Social investment: an overview of the landscape for VCSEs in the youth sector

Produced by Social Enterprise UK for the Catalyst consortium

The Catalyst consortium

About this programme

Catalyst is co-ordinated by the National Council for Voluntary Youth Services (NCVYS) and is a consortium of four organisations working with the Department for Education (DfE) as the strategic partner for young people, as part of the Department's wider transition programme for the sector. Catalyst has been working to deliver three key objectives over a two year period: strengthening the youth sector market, equipping the sector to work in partnership with Government and co-ordinating a skills development strategy for the youth sector's workforce.

Social Enterprise UK

Social Enterprise UK was established in 2002 as the national body for social enterprise in the UK. We conduct research; develop policy; campaign; build networks; support individual social enterprises; share knowledge and understanding, support private business to become more socially enterprising, and raise awareness of social enterprise and what it can achieve.

We are a membership organisation and our members come from across the social enterprise movement, from local grassroots organisations to multi-million pound businesses that operate across the UK. The UK social enterprise movement is recognised as a world leader and our members are united in their commitment to changing the world through business.

Social enterprises are businesses driven by social or environmental objectives whose surpluses are reinvested for that purpose in the business or in the community. They operate across a wide range of industries and sectors from health and social care, to renewable energy, recycling and fair trade and at all scales, from small businesses to large international companies. They take a range of organisational forms from co-operatives and mutuals, to employee owned structures and charitable models.

About this paper

This paper is designed to provide an introduction to the social investment landscape for youth sector voluntary and community organisations and social enterprises (VCSEs). It provides an overview of how the social investment market is driven, why it's affecting more and more organisations and the challenges that the sector faces in engaging with social finance. It is important to recognise that social investment is not always suitable for every organisation and you need to take the time to become familiar with all the options available to decide whether social investment should be pursued. To this end, this paper ends by signposting to a number of practical resources that might help your organisation to learn more about ways to address some of the common challenges.

Research undertaken by The Young Foundation on behalf of the Catalyst consortium in Summer 2011 concluded that the youth sector, which comprises around 11,000 organisations working with and for young people, has a total income of between £470 million and £580 million. However, the way that this income is being generated is changing.

The amount of money available from government through grants to start up or grow organisations, or as funding for core activities, is diminishing rapidly as public sector cuts to reduce the deficit increase. Meanwhile, the nature of funding to deliver services is also changing: more and more service-related grants are switching to contracts, and these contracts in themselves are more frequently being operated along payment by results mechanisms that require organisations to wait until the delivery of services has been successfully completed before payments are made.

Organisations are therefore having to explore new models of finance to attract capital for start up and growth projects, as well as to enabling them to operate under new payment mechanisms for contracts. In light of this, the government is keen to grow the social investment market as a lever to help address the financial needs of voluntary, community and social enterprise organisations.

Useful definitions:

Business model – sets out what an organisation wants to achieve and how it will do this (financially, it describes how revenue is generated and spent)

Capital – money that is/can be invested. Also can refer to financial value of assets held by an organisation

Cash flow – money that is moving in and out of your business (the ‘flow’ of income and expenditure)

Investment readiness – the state in which an organisation has to be in before an investor would consider investing in it (this may involve assessing a whole range of issues including the business model, finance skills, management experience etc.)

Social Impact Bonds – a form of outcomes-based contract where payment is only made after improved outcomes have been achieved

SIFIs (Social Investment and Finance Intermediaries) – SIFIs are organisations that connect those interested in investing for social impact with organisations that need capital to achieve social impact (this includes social banks, specialist social investors and support organisations)

Working Capital – the cash required for the ongoing everyday running of an organisation

Social Investment Market developments and youth sector needs

Social investment is widely understood as the provision of finance with the purpose of achieving both a social and financial return. In the UK, it is generally understood as involving investment into VCSEs in their various organisational and legal forms, including community interest companies, cooperatives and charities.

A study carried out by the Boston Consulting Group and the Young Foundation[1] estimated total investment inflows into the UK social investment market in 2010-2011 to be £165 million. Government was the main source of this funding (50%-60%) and the majority of the investment was made through four social banks[2]. Meanwhile, it is estimated that social enterprises are receiving £0.9-1.7 billion less finance than they need[3], when compared to the level of financing of SMEs using information derived from the 2010 BIS SME survey. Research[4] has further revealed that:

- there are only a handful of small grant providers (e.g. UnLtd Level 1)
- there are few or no investors in this space who understand innovation within the youth sector;
- CAF Venturesome, one of the leading providers, says it cannot meet demand in this space currently, and is turning away significant quantities of business, and is confident that there is demand and room for several other providers; and
- several growth funds looking for a commercial return are struggling for pipeline/deal-flow.

Our market analysis and consultation with social enterprises suggests that the most underserved parts of the market could be:

- Start up capital (finance needed to start an VCSE organisation, sometimes also referred to as seed capital).
- Pre-development capital (finance to develop initial ideas into a workable business model, including, for spin-outs[5] during their transition and pre-launch phase).
- Risk capital (finance required for an organisation or project which is deemed to carry a higher level of risk, often this is required to enable greater innovation).
- Patient capital (finance required by organisations where the social and financial return may not be realised for a longer timeframe)

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[1] *Lighting the Touchpaper: Growing the Market for Social Investment in England*, Boston Consulting Group and the Young Foundation, November 2011
[2] Charity Bank, Ecology Building Society, Triodos UK and Unity Trust Bank
[3] 2011 State Aid application of the UK Government in respect of Big Society Capital
[4] *Growing Interest*, The Young Foundation on behalf of the Catalyst consortium
[5] The process of moving an organisation from the public sector into a social enterprise or mutual model – to 'spin out'. For more information see our guide: The Right to Run

Potential Growth

A June 2012 study[6] carried out by Boston Consulting Group on behalf of Big Society Capital estimates that total investment inflows into the UK social investment market have the potential to grow *from £165 million to up to £750 million* by 2015 on the basis of demand for social investment on the part of social enterprises.

Market analysis undertaken in mid-2011[7] shows there are investors who are interested in supporting young people and youth sector organisations with the potential to grow. While only one in 10 of the youth sector organisations surveyed identified themselves as ready for social investment at present, if extrapolated across the sector this represents organisations with a combined turnover of over £50m. Furthermore, one in five organisations expect to receive the equivalent value of up to five per cent of their income from social investment in the next three years. This equates to around £25 million worth of demand for new investment over the next 5 years.

Market research[8] tells us that latent and active demand for finance falls into the following categories:

- Innovation, start-ups and spin-outs - to find new, cheaper or more effective ways of delivering youth services - organisations typically are looking for anything from £20,000 to £150,000.
- Scale-up, growth or mergers and acquisitions (including assets) - youth sector organisations are many and small, varying from £100,000 to several million pounds.
- 'Cash-flow' finance - with a potential increase in 'payment by results' or traded income business models, organisations are likely to require significant working capital.

So this is a sector with income of around half a billion, with a growing interest in finance and becoming investment ready[9], and tens of millions of pounds of finance expected to be sought over the next few years.

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[6] *The First Billion: A forecast of social investment demand*, Boston Consulting Group and Big Society Capital, September 2012
[7] *Growing Interest*, The Young Foundation on behalf of the Catalyst consortium
[8] *Growing Interest*, The Young Foundation on behalf of the Catalyst consortium
[9] A survey of VCSE organisations commissioned by the Big Lottery Fund, *Investment Readiness in the UK*, July 2012, estimated a pipeline of potential demand for investment readiness support from the VCSE sector to be in the region of 70,000 or more organisations in the 'foreseeable' future (up to five years)

Government policy and strategy

In July 2012, the Government published "*Growing the Social Investment Market: Progress Report*", which sets out its priorities for the development of social investment. The Government wants to "*make it easier to invest in social ventures, whether that is buying shares in a local community shop, lending to a start-up social venture employing disadvantaged people through a new crowd funding platform, or investing alongside others in a dedicated social investment fund*".

Payment by results: a policy led demand for social investment

This support from Government has grown alongside one of the biggest developments within the public services market in the past few years - payment-by-results (PbR). These contracts – which pay for improved outcomes in arrears – have emerged as part of the wider shift towards outcomes-based commissioning[10], whereby a service is paid for on the basis of a set of agreed outcomes. These contracts demand a new set of skills from service providers and require them to identify finance that will enable them to pay for their services in advance.

The Work Programme, the Government's employment programme, is the first major move into a system of payment by results for the public sector, whilst the Department for Work and Pensions is piloting PbR through its Innovation Fund, and The Home Office's Drug Strategy set out plans to introduce PbR pilots in drugs recovery for adults. The Open Public Services White Paper also includes proposals to include PbR to support vulnerable people.

Social Finance Ltd has undertaken feasibility studies in Essex, Liverpool and Manchester to assess the opportunities for establishing Social Impact Bonds to address the problems of vulnerable young people and their families. This has resulted in Essex County Council becoming the first local authority to commission a Social Impact Bond in Children's Services.

It is within this context that the growth and innovation taking place in social investment becomes of significant importance to VCSEs wishing to engage in public service delivery. However, the idea of receiving payment after costs are incurred will be new to many organisations. Our policy work looking into public sector markets[11] found that those organisations most able to deal with PbR will be larger organisations with strong capital reserves or with the ability to raise capital quickly. There is a critical need for a specialist supply of finance and business expertise to help youth sector organisations survive and thrive in this emerging world of PbR.

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[10] Set out in The Open Public Services White Paper, 2012
[11] *The Shadow State Report*, December 2012

Payment by results in practice

Outcomes-based contracts such as PbR can have a number of advantages for VCSE providers as it should mean that a provider's ability to win contracts is aligned with their ability to deliver social value. However, outcomes-based contracting really requires a new way of working and thinking from the providers, and as an organisation you may decide from the outset that certain contracts are not suitable. This may be for a variety of reasons including a lack of compatibility between the contract and how your organisation likes to operate or the outcomes required are not appropriate to the remit of your organisation's aims and expertise. Should you decide your organisation is able to engage in principle then there are a few fundamental actions to consider beforehand:

1. **Identify the risks involved** – remember, there are a variety of different PbR models being utilised which can range from 100% of the payment being tied to outcomes to a small proportion of a contract being based on PbR. This means that there are varying levels of risk involved which will have implications on your finances (see point 2.b. below)
2. **Understand how your organisation will be able to manage this risk**, both in terms of:
    a. **delivery capacity** - as PbR works on the basis of measurable outcomes there is a need to track, monitor and report outcome metrics. Contracts with multiple outcomes or overlapping payment periods may be more complicated to manage and may require specialist data collection and monitoring resources; and
    b. **financial viability** – operationally, PbR means that organisations will need sufficient working capital to pay for the service delivery upfront. Organisations need to be brutally realistic in assessing: how paying upfront for this working capital will affect their cash flow (impact on other work); how robust the business model/revenue generation is (crucially, if you look to social investment to provide working capital finance are you able to meet the repayment requirements); track record (capability to deliver such outcomes to the agreed timeframes and expected upfront and unforeseen costs). Remember, assessing your financial viability will involve a great deal of forward planning as social investment cannot be secured overnight; many social enterprises fail to secure finance because they approach investors too late.
3. **Realise what engaging in social investment could mean** – Social investors interested in providing working capital finance may include charitable trusts and foundations, social investment and finance intermediaries (SIFI) and high net worth individual investors. Importantly, organisations need to be aware that certain investors may require a level of control over how the service is monitored and delivered. Potential providers need to be comfortable knowing from the outset that there may be an extra degree of external scrutiny involved; they will need to be accountable to these investors also.

Challenges of taking on social investment

Social investment offers VCSEs a financing route which can provide the much needed sustainability and security they need to plan long-term and improve their services for young people. Social investment also offers greater freedom for the sector to innovate and focus on improving outcomes.

However, it is widely recognised that there are low levels of confidence and capability within the sector to access social investment – both engaging with investors and being able to navigate the market to find the most appropriate product or service. These challenges cut across all the other sectors that VCSEs operate in, including, health and social care, transport and the environment. The potential for the market cannot be realised unless there is sufficient and growing demand for social investment which means a great deal of effort must be focused on getting the VCSE sector, as a whole, ready to receive investment.

The report from the Young Foundation[12] found that there are a number of challenges around organisations' capability and capacity to take on social investment. If social investment is to become a viable option to support the sustainability and growth of the youth sector organisation in the changing policy landscape then it is down to the individual organisations to become investment ready.

In their detailed investigation into the sector's engagement with social investment, the Young Foundation found three common challenges for taking on social investment, based around capability, capacity and confidence.

Capability: Organisations need a better understanding of social finance and its varied implications, more confidence in negotiation processes, and an ability to show clear evidence of the positive impact they make in the sector.

Capacity: Organisations need the time and money to develop the skills necessary to adopt new business models, but with a quarter of organisations turning over less than £100,000 a year, and a further 40 per cent operating under £1 million, finding the required capital is very challenging.

Confidence: Erratic revenue streams, fear of being unable to pay back loans and uncertainty about the long-term future of a service can all hold organisations back, so the confidence to network, adapt to an ever-changing environment, and be entrepreneurial will be essential.

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[12] *Growing Interest*, The Young Foundation on behalf of the Catalyst consortium

Many of the key findings from this report were reinforced in a more recent survey[13] commissioned by the Big Lottery Fund this year which looked at investment readiness in the VCSE sector. The key challenges were couched as mismatches between the investors' (and intermediaries') side and the investees' side in their perception of what constitutes investment readiness and the support needed to reach it. Crucially, for individual organisations seeking social investment, investors and intermediaries reported significant challenges around the lack of suitable financial skills as the biggest barrier to investment readiness. Intermediaries also spoke of the challenge of changing mindsets from the traditional charitable model to a business model. There was also much made of the lack of adequate infrastructure to provide better co-ordination and signposting of appropriate support for individual organisations.

Further resources and support programmes

To help organisations to address the internal challenges above, the Catalyst consortium continues to provide a programme of support to help VCSE organisations to better understand, navigate and engage in the growing social investment market. It has secured funding to take forward a programme of investment readiness, led by The Young Foundation. During the first wave in 2012, the Young Foundation delivered workshops on social investment across England to over 175 youth sector organisations, infrastructure bodies and local and central government officials. Support in 2013 will be centred on a second series of masterclasses to support organisations become investment ready. Anyone who would like to find out more about the Catalyst Investment Readiness programme should contact catalyst@youngfoundation.org

There are also a number of resources, support programmes and funds available from various VCSE support bodies, SIFIs and think tanks:

- **Big Venture Challenge** – Run by UnLtd and supported by the Big Lottery Fund this is a programme to find investment for social enterprises.
- **Investment and Contract Readiness Fund** – Managed by the Social Investment Business on behalf of the Cabinet Office, this is a £10m fund is now accepting applications from social ventures to enable them to access new forms of investment and compete for public service contracts.

[13] *Investment Readiness in the UK*, ClearlySo and New Philanthropy Capital on behalf of the Big Lottery Fund, July 2012

- **Social Incubator Fund** – Managed by Big Fund on behalf of the Cabinet Office this £10 million fund specifically targets social incubators to help them provide investment and support to early stage social ventures.
- **Fact Sheet : Social Finance for Social Enterprise** – This is a factsheet of social finance terminology commonly used by Social Enterprises and VCS organisations provided on behalf of the Department for Education's overarching strategic partnership for voluntary, community and social enterprise sector organisations that serve children, young people and families.
- **Payment by Results in the Youth Sector** - This guide has been produced by Social Finance in October 2012 on behalf of the Catalyst consortium, a NCVYS coordinated partnership, and is intended to complement the Payment by Results and Social Investment briefing published by NCVYS last year.
- **Inspire2Enterprise** – A free-to-access service provided by The University of Northampton and delivered by Exemplas for the social enterprise sector providing information, specialist advice and support from start up through initial growth and beyond.
- **The Accelerator** – A four month programme run by The Young Foundation intended to propel and rapidly accelerate small but successful social enterprises, combining expert tutoring, business support and social investment.
- **Mentoring for Social Entrepreneur** – Run by Business In The Community (BITC) this mentoring programme offers social entrepreneurs the opportunity to access mentoring from senior level executives from across all sectors, with a view to increasing the profitability and the social impact of their organisation.