Committee:	Date:
Social Investment Board	18th September 2013
Subject: High-Risk, High-Impact Investments	**Public**
Report of: Chief Grants Officer	**For Decision**

Summary

This paper discusses the positive contribution that finance for early stage social enterprise activity could bring to the social investment market. Such finance has the potential to achieve a high social impact and to build the market, but it is high risk as (on a per deal basis) investors have little evidence of track record on which to base their decision, and as new ventures there is greater likelihood that capital will be lost.

The paper proposes that you ring-fence a small percentage of your Fund (1.25% - 2.5%) for high-risk, high-impact investments. It notes that this could be done without negative impact on your target return.

Recommendation:

That you agree to consider high-risk, high-impact investment proposals.

That you ring-fence between £250,000 - £500,000 of your Fund in order to support this work.

That you ask officers to prepare a paper for your next meeting outlining dispersal and assessment criteria and for high-risk, high-impact investments.

Main Report

Introduction

1. The Corporation is working to establish London as a global hub for social investment, and the creation of your Fund is a central part of achieving this strategy.

2. One of the aims of your Fund is to develop the social investment market, and at your meeting on 20th June 2013 you asked officers to prepare a paper on options for using capital for earlier stage, potentially high-risk, high-impact investments that may not be secured by assets.

3. On 14th February 2013 you met social investors from the Esmée Fairbairn Foundation and your advisors at Social Finance Limited to discuss the state of the social investment market. This meeting highlighted that the majority of social investment issued so far has been in the form of secured loans. You, like the majority

of other social investors, prefer to back organisations that can provide evidence of reliable revenue streams and a track record of high performance.

Market Need

4. Research by the Big Lottery Fund and Big Society Capital, however, indicates a growing mismatch between what social investors currently offer and the investment needs of social purpose organisations. *“Investment Readiness in the UK”* (July 2012), for example, found that the majority of organisations seeking finance were looking for longer-term investment of less than £100,000. *“The First Billion”* by Boston Consulting Group (September 2012) found that the majority of demand for social investment over the next five years was likely to be for unsecured forms of finance.

5. Whilst the market has grown, the majority of social investment on offer to organisations is in the form of secured lending. Research which the City of London co-commissioned in July 2013 (*Growing the Social Investment Market: the landscape and economic impact*) found that whilst secured loans had grown as a proportion of total market value from 84% in 2010/11 to 90% in 2011/12, unsecured lending had fallen from 11% of total market value to 5% over the same period.

6. The current funding environment makes it particularly hard for start-up social enterprises or even established social purpose organisations starting new ventures, to raise the investment capital they require. There are three reasons why there is a gap between the capital sought from social purpose organisations, and the capital offered by social investors.

7. First, social purpose organisations are not generally well endowed with assets on which to secure asset backed lending (the notable exceptions being those which hold property). This usually makes the investment riskier, with the potential for capital loss.

8. Second, many of the activities that social purpose organisations deliver are innovative, and there is often a gap in the available data to help investors determine whether the enterprise is likely to achieve its aims. Whether the work is concerned with reducing re-offending rates, improving the quality of family support offered to parents of disabled children, providing loans to small businesses in emerging economies, or offering supported accommodation to adults with learning disabilities, social purpose organisations are usually trying to do something new for which there is little track record.

9. Third, social investors cannot necessarily seek high returns on successful investments to cover the write-offs of unsuccessful investments. Many social purpose organisations are established with some form of asset lock that, whilst ensuring the continuation of their social focus, also places a ceiling on the returns they can offer to their investors.

10. The combined effect of these challenges is to create a funding gap between the investment that is offered, and the investment that is needed. Without other investors and grant-makers making such funding available it is unlikely that your existing investees would have been able to bring their proposals to you. Golden Lane Housing, for example, was able to develop the track record for its 2013 4% bond by piloting a housing bond programme in 2003. Similarly, the investment proposal from Midlands Together available today as a result of pioneering work done in 2011 in Bristol which the Esmée Fairbairn Foundation backed despite the investee's lack of track record.

11. A growing number of programmes and awards are helping to identify social purpose organisations with the potential to develop their business models to significant scale (see annex). However, these initiatives are only useful if there is a realistic opportunity that the participants can then secure investment. As noted above, currently, the number of investors offering high risk social financing for non-asset backed early stage lending is limited to a small number of trusts and foundations, high net worth individuals, and (social) business angel investors.

Ring-fencing capital for High-Risk High-Impact Investments

12. Officers believe there is potential for you to help meet the social investment financing gap by providing some support to organisations that are currently unable to attract mainstream finance but which, nonetheless, have high potential to grow and generate significant social impact.

13. Procedurally, the most straightforward way to do this would be to ring-fence a small proportion of capital (£250,000 - £500,000) within your existing £20m City of London Corporation Social Investment Fund.

14. If you were to ring-fence existing funds, consideration would be needed for the potential impact on your target total return which, at your meeting on 23rd April 2013, you set at 2.7% on investments placed (to be reviewed on 25 October 2015). It is worth noting that currently, assuming no bad debt or write-offs, investments placed to date exceed this target:

Investee organisation	Expected IRR	Investment size	Return over 3 years*	Total expected value of Investment
Golden Lane	4% p.a.	£500,000	£62,432.	£562,432
Real Lettings	4% p.a.	£500,000	£62,432	£562,432
Oxfam SEIIF	5% p.a.	£318,513	£50,206	£368,719
Total investments to date		£1,318,513	£175,069	£1,493,583
Target equivalent	2.7%	£1,318,513	£35,600	£1,354,113
Difference between current portfolio return and target return				£139,469

in the case of Real Lettings and Oxfam SEIIF these are nominal rather than actual returns, as only Golden Lane will pay interest each year, and full repayment to the investor is realised in terms longer than 3 years. These indicative returns make no provision for bad debt or write-offs.

15. The difference between the expected returns on the portfolio from existing investments compared with the target return identifies some scope to make higher risk investment and Chamberlain has confirmed that returns are available to the Fund for reinvestment.

Disbursement options for high-risk, high-impact capital

16. If you were to ring-fence capital for high-risk, potentially high-impact investments, then your disbursement options could include:

Disbursement option	Advantages	Disadvantages
Make investments according to the pipeline of acceptable propositions	Straightforward and meets investees' immediate needs for capital	There would be potential to use up the total allocation very quickly and have little to offer in later years, when proposals might be more robust. If the allocation was invested rapidly then higher risk investments could be the highest proportion of investments placed, thus raising the return needed on larger, less risky, social investment proposals.
Establish an annual ceiling	Spreads the capital and prevents fast usage of the total sum	May limit the extent to which this capital can catalyse the social investment market.
Stipulate a ceiling of high risk investments as a proportion of the overall portfolio of investments – (e.g. total high risk investment must be under 10% of all of the Fund's investments held at any one time)	Mitigates some risk to the portfolio return	May limit the extent to which capital can catalyse the social investment market and could cause perverse incentives to make other investments.

17. You could set additional criteria to guide investment such as:

- setting a maximum sum per investee (e.g. £50,000 maximum) in order to spread funding more broadly and encourage others to co-finance the proposal;
- providing no more than a certain percentage of the total investment sought (e.g. 25% - 50%);
- expectations are set with each investee regarding business-development support;
- only providing finance where match funding is already committed; and
- providing investment in staged tranches on evidence of specified milestones to help ensure that the entire capital sum is not at risk from the point of investment.

Criteria would be worked up more fully by officers depending on your preference for investment in high-risk, potentially high-impact enterprises.

Conclusions

18. Social investment capital can play a critical role in developing the market by supporting high risk, potentially high impact enterprises. You have discussed the possibility of providing such catalytic capital at previous meetings, and it appears that the market will struggle to grow without more investors offering unsecured, high-risk finance.

19. The Corporation is working to establish London as a global hub for social investment, and one of the aims of your Fund is to develop the social investment market. Allocating capital for early stage investments would be in line with these goals and would likely results in very positive publicity for the Corporation.

20. Based on the indicative returns of investments placed to date and the comparison of these to your current target returns it appears possible to allocate a small percentage of your Fund for a high risk potentially high impact allocation. However, should you choose to do so, it is advisable that this remains in balance with active investments, and that any allocation takes account of provision for bad debt and write-offs from these investments.

Recommendations:

That you:

a) note the contents of the report,

b) agree that your Fund will make high-risk, high-impact investments

c) ring-fence between £250,000 and £500,000 of your Fund for high-risk, potentially high-impact investments

d) ask officers to prepare a paper with detailed disbursement and investment criteria for your next meeting.

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Annex: sources of investment opportunities in high-risk, high-impact social purpose organisations

The following sources could provide a pipeline of potential investment opportunities, where prospective investees have already been screened and received some form of business development support:

- Organisations receiving support from the Cabinet Office's Investment and Contract Readiness Fund and/or Big Lottery Fund's Big Potential Programme
- Social purpose organisations participating in the RBS Inspiring Enterprise programme
- Incubator programmes supporting selected high potential organisations such as the. DeLoitte Social Pioneers programme and the Young Foundation Accelerator
- Business development hubs attached to universities including UCL, London School of Economics, University of Oxford, and the University of Northampton
- Competitions and award schemes to identify high potential, high impact social enterprises such as the Big Venture Challenge, Nexters, and the European Social Innovation award (especially where winners are awarded grant-funding or match finance)