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ENTREPRENEURIAL SOLUTIONS TO GLOBAL CHALLENGES

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About *Innovations*

Innovations is about entrepreneurial soultions to global challenges.

The journal features cases authored by exceptional innovators; commentary and research from leading academics; and essays from globally recognized executives and political leaders. The journal is jointly hosted at George Mason University's School of Public Policy, Harvard's Kennedy School of Government, and MIT's Legatum Center for Development and Entrepreneurship.

Ann-Kristin Achleitner, Andreas Heinecke, Abigail Noble, Mirjam Schöning, and Wolfgang Spiess-Knafl

Unlocking the Mystery

An Introduction to Social Investment

The field of social entrepreneurship has changed significantly over the past decade. Traditional sources of funding, such as charitable donations, foundation grants, and government subsidies, are not keeping pace with the innovations social entrepreneurs are creating to address the world's most intractable problems. As social enterprises have gained scale and credibility, new funding sources have emerged that aim to provide both financial and social returns to the investor.

Social investment or impact investment, as this form of financing is often called, provides an important complement to grants and government subsidies. Social investors typically invest in organizations that have a strong mission of social change and generate an income but are not yet considered commercially attractive.

Paradoxically, while successful social entrepreneurs with proven track records face a chronic lack of capital, social investors say the opportunities to invest are limited. However, it is more than a simple market inefficiency that must be solved. When social investors and social enterprises do not transact, it is often because the skills and expertise needed to achieve a particular objective are not understood. The best of intentions on both sides cannot prevent such deals from failing.

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The authors of this article believe that this is a multifaceted problem and that improved information and understanding can play a key role in resolving it. First, a better understanding of the social investment space is needed on both ends. Second, rigorous and mutually agreed to metrics that facilitate social investment transactions are imperative.

This article intends to unlock the mystery of social investment for social entrepreneurs. It is written from the perspective of social entrepreneurs who have gone through the process of bringing an investor on board and wished they had been aware of several key issues up front. Our aim is to help shorten the time and effort entrepreneurs expend in the initial stages of the investment dialogue, to evaluate the expectations once they have found the right investors, and to have more informed negotiations with them.

WHO SHOULD CONSIDER SOCIAL INVESTMENT?

Social investment is neither a silver bullet to close the funding gap in the social entrepreneurship space nor a suitable solution for every social enterprise at every stage of growth. The social enterprises that are best served by social investment are those that have clear and realistic plans for how they will address their short- and medium-term needs and are open to inviting outsiders into their decision-making processes—and, in some cases, to ceding decision-making rights on their strategy and operations to outsiders.

Given that investors demand a high level of accountability and quantifiable results, social investment should not be used to plug holes in a budget, nor is it well suited to enterprises operating in a saturated social market with limited future growth.

WHAT DOES THE SOCIAL INVESTMENT PROCESS ENTAIL?

The social entrepreneurs we spoke with found it helpful to break down the process into several concrete decisions they must make in order to determine what form of social investment is best for their social enterprise, and with which social investors they should continue the conversation. The following pages explore each of the following steps:

1. Finding the financing instrument most appropriate for your enterprise
2. Finding the right social investor
3. Approaching the social investor
4. Passing the initial screening and participating in the due diligence process
5. Negotiating the financing terms
6. Working with the investor, including performance measurement
7. Exiting the investment

Financing Instrument	Duration	Annual Payments	Obligatory Repayment	Implications for Social Enterprise
Debt Capital	Long term	Interest payments	Yes	Requires predictable cash flows No dilution of ownership Far-reaching rights of capital providers if default
Equity Capital	Unlimited	Dividend payments	No	Dilution of ownership Social investor receives control and voting rights Potential impact on corporate culture
Grants	Short term	None	No	Usually restricted use for predefined projects Low entrepreneurial flexibility
Hybrid Capital	Long term	None	Depends on structure	Inexpensive Risk-sharing with the social investor Great structuring flexibility
Mezzanine Capital	Long term	Interest payments	Yes	Requires predictable cash flows No dilution of ownership Mandatory repayment

Table 1. Comparison of Financing Instruments

FINDING THE FINANCING INSTRUMENT MOST APPROPRIATE FOR YOUR ENTERPRISE

When determining the right financing instrument, social entrepreneurs should first ask themselves questions that will help them determine whether debt or equity is more suitable for their purposes. For example:

- Can we set aside capital to repay any debts incurred within 5-7 years?
- Can we take on capital that requires making regular interest or dividend payments (for example, 5 percent interest) throughout the course of the financing?

Below are brief descriptions of common financial instruments.[1]

Debt capital can be used for long-term investments or project financing that promises stable and predictable cash flows over the coming years. Stable and predictable cash flows are necessary, as the debt capital providers receive an annual interest payment. Debt capital is provided on a temporary basis and generally must be repaid within 5-7 years.

Equity capital gives the investor a share of the future profits generated by the social enterprise in exchange for an infusion of capital. This tends to be the financing instrument with the highest risk for the investor, who only gets paid when the enterprise is earning money. Besides a share of the profits, the social investor has certain control and voting rights that depend on the legal form of the enterprise.

Grants, often thought of as "free" capital, are usually provided by foundations or individuals for certain projects; they often exclude overhead or development costs. Grants can have a high opportunity cost, especially when they are short

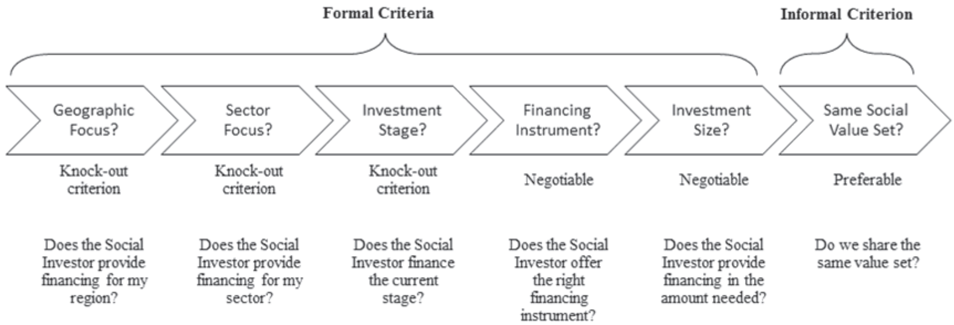

Figure 1. Investment Fit

term, paid out in small amounts, and require significant time to secure and maintain.

Hybrid capital contains elements of grants, equity capital, and debt capital. Like a grant, there are no interest costs, and in certain agreements the financing instrument is converted into a grant. Financing instruments in this category include recoverable grants, forgivable loans, convertible grants, or revenue-sharing agreements.

Mezzanine capital combines elements of debt and equity capital and represents a convenient financing alternative if pure equity or debt capital is not applicable. The interest payment can be linked to the company's profits, and the total amount is repaid after a certain time. The flexible structure makes mezzanine capital an attractive option for both social entrepreneurs and social investors.

KNOWING WHETHER AN INVESTOR IS RIGHT FOR YOU

The social finance sector emerged with the goal of reducing transaction costs and helping to allocate capital more efficiently in the social enterprise space. Below we describe several of the types of investors available to a social enterprise.

Value banks, which take deposits from savers and give loans to individuals and enterprises, offer loans and have more experience in the financing of social enterprises than traditional commercial banks. Some of the leading banks involved in the social finance arena form the Global Alliance for Banking on Values.

Social stock exchanges, which create efficient public trading platforms for both equity and debt capital in a social enterprise, can be an attractive financing option for social enterprises with a proven business model, a good track record, and significant financing needs. In Singapore (Impact Investment Exchange Asia), London (Social Stock Exchange), and Mauritius (NeXii), social stock exchanges are currently working on building a fully functional stock exchange under strict regulatory requirements.[2]

Social investment funds, which collect funds from individuals or foundations and invest in a given sector, such as microfinance or the solar industry, act as intermediaries by bundling funds from investors that they subsequently invest in certain asset classes. This approach reduces the transaction costs and the risk through diversification effects.

Venture philanthropy funds, which bring together medium-term venture financing with a screened portfolio of social investees, offer social enterprises nonfinancial support such as management consulting or access to networks in order to create a multiplied social return on investment. The funding can be structured according to the needs and requirements of the social enterprise and in some cases even includes grant funding. In some cases, venture philanthropy funds (sometimes called high-engagement philanthropy or social venture capital) do not focus on the financial return on the investment.

Once the social entrepreneur has decided which types of investors might be right for the enterprise, they can begin to explore which prospective investors would be the best partner for their enterprise in the near future. In so doing, the social entrepreneur should consider not only formal criteria related to the investor's profile (for example, sector, geography, or instrument type), but also informal criteria related to their values and personality. The questions in Figure 1 are designed to help the social entrepreneur determine whether a particular social investor is the right fit.

Many social investors concentrate their funding in a particular geographic region or sector, thereby deepening their expertise and allowing them to transfer knowledge among various social enterprises. The geographic and sector focus tend to be important criteria for how the investor chooses to invest.

Investors focus on specific investment stages—seed, early stage/start-up, and later stage/mature. This can make it difficult to negotiate when the social enterprise is at a different stage than the social investor is usually interested in.

Financing terms often offer room for negotiation. As social investors consider financial return as well as social returns, they can be flexible in structuring the financing instrument to meet the requirements of the social enterprise. Investors often have a set amount they can invest; if the enterprise requires more capital than the investor alone can offer, investors may syndicate the investment, resulting in the simultaneous investment of two or more investors. This lowers the risk for the investor, as another investor has been vetted and is committed to the success of the investee.

Conflicts can arise between the investor and the enterprise around the social mission, profit distribution, and future development of the enterprise. These conflicts can dramatically change the vision, mission, and strategy of a social enterprise. Therefore, before giving an investor a key decision-making role, the social entrepreneur should be certain the investor is the right partner over the next few years. When first meeting with the social investor, the social entrepreneur can gauge whether the investor shares the organization's vision and mission and the entrepreneur's values.

APPROACHING THE SOCIAL INVESTOR

Investors cast a wide net in the early stages of the selection process in order to identify investment prospects from as large and competitive a pool as possible. Social enterprises can get on the radar screen of prospective investors by various means, including attending relevant conferences and networking events, and occasionally by making a "cold call."[3]

Social investment advisors, who assist social enterprises in setting up an appropriate financing structure and finding the right investors, can also act as financial advisors and play an intermediary role between enterprises and investors.

At this stage, the social entrepreneur should have a polished "elevator pitch" that explains their vision or concept, business model, and the reason they need funding (for example, to scale the business model, launch new activities, or provide working capital).

SCREENING AND DUE DILIGENCE PROCESS: HOW YOU WILL BE JUDGED

Social investors analyze several hundred social enterprises per year, but only a few make it to the final round. Investors assess nearly 50 different selection criteria when evaluating these enterprises, which include the overarching themes listed below:

- Concept
- Market
- Financials
- Social impact
- Social entrepreneur[4]

Concept, the single most important selection criterion, allows investors to understand whether the offering will change the relevant sector through its strategy or innovation. Investors assess how the social enterprise works with the target group and whether it has the support of the relevant stakeholders. For the due diligence, social entrepreneurs can prepare to answer specific questions on whether the enterprise has a clear strategy to solve the social problem (the theory of change) and how it differs from existing concepts.

Market, which allows investors to evaluate the potential of an enterprise, explores the competitive environment and the characteristics of the target group. Social entrepreneurs should be prepared to answer questions about the total number of people affected by the social problem and how the social enterprise is positioned to reach them.

Financials, which are relevant for debt capital investments, evaluate the business model and capital requirements in the context of how and how much income will be generated. The social enterprise should have 3- to 5-year projections in terms of revenue, costs, and budget based on realistic assumptions and past data.

Social impact refers to both the scalability and reach of the business model. Scalability depends on the business model characteristics, such as the necessary know-how for providing a service and how certain stakeholders can block the scaling of the social enterprise. Reach is the percentage of the market covered by the concept. The social entrepreneur should be prepared to speak in depth about the external and internal factors that will facilitate (or might limit) the enterprise and increase its scale and impact.

Social entrepreneur refers to the leader of an organization. Many investors say that they invest first in the entrepreneur and second in the enterprise. Once an investor has faith in an entrepreneur, they will invest in whatever that person churns out. There are five different aspects of the social entrepreneur that investors consider: strategic skills, professional skills, creativity, attitude, and development potential. Most important to the assessment of the social entrepreneur are their commitment to the concept, creativity in achieving the social impact or reaching the market, and their previous track record.

NEGOTIATING THE FINANCING TERMS

The financing terms differ between debt capital (loan) and equity capital (ownership stake). In some cases, the social investor provides the financing in separate tranches after the completion of certain stages (for example, $250,000 at the start and $250,000 after setting up a second location).

Equity capital: First, the social entrepreneur has to negotiate the valuation of the social enterprise and whether the financial return should be realized through an increase in its value or through regular dividend payments. Second, the entrepreneur and investor should agree on a financial and dividend policy during the holding period. Third, while the investor should be able to influence decisions in the company, the social entrepreneur should maintain the rights to flexible and entrepreneurial decision-making authority for the social enterprise. Fourth, social entrepreneurs and social investors should discuss the options for the investor's future exit strategy.

Debt capital: First, the social enterprise and investor should discuss the interest rate and the repayment schedule. Then the two parties should discuss the interest payments and the principal repayment schedule in the event of distress to secure the necessary financial flexibility. Grace periods can be an attractive option for social enterprises. Third, the parties should discuss the worst-case scenario. In the event of default or bankruptcy, the loan provider's right to be repaid might take precedence over the social entrepreneur's rights. For this reason, the social entrepreneur should avoid taking on personal liabilities for the social enterprise or negotiating extensive debt-to-equity swaps in case of default. A debt-to-equity swap gives the loan provider a certain share of the equity capital (ownership) if the social enterprise defaults on its debt. If the social entrepreneur takes on personal liabilities and the social enterprise defaults or goes bankrupt, the social entrepreneur can lose his personal assets.

WORKING WITH INVESTORS

After working out the structure of the investment, the social entrepreneur and the investor should discuss how to formalize their ongoing relationship. The most common way is to create an advisory board.

An advisory board involves the social investor in the operations and gives them voting and control rights (for example, one social enterprise sends a monthly overview of the financial situation to the members of the advisory board, which convenes four times annually). The members of the advisory board usually include representatives of the social enterprise and of the shareholders, as well as independent experts who can contribute expertise from the social or the business sector.

The advisory board can strengthen the quality of entrepreneurial decisions and management accountability by asking tough questions about current practices and suggesting new policies, procedures, or approaches. Social investors tend to have extensive knowledge about corporate governance, reporting, controlling, and corporate finance, but only limited knowledge of the core activities of the company, such as delivering the social services to the target group. The social entrepreneur should adjust their expectations and use the existing skill sets and network of the social investor.

PERFORMANCE MEASUREMENT

Performance measurement enables the social investor to control and monitor the work of the social entrepreneur. Performance measurements include both financial and social indicators. While there is not yet a globally accepted and applicable performance or impact measurement method, a few have become more widely used.

The Roberts Enterprise Development Fund has developed a quantitative method called social return on investment (SROI), which aims to express the value of an enterprise's activities in monetary terms. Qualitative methods include a balanced scorecard for social organizations.[6] The choice of performance measurement method should be discussed with the capital providers in advance.

Performance measurement methods require similar information to financial analyses that assesses the valuation or the credit rating of a company. Those methods require solid and comparable information. The traditional capital markets standards, such as the International Financial Reporting Standards (IFRS) or the United States Generally Accepted Accounting Principles (US-GAAP), guarantee that companies are reporting on a comparable basis. Regional standards have been developed to address the special characteristics of social enterprises. Two popular standards include the Social Reporting Standard (SRS) developed in Germany, and the Impact Reporting and Investment Standards (IRIS) developed in the United States.

From the social entrepreneur's perspective, reporting requires initial additional effort and costs, yet it generates long-term benefits. It allows the social entrepreneur to track results, improve processes, and have better documentation of the social enterprise's successes.

EXIT CONSIDERATION

The exit routes for equity capital, debt capital, and grant funding are quite different.

There are several exit strategies for equity capital. Shares can be sold to a third-party investor, the social entrepreneur can buy back shares from the investor, the parties can issue an initial public offering on a social stock exchange, or they can liquidate the ownership. The buy-back arrangement implies that the social entrepreneur has sufficient funds to buy back the shares held by the social investor.

In the case of debt capital, social entrepreneurs can either repay or refinance the loan. In the case of refinancing, the same or another social investor must be willing to provide debt capital for another period. If the social enterprise defaults on the loan (for example, failure to repay or a long-term delay on scheduled payments), there are three scenarios:

- Social investor institutes bankruptcy proceedings to recover part of the loan (liquidation)
- Social investor extends the period of the repayment schedule (financial flexibility)
- Social investor accepts equity in exchange for the loan (debt-for-equity swap)

Grant funding also presents several exit options. A social investor can fund a significant part of the total budget or take over part of the overhead costs for a given period of time. After this period, the social enterprise will have reached financial self-sustainability or will need to secure follow-up financing.

FURTHER DEVELOPING THE FINANCING ENVIRONMENT FOR SOCIAL ENTREPRENEURS

To bring the field of social investment to greater maturity and relevance, we must address several issues. First, we must create a deeper understanding among the broader community of social enterprises and investors of the respective requirements for both parties. Second, the sector must agree on rigorous, transferable, and consistent metrics that can facilitate smoother social investment transactions and deal flow. Third, we must create a common and open platform through which social investors and investees can sort through the range of opportunities quickly and accurately.

The challenge of the coming years is to bring to maturity the financing mechanics fueling the momentum of social innovation. Several actors have begun the hard work on each of the three actions proposed above. What we need is more conversation and collaboration and a commitment to building this sector into a viable and important avenue for advancing investment in enterprises that have a social and financial impact.

This article is based on the *Social Investment Manual* that has been conceived by the social entrepreneurs in the Social Investment Task Force initiated by the Schwab Foundation for Social Entrepreneurship. A.-K. Achleitner, A. Heinecke, A. Noble, M. Schöning, and W. Spiess-Knafl, *Social Investment Manual,* 2011. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1884338. We would like to thank the members of the Social Investment Task Force and our interview partners.

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1. For more information on these and other instruments, see Achleitner et al., *Social Investment Manual*.
2. A key concern of social entrepreneurs is the ability to protect the social mission, as they cannot control the ownership structure, which can lead to unsolicited takeover bids. The social enterprise can protect its social missions through various measures, such as the control of a minority stake by a foundation, setting up adequate articles of association, or the use of poison pills; see A.-K. Achleitner and W. Spiess-Knafl, “Financing of Social Entrepreneurship,” in *Understanding Social Entrepreneurship and Social Business*, C. Volkmann, K., Tokarski, and K. Ernst, eds. in press. Poison pills discourage unsolicited takeovers and become effective when there is a change of control.
3. A long of list of investors active in this field can be found in Achleitner et al., *Social Investment Manual*.
4. P. Heister, *Finanzierung von Social Entrepreneurship durch Venture Philanthropy und Social Venture Capital*, Wiesbaden, 2010.
5. A list of 20 preparatory questions can be found in Achleitner et al., *Social Investment Manual*.
6. For an overview and case studies, see C. Clark, W. Rosenzweig, D. Long, and S. Olsen, *Double Bottom Line Project Report: Assessing Social Impact in Double Line Ventures*, 2004. Available at http://www.riseproject.org/DBL_Methods_Catalog.pdf; Rockefeller Foundation and Goldman Sachs Foundation, *Social Impact Assessment: A Discussion among Grantmakers*, 2003. Available at http://www.riseproject.org/Social%20Impact%20Assessment.pdf.

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