Social Enterprise ASSOCIATES

Emerging Topics Paper Series

Working Paper #16

Capital Sources for Social Enterprises

March, 2012

Drew Tulchin

Sunny Yi-Han Lin

Social Enterprise Associates

www.socialenterprise.net

info@socialenterprise.net

Financial Performance Social Impact Environmental Sustainability

This page blank for double sided printing purposes.

EXECUTIVE SUMMARY

Many entrepreneurs - social, triple bottom line or otherwise - do not avail themselves of all potential capital sources when seeking funding to grow or scale, limiting prospects to cash flow their initiatives. This paper explores a range of options for funding: external in the marketplace, internal within an organization, new ideas and classics not to overlook.

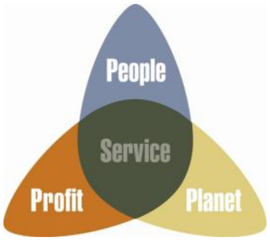
Entrepreneurs have too much to do and limited time in which to do it. Making good choices based upon understanding priorities and trade-offs is valuable in order to pursue best matched capital sources. For example, bank relationships take time to build and the money can seem expensive at first, especially for start-ups, but might be a best choice over the long term. Socially responsible investors / Impact investors may have closer mission alignment and more attractive rates, but might be difficult to access, require extensive documentation, which carries a cost, as well.

Organizations often overlook sources of capital, within their own finances. Controlling expenses, increasing cash turnover, and leveraging the balance sheet improve cash flow. "Crowd funding"[1] has emerged as an exciting tool to access funds through the Internet.

To develop and secure the money needed to grow a social venture, social entrepreneurs must understand what financiers' value, establish long-term networks, build their credit history over time, formally register the enterprise, and have contingency back-up plans.

Looking into the future, there are financial tools that are becoming available to support social enterprises and community betterment. These include community guarantees, cross collateralization, and social investment bonds, among other tools.

This paper was written by Drew Tulchin & Sunny Yi-Han Lin of Social Enterprise Associates (www.socialenterprise.net) with support from Malgorzata Wojcik and input from Bart W. Édes, Asian Development Bank (ADB). Social Enterprise Associates is a boutique consulting firm and registered "B Corporation". It specializes in helping non-profits, for-profits, donors, and foundations with new ventures, capital needs & earned income strategies to achieve 'triple bottom line' results. Reach us at info@socialenterprise.net.



[1] Crowd funding describes the collective cooperation, attention and trust by people who network and pool their money and other resources together, usually via the Internet, to support efforts initiated by other people or organizations.

INTRODUCTION

Entrepreneurs have to fight and pinch for every dollar, peso, rupee or other currency to make their effort successful. Many entrepreneurs - social, triple bottom line or otherwise - do not avail themselves of all potential capital sources when seeking funding to grow or scale, limiting prospects to cash flow their initiatives. "Existing social enterprises and entrepreneurs who want to step into this field surmount many new challenges, including lack of funding, weak capacity, lack of government support and lack of networks."[2]

This paper explores a range of options for capital - external in the marketplace, internal to the organization, new emerging ideas and how to organize decision-making. Please note: mention of any institution or product is not an endorsement or recommendation. One should always do their own research and due diligence before making any decision.

I. EXTERNAL OPTIONS

Capital comes in many forms and has numerous sources for social enterprises. As a "do good" entrepreneur, the social and environmental value creation of efforts is a competitive advantage, setting apart from others in the marketplace. In addition to traditional financing outlets, options include socially-driven investors, donors and - in some cases - philanthropy.

1. Conventional Finance

Many social entrepreneurs feel they cannot qualify for conventional financing, don't understand how to apply for it, or distrust the institutions that offer it. "The capital markets", aka "Wall Street", may seem out of reach for small, new social enterprises. However, as the largest source from which to draw, it presents the greatest opportunity. If this is a new world with unfamiliar terms and references, don't be frightened. Investopedia is a premiere resource among many others for education, personal finance, market analysis and free trading simulators.

Sources some social enterprises overlook:

- Equity: Can you sell part of the business? Even a non-profit or public entity has 'ownership', 'sold' through imaginative structures, donations or joint ventures with private firms.
- Friends / family / fools: If you believe in your endeavor, can you ask those you know to support it, too? If you pursue this route, as many small or start-up SEs in the U.S. do, be sure to document any relationship formally and ensure that expectations are matched before agreements are made. Online sources, like SE Toolbelt, provide examples, although they may be limited to U.S. or Europe registrations.
- Banks and credit unions: Formal institutions will not provide volumes of affordable capital right away. These are relationships to build trust, education and a track record. Manage expectations and approach a long term investment; it may be expensive at the beginning.

[2] Pred Evans & Sumalee Amnuaiporn, "Social Entrepreneurship in Southeast Asia," Trendnovation Southeast Newsletter, 9th issue.

- Credit cards: In the U.S., almost anyone can get a credit card. Benefits include 30 days to pay, points, perhaps a low initial rate, and building credit history. But, be careful, as interest rates are often high, may have additional costs and can be an expensive failure.

Institutions with mission alignment and better understanding of social enterprises include:

- Microfinance Institutions (MFIs): Often serve lower-income clients who lack access to financial services. NGOs and Social enterprises count to some. Internationally: find entities via Mix Market; in the U.S., look up community development financial institutions (CDFIs) via OFN, AEO, and the CDFI Fund.
- Community Banks: Typically have a local focus in their region with few branches and limited size. They are regulated by a different overseer. Historically, they know the community in which they lend. Loan paperwork is not sent off to "some mountain." Local personnel make decisions. The list of community development banks on Wikipedia is a good reference.
- Sustainable Banks: Also known as ethical or civic banks. This may seem a contradiction to some. Their numbers are growing in the U.S. New Resource Bank based in San Francisco is a commercial bank that focuses on businesses that share their mission to progress sustainability within their community. Permaculture Credit Union operates nation-wide supporting customers seeking to do green things (Note: Author serves on the board).

2. Social Investors

Investors interested in social, environmental and community efforts are increasingly prevalent. Socially Responsible Investing (SRI), as well as "patient capital", "impact investing" or "slow money," are not new concepts, just new terms. They consider financial return with other value creation. SRI in the formal markets uses screens to avoid certain "bads" – companies selling weapons, alcohol, tobacco, gambling, or nuclear energy – and encourages investment for positive change, environmental stewardship, consumer protection, human rights, and/or fair trade.

Community investing is the subset of SRI best fit for social enterprise. In the U.S., it is a $7 billion annual market. The number of institutions offering debt and the amount of capital is much higher than for equity. Debt providers may balance below market return expectations and modest borrowing obligations in exchange for social / environmental value creation. Underwriting criteria are still formal, but may be more lenient than conventional financing. Equity typically must be able to generate significant increases in value, which is harder for new SEs. Currency risk should be considered in any international investment.

Example institutions with international approaches include Grassroots Business Fund, Root Capital, Bamboo Finance, Oikocredit, and Calvert Foundation. Lists are available at Aspen Network of Development Entrepreneurs (ANDE) and Cause Capitalism. There are 100s of U.S. investors, listings at SocialFunds.com and Forum for Sustainable & Responsible Investing.

Case Study – RSF Social Finance
rsfsocialfinance.org

RSF Social Finance (RSF) is a pioneering non-profit financial services organization dedicated to transforming the way the world works with money. In partnership with a community of investors and donors, RSF provides capital to non-profit and for-profit social enterprises addressing key issues in the areas of Food & Agriculture, Education & the Arts, and Ecological Stewardship.

For over 25 years, RSF has been expanding the definition of social finance by providing loans, gifts, and investments that foster social and spiritual renewal. RSF manages a variety of investment, lending and giving funds.

Since 1984, RSF has lent more than $230 million and granted over $100 million, placing it among the largest social finance organizations worldwide. Its risk management maintains extremely few defaults and high quality leverage ratio.

3. Philanthropic Grants

Grants are typically approached as a gift from a foundation or wealthy individual. In the U.S. and the U.K., there are tax benefits to providing money to legally registered NGOs. The IRS tax designation is 501c3. For-profits with strong mission focus may quality, such as if in rural areas, minority/women owned, or technology for the bottom of the pyramid. In general, grants are not for businesses. Some foundations are becoming more actively engaged on social enterprise issues, like Gates, Rockefeller, Skoll, and Omidyar. Philanthropy can be done without tax motivation; religious institutions have benefited from rich and poor. Natural disasters have motivated giving around the world, made even easier with cell phones providing small amounts.

It is not recommended as a central focus for social enterprises. It is a small and competitive source, which scales for few entities. If grants can be secured, especially for one time start-up or as an offshoot to a larger capital strategy, that is great and helpful. Institutions that focus their financial strategy only on philanthropy will likely always be raising money, and slower growth.

Business social responsibility is becoming more prevalent; corporations increasingly see their interests tied to community and environmental well being. This is an opportunity to build win-win partnerships between the private and public sectors. Social Enterprise is a natural bridge. Corporations financing start-up of sustainable ventures leads to greater good than just writing checks to grant-seeking NGOs.

Success in this arena often hinges on relationships. Having access to wealthy or well connected people and institutions is beneficial. Corporations may be a channel, providing professional volunteers or other in-kind support, even if not cash. Appropriate approaches, presentation, particularly specifying impact and value creation, and networking help here.

4. Government and Donor Capital

The public sector is another source of funding for SEs. It has been a consistent resource for decades, with international funding in the US billions and domestic financing arguably higher.[3] One potential source of funding is government contracts. It often requires extensive competitive application and long lead times. This option is often financially cheap but far from free, as there are obligations like information tracking which takes staff time, relationship requirements and perhaps the institution's perception in the marketplace.

Many NGOs are familiar with this format. For those that are not, it may be easiest to start here by partnering with organizations that are more experienced at this. Or, getting to know local donors or government personnel to learn what their organizations want.

[3] Source: Wikipedia, en.wikipedia.org/wiki/Development_aid.

II. INTERNAL OPTIONS

An entrepreneur should consider capital s/he may already have access to cash within the organization. Controlling expenses, improving cash turnover (the rate between when bills are paid and income is received) and leveraging the balance sheet all improve cash flow. Below are financial principles to implement.

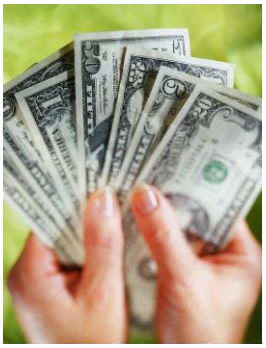
1. Get Paid As Soon As Possible – A/R

Accounts receivable (A/R) is money due from clients / customers. The faster what is owed is paid, the better. Ensure customers understand financial expectations: use invoices and state terms. Late pays risk becoming losses. Consider providing incentives to motivate the behavior you want to see – cash paid!

- "Cash on delivery" (COD) is payment at time of delivery of good or service
- Pre-sell. Collect money in advance, whole or in-part, perhaps for a discount as incentive
- Offer discounts for paying quickly. 2%/15 means two percent off if paid within fifteen days
- If payments are made over time, it is reasonable to charge interest, say 2-3% per month

A/R is an asset – if documented, like in a contract or purchase order, it can be collateral for financing. In the U.S., this is called factoring. An enterprise 'sells' a third party its invoices or contracts in exchange for money today. Often, this is done at a discount based on risk and time to collect payment. Factoring increases working capital and cash flow, but comes at a cost. It can be expensive, reducing benefits; know the annual percent rate (APR). Negotiate with the vendor, shop around, get things in writing and carefully review legal documents.

2. Delay Making Payments – A/P



Accounts payable (A/P) is money owned to vendors, government or other obligation. Tactics here are the inverse of the section above – delay spending money as late as possible to keep cash. Is it possible to wait to pay a supplier? Even waiting until the end of the month is some time; 30 days is standard. Perhaps a vendor would wait on partial payment as a mission support to the NGO. Would they finance their receivable and charge you a reasonable interest rate? More imaginatively, could you enter a joint venture or shared risk so they provide their supplies and get paid when the product sells? It is reasonable to give them a bonus or 'greater upside' for this. Would it be possible for them to invest in your organization?

Barter or trading goods and services for non-cash is another option, an older form of "sales." It is best when one party wants what the other has to offer. If a ready solution is not clear, ask. Options might present themselves when explored.

The time period between when an organization pays its bills and when it collects payment is cash turnover. The shorter this time is, the better for cash flow.

3. Leverage Existing Assets

Organizations with capital should make sure they manage it well. Money earns money. Treasury management addresses risk and cash flow: cash needed and timing between that owed and earned. A dollar not spent is a dollar saved. For example, can you get paid electronically faster than getting a paper check? If you do receive a large amount of cash at one time, can you earn interest on it (even if just a little bit in today's economy)?

All assets on the balance sheet require financial management: cash, real estate, investments, etc. Risk is an important consideration for institutions to preserve assets. What insurance protects against calamities? How does the organization guard for natural disasters, theft, etc.

Even if the amounts generated are small or they come and go, treasury management on cash helps maximize liquidity and preserve value.

III. CROWD FUNDING

There are interesting new channels to access capital, including through the Internet. And, they are legal. They are built upon old ideas to foster community, making things affordable for everyone and building trust. 'Crowd funding' is one, imagine an eBay or online auction for debt.

Crowd funding describes collective cooperation, attention and trust by people who network and pool money and other resources, usually via the Internet, to support efforts initiated by other people or organizations. It has taken off with many sites offering similar services. Kickstarter focuses on projects, mostly for artists. Indiegogo is quite large and works with a wider range of efforts. Some specialize in nonprofits. Caveat Emptor, buyer beware, but an interesting tool, mostly for smaller quantities of money (< $10,000).

There are a number of other online capital avenues. Prosper is America's largest peer-to-peer lending marketplace, of which there are now a half dozen. Vittana: This entity offer educational loans to foster the next generation in select developing countries. These models shows how trust and simple ideas, spurred by technology, make a difference. The power of the internet makes capital available affordably to benefit individuals, businesses, and entire communities.

Case Study – IndieGoGo
www.indiegogo.com

IndieGoGo, founded in 2008, is a crowd funding platform raising money online for projects and causes. The site is available to anyone to start a campaign –entrepreneurs, artists or individuals raising money, anywhere in the world.

To raise funds, users apply to have their project posted online. They set a target amount to be raised and specify campaign type (i.e. fixed or flexible) and a deadline. They are responsible for their own promotion and marketing.

On the other side, people browse projects and donate money to opportunities they find interesting – in exchange, are offered awards specified by the project initiator: products, gifts, recognition, and/or experiences. U.S. tax deductions are possible for qualifying efforts, via nonprofit status or fiscal agency. Donations are made through PayPal or by credit card (3% fee).

Fees to the entrepreneur vary: for those achieving the fundraising goal, it is 4%. The fee is 9% to fund below the goal or if no target is selected. To date, more than $1.5 million has been raised for 65,000 + projects in 211 countries.

IV. HOW TO CHOOSE APPROPRIATE SOURCES FOR CAPITAL

1. Overall Capital Strategies

To develop and secure capital, an anticipatory, pro-active plan is suggested. A few strategy considerations include:

- Understand what financiers' value and how they make decisions: Consider the other person with whom you negotiate - your counterparty. What is important to that individual and how do they make decisions? What bankers see in a start-up social enterprise is different than what an entrepreneur communicates. Many entrepreneurs explain their world well in their language. Consider bankers' language like "value proposition," "return on investment", and "debt service coverage".
- Establish long-term networks: Supportive community builds social enterprise. Networks of potential value include Social Enterprise Alliance (SEA), B Corp (Note: author is one), and Small Business Development Centers (SBDCs). Net Impact has chapters worldwide. Think long-term by starting small and immediate. Who can you access to bring into your circle?
- Build credit history and credit score over time: Establishing credit is part of how investors like banks assess borrowers. Entrepreneurs are encouraged to set up commercial accounts early on with formal institutions so the entity becomes known financially. And, protecting ones personal credit is important, as that is a measure for analysis.
- Formalize and report the enterprise: Cutting corners keep social entrepreneurs in the informal economy. Compute enterprise value, even if you have to pay taxes. Financial professionals need to document how loans get repaid. An existing track record is the strongest evidence. In a loan package, make it easy to understand how the enterprise repays debt, the collateral available and other financial assurances.
- Equip the enterprise: There are common prerequisites for most funders – experienced management, transparent board governance, solid accounting, internal systems, independent auditing, written business plan, etc. These are known and expected by all. Enable success by starting early and being disciplined.
- Have back-up plans: Always have alternatives and contingencies if at first you don't succeed. Developing multiple sources for capital distributes risk.

2. Comparison to Pursue Capital Sources

Entrepreneurs have limited time. There are many options to raise capital; it is valuable to identify appropriate sources by personal preferences, enterprise qualities, access, and situation. Here are different criteria to consider for focus, among others. Your situation might include additional factors or reduce importance of those here. A comparison scoring example includes:

Financial Options	Timeliness	Amount	Stability	Mission	Distance
Conventional Financing	OK	Good	OK	Poor	Good
Social Investment	Poor	OK	Good	Good	OK-Varies
Gov't Contracts	Poor	OK	Poor	Good	OK
Crowd Funding	Good	Poor	OK	Good	n/a
Internal Resources	Good	OK	Good	n/a	Good

SCALE: Poor = smaller / worse, Ok = medium, Good = higher / best

Factors Defined:

- Timeliness: Level of effort needed to obtain the cash
- Amount: Funding levels likely from that source
- Stability: Availability of capital over time
- Mission: How motivated the option is by an enterprise's purpose
- Distance: How far the option is to the U.S.

Capital options have trade-offs, making comparisons dependent on entrepreneurs' needs:

- Bank are near entrepreneurs and plentiful, but indifferent to missions
- Social investors are often far away geographically, but share values
- Donor contracts could bring in decent money, but might be unsustainable
- Crowd funding is cost-effective, but needs promotion and often small amounts
- Internal options usually offer results quickly; sums may be small

V. LEVERAGE NEW FINANCIAL MECHANISMS

Financing is a tool to be used. "Wall Street" has liquidity-money-it is a question of understanding how decisions are made to best approach. Ignoring these typically results in slower growth.

Some financial tools emerging as available for sustainable community efforts:

- Cross collateralization: Financial terms securitization and secondary market are tarnished, but there are financial tools that separate risk pricing and structure investments. One potential is pooled capital, as with bonds. The idea is people vouch for each other and put up support, like a guarantee. This is how Mohammad Yunus' Grameen Bank began, with five ladies covering for each other. Imagine 1,000 people, all part of the same loan financing.
- Social investment bond: This idea is gaining traction in the U.K. to avoid high social costs later, through investment today. Imagine a community in which 100 people suffer drunk-driving accidents each year with each incidence costing $100,000 in insurance, property, legal, hospital, etc. (Let's hope little loss of life). The aggregate cost is $10,000,000 every year. This is actual money. Wouldn't implementing programs developed today that reduced the number and expense make sense? A community could invest in alternatives: more police, awareness of the problem, alcohol abuse prevention programs, etc. financed through future savings of reduced DWIs.
- Community assets: What if a remote community in a rainforest used its surroundings as collateral? If it protects and maintains the health of the environment, the value of the asset increases. If it cuts down all the trees or sells all the turtle eggs, value decreases. Advanced Conservation Strategies is putting forth 'Environmental Collateral' to match positive, sustainable development with resource stewardship. Similar efforts are in the U.S., as well.

CONCLUSION

Securing financing is a regular hurdle for entrepreneurs, but a crucial step to grow good causes. There are options to the financing conundrum that you need to have money to make money. Solutions do exist. Accessing them requires structure, planning and building towards the future. Working to foster the community we want to see is not easy. Together we can make progress.