to a flat rate, agreed percentage of gross annual (audited) revenue (i.e. not just the element over an agreed hurdle.) Venturesome have used this mechanism of financing since 2007, referring to it as a Revenue Participation Agreement (RPA). The diagram below provides an overview of how this works in practice.¹⁴



¹³ Financehub on-line reference material, 2008c. *Quasi-equity Finance*

¹⁴ Venturesome 2008b, *Quasi-Equity: Case Study in Using Revenue Participation Agreements*, p6

Community Land Trusts (CLTs)¹⁵

“A Community Land Trust is a mechanism for the democratic ownership of land by the local community. Land is taken out of the market and separated from its productive use so that the impact of land appreciation is removed, therefore enabling long-term affordable and sustainable local development. The value of public investment, philanthropic gifts, charitable endowments, legacies or development gain is thus captured in perpetuity, underpinning the sustainable development of a defined locality or community. Through CLTs, local residents and businesses participate in and take responsibility for planning and delivering redevelopment schemes.

CLTs are established in communities to acquire fixed assets and then hold them in perpetuity for local use. They work on a non-profit basis, raising money from new sources and unlocking other resources, to provide and manage housing, workspace, community buildings and green spaces (including allotments).

CLTs work by enabling occupiers to pay for the use of buildings and services at prices they can afford, while the value of land, subsidies, planning gain and other equity benefits are permanently locked in, on behalf of them and future occupiers, by the Community Land Trust.

CLTs are not a wholly new kind of organisation - in spirit they are similar to some development trusts or almshouses and smaller housing associations. What they offer is a vehicle for the delivery of community aspirations. They are expressions of community engagement - and they also offer a new set of legal, financial and resource management tools that are relevant to a wide range of existing as well as new organisations.”

CLTs, while not available as a financial instrument to the broader social sector, are included here as an interesting financial innovation aimed at enabling social impact. The model for financing CLTs at scale is still to emerge.

¹⁵ Where the full text in this section is taken from the Community Land Trust website: www.communitylandtrust.org.uk

Social Impact Bond “SIB” (Social Finance product, in development)

An outcomes-led contingent financing mechanism that aligns government and non-government stakeholders to common social outcomes and can be applied to address a broad range of social issues.

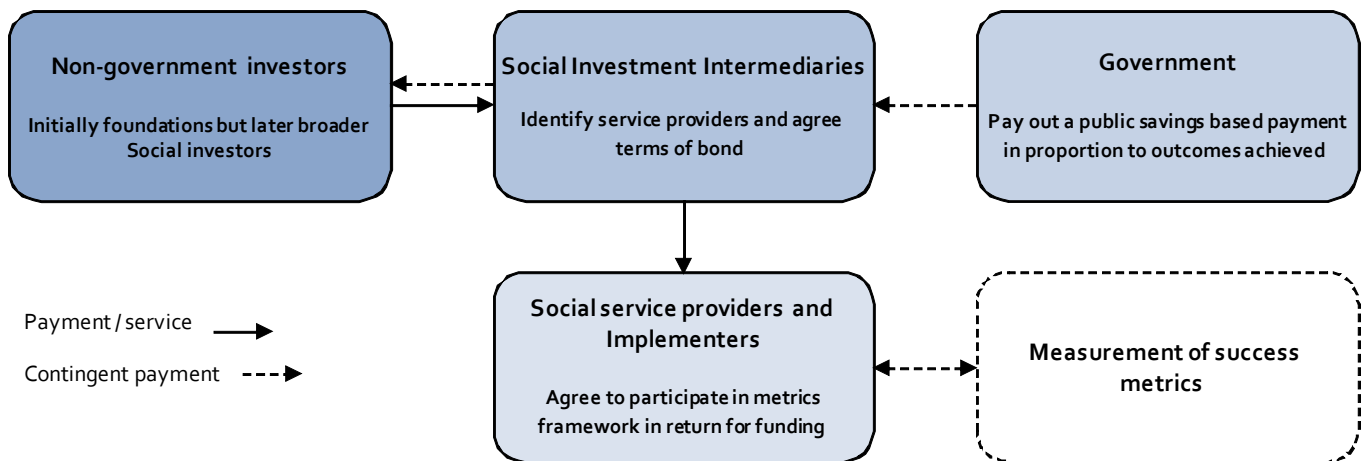
The Social Impact Bond (SIB) is an outcomes-based revenue stream that is negotiated with government, against which capital can be raised from foundations and other social investors to pay for services that target the agreed social outcomes.

The mechanism is designed to enable non-government social investment to take place now on the basis that government will pay when social outcomes that are achieved in the future. This should facilitate:

- Increased funding for prevention and early intervention around entrenched social problems by transferring both risk and the upfront capital requirement to non-government investors;
- Cost savings for Government;
- Provision of upfront preventative intervention finance to service providers, rather than payment in arrears for outcomes that are achieved;
- Increased sustainability and responsiveness of third sector service providers through a rational revenue and investment framework

The SIB structure could be used to address a wide range of social issues in the fields of health, young offending and employment. Following successful pilots, the structure could be applied at national scale.

Simplified SIB structure



Deep discounted bond

A deep discounted bond is a bond bought at a price lower than face value, with face value repaid at the time of maturity.

The benefit of this type of bond financing for an organisation operating in the third sector would be around cash flow management as, whilst the discount would be accrued for in the financial accounts, the organisation is not required to pay cash out of the business at regular intervals (as it would have to do with a traditional interest bearing instrument.) Instead, cash would leave the organisation as a lump sum at maturity.

For the investor, the return achieved is the difference between the bond price at issue and the face value at maturity.

This product has not thus far been used in the social arena.

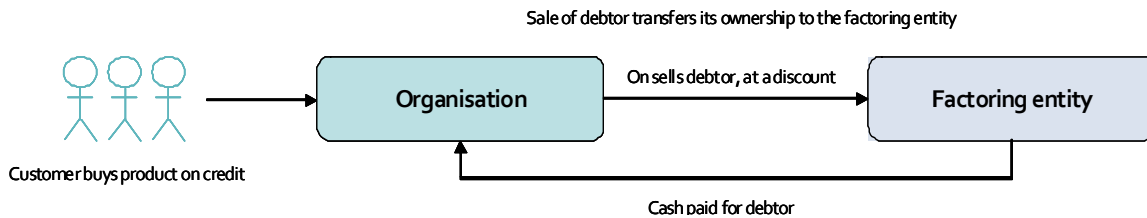
Factoring and Invoice Discounting

In overview, factoring and invoice discounting provide a prepayment against an organisations sales ledger, thereby increasing its working capital and cash-flow.

The main difference between the two forms of transaction is that factoring involves the sale of receivables whereas invoice discounting is borrowing where the receivable is used as collateral¹⁶.

Factoring

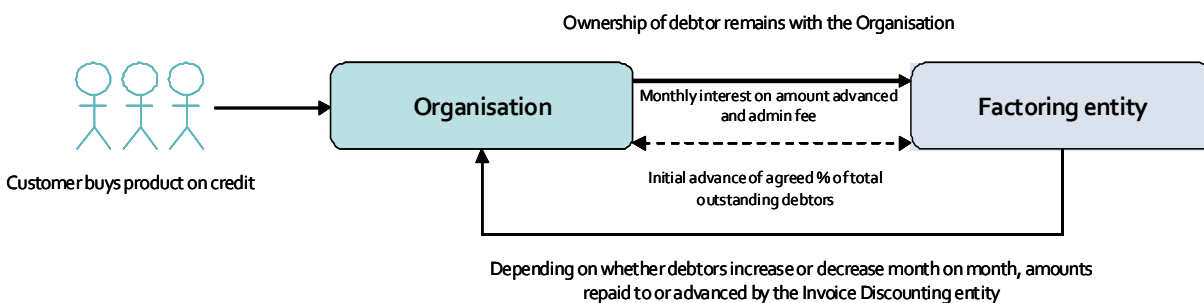
Factoring involves the sale by an organisation of its debtors. The sale is undertaken at a discount, as illustrated in the diagram below¹⁷.



The cost of this additional liquidity for the organisation is the discount applied to the on sale of the debtor (and potentially an administration fee / set up costs.)

Invoice Discounting

Invoice Discounting involves an initial advance by the invoice discounting entity equal to an agreed percentage of the organisations outstanding debtors. The process is outlined diagrammatically below.¹⁸



Application in the third sector

Clearly, in their “traditional” form, factoring and discounting could be of limited application in the third sector in that they would only be available to social enterprises (including trading subsidiaries of charities) with a significant turnover (typically over £500,000) derived from the sale of goods and services.

¹⁶ Definition drawn from <http://en.wikipedia.org/wikw/Factoring>

¹⁷ Diagram derived from information drawn from <http://en.wikipedia.org/wikw/Factoring>

¹⁸ Diagram derived from information drawn from <http://businesslink.gov.uk>

However, there may be scope for a social investment intermediary to offer variations of the existing model so that, for example, an organisation could raise immediate finance on the back of future income from government contracts, thereby improving its cash flow position.

These products have been discussed for the social sector but have not thus far been made available at any scale.

Summary – financial product spectrum

The table below provides a summary of the risk profile of each of the financial products outlined in this paper. Column 3 outlines the indicative level of risk for the finance provider whereas column 5 outlines the indicative level of risk for the borrowing entity.

It is noted that this diagram was developed by Venturesome¹⁹ and not Social Finance, and has been adapted to include the products not included in the original Venturesome template.

Example of suppliers	Financial product	Financial risk to supplier	Spectrum	Repayment risk to organisation (government in case of SIB)
Caring Foundation Esmée Fairbairn CAN Permira Breakthrough	Grant	Complete – no repayment	↑ ↓	None – no repayment
Social Finance product in development	Social Impact Bond	Very high (potential reward also very high)		Government: low (as linked to success)
Triodos Opportunities Fund Venturesome	Equity	Very high (potential reward also very high)		Low (as linked to success)
Venturesome	Quasi – equity	Very high		Low (as linked to success)
Adventure Capital Fund Future Builders England Big invest Venturesome	Patient capital	High – but repayment expected		Low/medium
Local application	Community Bonds (excluding savings with commercial bank)	Medium – high: but repayment expected		Medium (typically 5 year repayment)
Not yet in known application	Deep discounted bond	Medium – repayment expected		Medium (typically 1 – 5 year repayment)
Barclays Bank Charity Bank Triodos Bank Unity Trust	Unsecured loan	Medium		Medium (1 – 5 year repayment)
Not yet applied at scale	Factoring and invoice discounting	Generally low		High
As above	Working capital facility	Generally low – short term cash flow cover		High – short term funding
Charity Bank	Asset purchase arrangement	Low – asset backed		High
Barclays Bank Charity Bank Triodos Bank Unity Trust	Overdraft/standby facility	Low – short term cash flow cover		High
As above	Secured loan/mortgage	Low – asset/backed		High

¹⁹ Venturesome, 2008a. Financing Civil Society: A Practitioners View of the UK Social Investment Market, p23

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