Financing Social Enterprise

Understanding Needs and Realities

Foresters Research Report

A **Foresters Community Finance Action Research Project**, this is the first part of a two part project examining the financing of social enterprise. This first part examines the financial realities and the needs of social enterprise, and the second part will pilot a number of finance products with social enterprises which will help to further develop and understand the particular financing needs of such businesses.

Written by Ingrid Burkett.

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Finally, sincere thanks to all the enterprises who shared with us so honestly - their work and commitment is at the heart of this research. Thanks also to the New Mutualism Group – who for many years in many small ways have been at the heart of social enterprise development in Brisbane.

All mistakes and inaccuracies however remain the responsibility of the author. Photo on Front Cover: Taken by Ingrid Burkett in the New York City Subway, artist unknown.

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Preface

This research report aims to explore in more depth than has previously been the case, what the financial needs and realities of social enterprises in Australia are. The concept of 'social enterprise' is relatively new and somewhat underdeveloped in the Australian context – though the practice of enterprising for social purpose is by no means new and there are many examples of this from across the history of this country. 'Social enterprise' as a concept has been widely embraced and there is much excitement around its potential to bring energy and innovation to the social sectors in Australia. Alongside this excitement, however, is a degree of hype and a resultant array of fairly unrealistic expectations of what social enterprise could achieve (often without any real or extended support systems in place). Social enterprise is not, in our opinion, a magic solution for addressing wicked social problems, nor is it an alternative pathway for social sector organisations wishing to find ways to get off the funding treadmill. Rather, it is an addition to the stable of ways in which we can address the most pressing issues facing our society today. Social enterprise is a hard road – it asks us to tread the slippery path between social objectives and commercial practices. It is not for the fainthearted nor for idealists. It calls for 'practical visionaries'[1].

We began this research with a very real sense of the possibilities for improving access to capital for social enterprises but also with a parallel sense of frustration at what we saw as:

- simplistic assumptions such as 'add business know-how and stir' posing as solutions to 'fix' the capital needs of social enterprise;
- illogical assumptions such as that growing gift and grant funding for social enterprise would magically result in greater levels of sustainability.

The picture that we paint of the realities of social enterprise in this report is not one of instant success or pathways lined with gold. It is a sobering account of just how difficult the task is – but one which also points to the opportunities and potentials of this sector if we put in place the right supports and access to new resources. We are very aware of the incredible honesty and openness of our interviewees in this research. We applaud and thank them for this contribution to the sector's learning. However we have also struggled with how to present this honesty in a way that protects the anonymity of the interviewees and their enterprises – and which leads to learning rather than any kind of demonizing, depression or dejection. We hope we have created a report that balances the realities with the possibilities. As a social business ourselves Foresters Community Finance is aware of how hard the road is between social impact and commercial realities and we are very confident that together we can find ways to 'smooth this ride'.

This research has some clear limitations – not the least of which is that it profiles the financial realities of only a very small handful of enterprises of the thousands that have been identified across Australia in recent studies (eg. the FASES research that is currently underway[2]). We do not suggest or propose in any way that what we have presented is a representative sample nor that our results are generalisable across the social enterprise sector. Our aim in publishing this report is to stimulate debate and discussion, and hopefully, further empirical research into the financial needs and realities of social enterprises in Australia. We offer this report as a stimulant for rigourous and vigorous debate and we hope it will lead to much greater respect and levels of support for those brave souls who enter the territory of social enterprise.

[1] A term used by Susan Blackburn (1993) to describe the work of Father Tucker who started organisations such as the Brotherhood of St Laurence and Community Aid Abroad, who in turn have fostered much social innovation and begun a number of key social enterprises in Australia.
[2] See Centre for Philanthropy and Non Profit Studies at QUT and Social Traders.

Introduction, Methodology and Overview

Over the course of the past decade, Foresters has been approached by numbers of social, ecological, community and micro enterprises in search of finance to capitalise their start-up, development and/or growth. In unpacking the stories that these enterprises present there have been recurrent themes. Such enterprises are often significantly undercapitalised and struggle to access mainstream sources of capital, particularly non-grant and non-gift capital. Foresters has also had contact with many other social enterprises (through its Education and Innovation program and through research and project work) who have raised concerns about undercapitalisation and the difficulties of building sustainable enterprises. As a financial institution Foresters is in a unique position of having undertaken financial appraisals of a number of social enterprises for the purposes of loans and investment. Through this work we have developed an understanding both of the emerging financial needs of this sector ***and*** of the challenges of offering capital and investment into this sector. Through this research we aim to add to this understanding to develop and document a more rigorous analysis of both the demand and supply sides of financing social enterprises. Some of the key questions on both sides of this picture are outlined in figure one below.

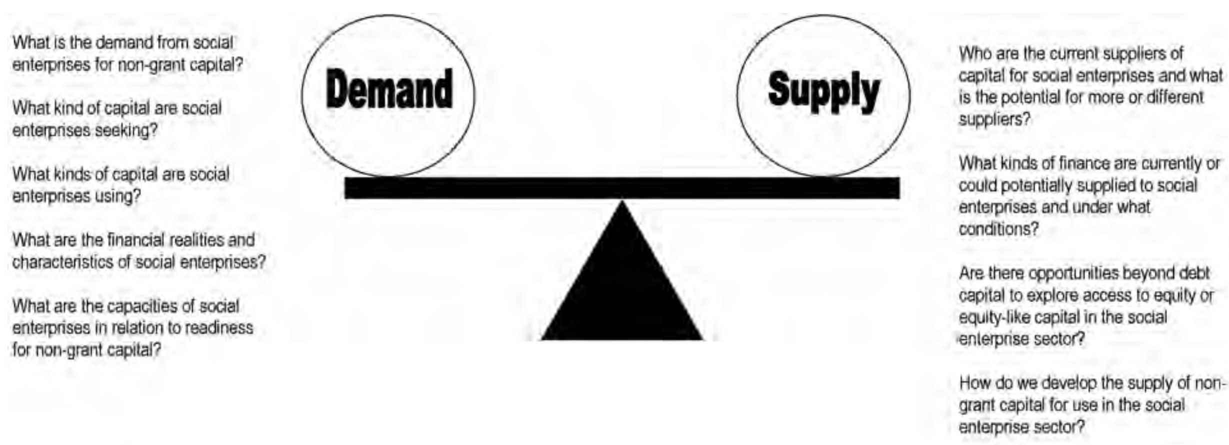

Figure 1: Key Questions of Demand and Supply in Financing Social Enterprise

Foresters initiated this action research project to answer some of these questions both through developing an in-depth understanding of the needs and realities of local social enterprises and by designing, developing and testing some pilot finance products with willing and eligible social enterprises in South-East Queensland.

This action research project has two phases:

Phase One: Between late 2008 and mid 2009
In-depth interviews were conducted with 16 managers or key people from social enterprises and three people from social enterprise ‘hubs’ or support organisations from around South-East Queensland to understand their financial realities, their experiences with finance and their financial needs. The interviews were complemented with surveys which collected more quantitative data from 13 of the enterprises. The data from the interviews and surveys was qualitatively and quantitatively analysed. This was followed by a more detailed analysis of financial reports from a range of these enterprises to closely examine the financial realities of different types of enterprises. This report focuses on the results of this first phase of the research.

Phase Two: Between early 2010 and late 2010
Phase Two involves the development and testing of a range of financial products that aim to provide capital to some of the social enterprises involved in Phase One. This phase will more closely examine how enterprises cope with and benefit from different types of capital at different stages of their development. Phase Two of the research will be built on the findings of Phase One such that the products that are designed will attempt to address some of key financial realities and needs of the enterprises involved.

This research report, which focuses on the first phase of the research, will integrate the data from surveys and interviews; local and international literature about financing social enterprise; and the practice experience of Foresters Community Finance in managing a social investment fund and lending to non-profits and social enterprises over the past 15 years. Quotes from the interviews are included where relevant – these are presented in grey shaded text boxes.

We have removed all identifying information from the quotes and financial data presented. This is principally because we are not making judgements on the financial position of any single enterprise, but rather, trying to make sense of the sector as a whole in order to work towards offering financial products into this sector. It should be noted that every effort has been made to present quotes that are representative of the diversity of enterprises, and to ensure that a diversity of positions and perspectives is presented. Therefore, no enterprise is quoted more than once in relation to a particular argument.

Overview of the report
This report is divided up into four main parts.

Part One: Revisiting the Definition of Social Enterprise examines why it is important to develop some common understandings or even a typology of what could be included under the umbrella of social enterprise - particularly if specific financial products and services are to be offered into this sector.

Part Two: Examining the Financial Realities and Needs of Social Enterprise analyses the data collected through interviews and through an examination of the financial statements of the enterprises included in the study. The financial realities and needs of social enterprise are examined over the course of an enterprises lifecycle.

Part Three: The Challenges of Financing Social Enterprise in Australia takes the perspective of a financial institution and examines what the key challenges are in considering non-grant capital (ie. debt and equity capital) in this sector.

Part Four: Bridging the Gaps - Towards an Ecology of Finance for Social Enterprise considers the ways in which the research could inform the development of a capital market for social enterprises in Australia.

The report concludes with an outline of the second phase of this action research project and some key challenges ahead for financing social enterprise in the Australian context.

Part One: Revisiting the Definition of Social Enterprise

Social Enterprise remains somewhat conceptually slippery in Australia as the context and the structures that have emerged here are different in nature and form from those that have emerged in the UK where much of the current research and writing on social enterprises originates. Conceptual clarity is a key issue for capitalising the emerging field of social enterprise, as a lack of understanding can be a major barrier to such entities accessing financial services and products from mainstream institutions (as is highlighted in the two examples below).

> *"When it comes to non-profits and things like loans, it's not something banks are generally very good at. So I think part of it is having someone who really gets what you do. And as lovely as our bank manager is I don't think she really gets what we do. She doesn't really understand how our needs may differ from the more traditional banking relationship".*

> *"Banks don't understand. … I don't even think they know what 'social enterprise' is. It's just not their area of interest to find out, from what I gather. That's been a big issue we've had, convincing people that what we're doing is sustainable (as a social enterprise)".*

It is important to examine some of the key features of the entities and models that together seem to increasingly congregate under the umbrella term 'social enterprise' (Mitchell et al, 2008). In addition, definitions of social enterprise need to be contextualised. The definition of social enterprise used in Australia is somewhat different to that used in the UK or in the USA because there are specific political, social and economic drivers of social enterprise in each of these contexts. For example, in the UK there is little or no distinction made between social enterprises and enterprising third sector organisations - indeed the latter are nearly always referred to as social enterprises. In the Australian context this is inappropriate and a distinction needs to be made to avoid increasing levels of confusion in the sector. For the purposes of this report, we argue that enterprising third sector organisations are not social enterprises unless:

- They develop a degree of independence from the third-sector organisation (for example by separating financial management and/or governance);
- They have a social purpose beyond that of generating an earned income stream for the third sector organisation.

Table one below, then, outlines definitions of some of the entities in an Australian context that are often included under the social enterprise umbrella and draws some distinctions between them.

Type of enterprise / business	Definition
Microenterprise	A commercial venture initiated by an individual or household previously excluded from mainstream employment, with the purpose of securing a stable livelihood or improving their economic condition. (Of course it should be noted that microenterprise is also a term used to describe enterprises initiated by people not excluded from mainstream employment, but such enterprises are not included within social enterprise definitions)
Social Enterprise	Common to all social enterprises: • **Social Objectives are core** to the purposes and focus of the enterprise • **Limited distribution of profits and/or distribution of profits with the purpose of maximising social impact** - the majority of profits are

	reinvested in the enterprise and/or an associated social entity and are used to maximise social impact. • **Mixture of capital inputs** - the enterprise is often supported through blending of earned income, grant income and philanthropic income. • **Blended Value Creation: Generation of social/ecological/ cultural returns (or a combination of these) in addition to a financial return** **Type A**: **Social Objectives and Social Outcomes** - an enterprise whose focus and purpose is to address a social issue using enterprising means. **Type B**: **Employment Creation** – an enterprise that seeks to create employment and integrate people who have been excluded from employment into the workforce. If such an enterprise focuses on people who have been excluded from employment because of a disability or health related issues, these enterprises are also sometimes referred to as **'social firms'**. **Type C**: **Social Wealth Generation** - an enterprise that is often linked with a non-profit organisation, which has at its core social objectives and which generates a financial return for the non-profit organisation. Variations of social enterprise can also focus on generating cultural impacts or economic impacts. So, this would mean that cultural or economic processes could be key instead of or in addition to social processes and objectives. These types of enterprises are sometimes referred to as '**cultural enterprises**' or '**local economic enterprises**' (see also, Hunt, 2009).
Community Enterprise	An enterprise whose focus and purpose is to address local or place-specific issues using enterprising means – could be local social issues, ecological issues, cultural issues etc. It is focused on a geographic location and the outcomes it is seeking are located in that geographic region. **Type A**: **Community Objectives and Community Outcomes** – an enterprise that seeks to address local issues and achieve community outcomes by utilising an enterprising orientation. **Type B**: **Local Employment Creation** – an enterprise that seeks to build local employment, particularly focused on building jobs within regional, remote, and/or disadvantaged communites. It may or may not focus on employment creation with people who have been excluded from mainstream jobs. **Type C: Community Wealth Creation** – an enterprise that seeks to establish local community-owned assets in order to create community benefits and address community issues.
Social Business	A commercial business that has social objectives at its core. A social business, unlike a social enterprise, is a commercial entity, so all its income is derived from commercial undertakings rather than from grants or gifts. It may, however, undertake activities that are non-commercial in nature (or approach issues from a 'more-than-commercial frame of reference) or conduct itself as a hybrid between the commercial and social spheres. Social businesses can be for profit however what distinguishes a social business from a socially responsible business is that in the former there is a clear intention that profits drive maximum social impact rather than build private wealth. Therefore even in a for-profit social business, the profits maximise impact by being used for example to fund innovation, are reinvested in the business or subsidize less profitable aspects which may deliver strong social returns.
Eco or Green Business	A commercial business that has environmental objectives at its core. It can be for profit, or not-for-profit. A green business, unlike a social enterprise, is not capitalised through grant or subsidised income. It is a commercial entity, so its income is derived from commercial undertakings and trading.

Table 1: A Typology of Social Enterprise

Key to assessments of any entities operating under the broad umbrella of social enterprise/business are three features:

1. A social (environmental or cultural) **purpose** that is core to it's focus, business and structure;
2. An orientation towards enterprise as a key activity and income source, with a significant proportion of **income** coming **from enterprising and business activities** (as opposed to grants or philanthropy);
3. A **profit distribution** that aligns with and/or supports the impacts that are driven out of the social purpose – whether it is structured as a non-profit or for-profit entity it must be **for the benefit** of something beyond private wealth creation.

In some reports (see for example Conaty and McGeehan (2001) Langdon and Burkett (2004) and Mitchell et al (2008)) a linear interpretation of where social enterprise fits, is offered – such as in the following figure.

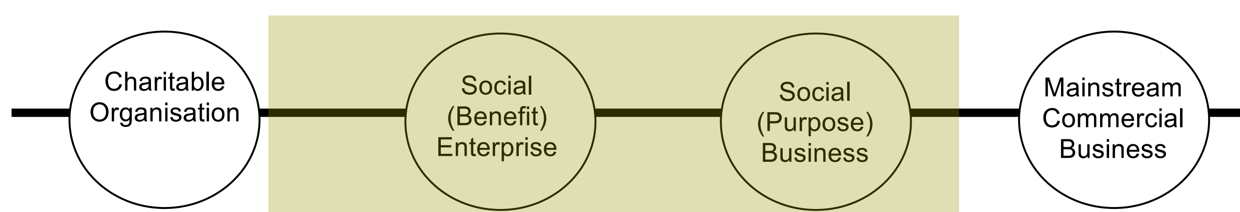

Figure 2: The Space Between: Where Social Enterprise Fits

Within the space between charitable organisations and mainstream commercial businesses sit a variety of entities, articulated by Mitchell et al (2008) as (moving from the charity end of the continuum to the business end):

- Charities with 'mission focussed' trading arms;
- Social benefit enterprises (or social enterprises);
- Social purpose businesses (or social businesses);
- Socially responsible businesses;
- Businesses whose purpose is to generate funds for charities.

This research focuses on the middle two entities – that is social enterprises and social businesses.

Another way to interpret the position of social enterprises is to see them as populating a new sector, which could be called 'the fourth sector'. This sits between the traditional sectors, sharing features of each but with a new form.

Figure 3: The Fourth Sector

Building on this, it can be helpful to map where the entities defined above actually sit in relation to other sectors on a matrix. So, for example, most microenterprises sit in the 'private sector' rather than the Fourth Sector. Equally, enterprising third sector organisations are not necessarily social enterprises, though they may sit close to the 'border' between third and fourth sectors. The actual position of any given enterprise on this sectoral matrix obviously depends on it's specific features, its purpose, focus, and structure, however we could broadly represent the entities listed above on the matrix as follows in figure four.

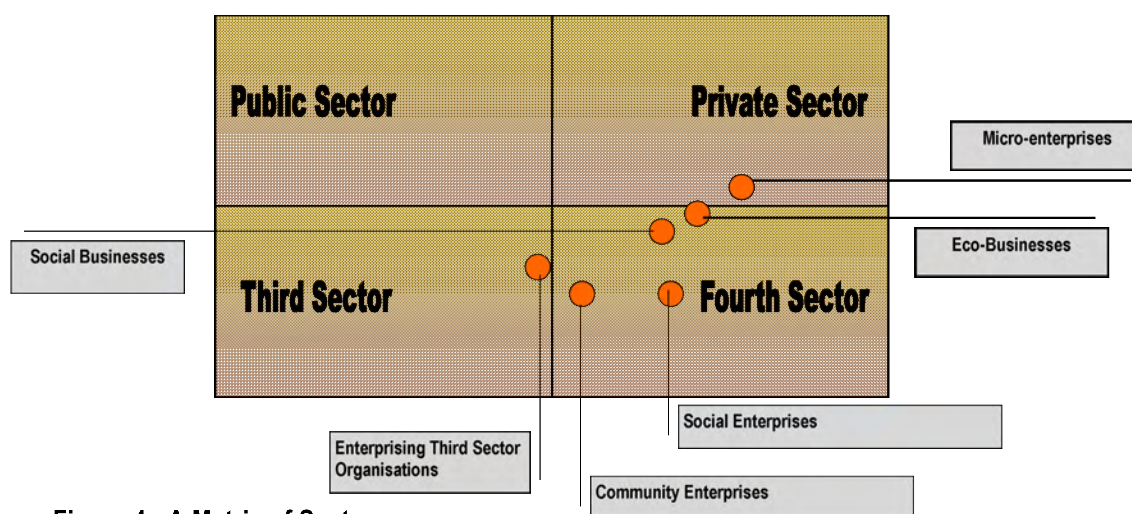

Figure 4: A Matrix of Sectors

Understanding the spectrum of social enterprises and being able to map or position different entities across this spectrum can help organisations such as Foresters to develop clear policy frameworks around what types of entities we consider to be social enterprises and to articulate this to our stakeholders. For the purposes of this research we included only enterprises that could be seen to sit predominantly in the 'Fourth Sector' – therefore we did not include microenterprises or enterprising third sector organisations (though as we will argue some of those included may actually be better thought of as enterprising third sector organisations). While we recognise the need for finance in microenterprises (particularly those operating in disadvantaged communities) and in enterprising third sector organsiations, this research does not engage with their particular needs.

The social enterprises that were included in the research identified their social purpose or social benefit in the following ways:

- Employment of people typically excluded from the employment market (including Intermediate Labour Market programs);
- Fair Trade;
- Arts and Cultural Development;
- Local Development (of a community or region);
- Ecological sustainability / Recycling;
- Local Food System Development / supporting local farming.
- Supporting the development of micro and social enterprises – (sometimes referred to as Hubs)

One of the difficulties of working in the sphere of social enterprise is the sheer diversity of organisations / entities that are starting to identify as social enterprises and populate space under this umbrella. It is increasingly difficult to make meaningful comparisons across social enterprises and it is important to realise that broad generalisations and 'one-size-fits-all' solutions are not the answer to addressing the undercapitalisation and financial exclusion of social enterprise. This also means, unfortunately, that this is a space that is not straight-forward to operate in. Some support organisations have addressed this by narrowing their definitions of what kinds of social enterprises they will engage with (for example that they have non-profit legal structures, or that they are focussed on employment of previously unemployed groups). However, as the field grows, there will naturally be more and more pressure to include a greater variety of groups under the umbrella (particularly as funding shrinks in other areas and moves across into this 'newer' sector). Therefore, the transaction costs to any institution who becomes involved in the capitalisation of such enterprises are necessarily going to be high. There needs to be a great deal of energy expended in understanding the 'business' of the enterprises who apply for capital and their espoused and actual social / environmental / cultural impacts, benefits and purposes[3]. For our purposes, defining social enterprise and developing clarity around what types of entities we will engage with as a financial institution and eventually offer finance to is a critical aspect of designing appropriate products and services.

[3] We will come back to the difficulties of making assessments about the impacts of social enterprise later in this report. It is the case, however, that we need to be aware of impacts of enterprise beyond purely 'social' impacts – and that we need to include ecological and cultural enterprises and impacts in our understandings of this sector.

Part Two: Examining the Financial Realities and Needs of Social Enterprise

There have been a number of commentators who have compared the ‘lifecycle’ of social enterprise to that of small business and suggested that there are significant similarities in their development. Such discussions are frequently accompanied by representations of the progression of enterprises through various stages as their revenue grows. Often the picture presented is very neat. The enterprises revenue grows steadily and the progress through developmental stages is sequential. Two such images are presented below.

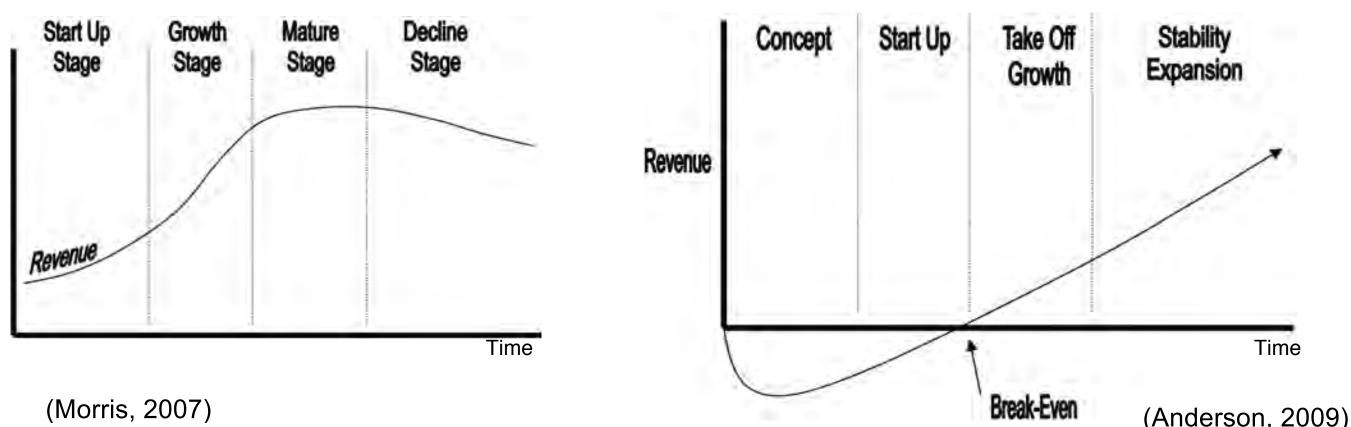

Figure 5: Typical Depictions of the Lifecycle of Social Enterprise

If, however, we look closely at some of the experiences of the enterprises studied through this research, the picture is not this neat, sequential or steady. While we could identify particular broad developmental pathways and we could say that the enterprises were at different stages of their development, the stories that were told of traveling along this pathway were messier in nature than the above images suggest. Every enterprise clearly had the goal of an overall increase in revenue and the development of some sort of revenue stability over time. However, the stories suggested that the journeys were frequently punctuated by fits and starts (particularly in the early stages); that there were more than occasional crises of revenue; and that the progression of the enterprises was often non-sequential rather than sequential, at times involving devolution, not just evolution. Increasing revenue was not the only factor that enterprises identified as an indicator of development. Many spoke of growing impact in line with their purpose, for example, as a measure of progress. Further, the smooth, progressive representations could not possibly depict all the ups and downs that occurred on the journeys of these enterprises. The stories that were told did not reflect gradual betterment, but jerky movements forward coming out of a deal of gritty determination, luck, faith, relationship and personal sacrifice.

We identified four basic phases in the enterprise journey, that link to particular achievements, realities and needs that the enterprises themselves articulated. However, as discussed above, we recognise that enterprises often take a circuitous route on their journey towards maturity. Some spend longer or shorter times addressing certain issues or building certain products / services. Many value things other than generating more revenue, some jump ahead or go back to revisit certain phases of development. Many of the people interviewed talked of stages prior to the actual start-up where the ideas were developed, refined, discussed and incubated.

Although we did not include this as a separate phase or phases, we acknowledge that this period can be crucial to the development of a social enterprise, and can take a great deal of time. The development of a social enterprise and the journey towards some kind of maturity can be long, hard, bumpy and full of challenges.

The broad phrases we have identified in the social enterprise journey are depicted in figure 6 below.

In the following sections, some key challenges and needs the enterprises in the study faced within each of these phases is examined. In addition, the findings from an analysis of surveys and financial statements which highlight some of the financial realities of the social enterprises are presented. Each section includes the following:

- the issues raised by the enterprises themselves;
- the issues raised by an examination of the financial realities of the enterprises;
- some initial analyses of implications of the above for developing appropriate mechanisms for financing social enterprises.

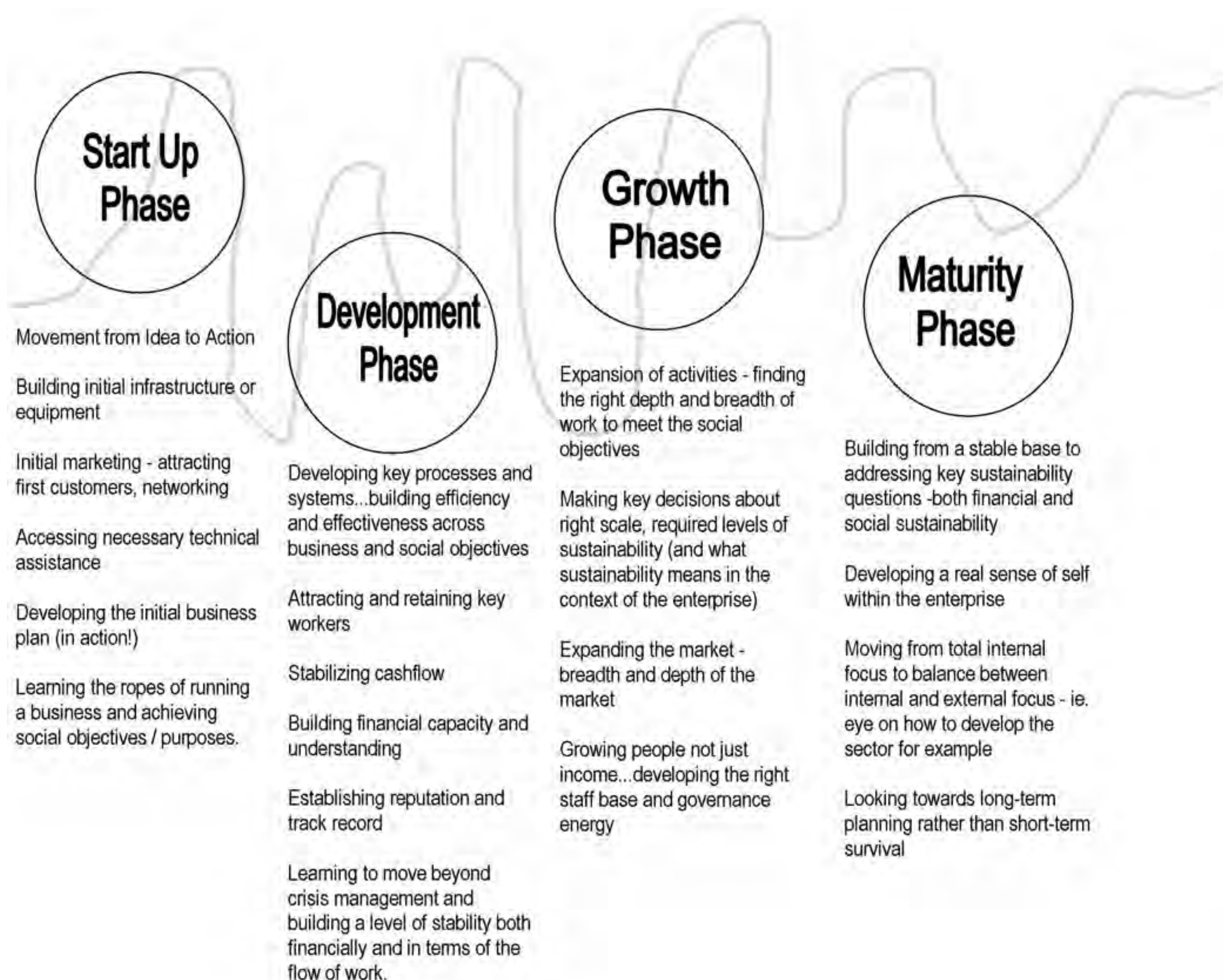

Figure 6: The Lifecycle Phases of Social Enterprise as they were identified in this research

Start Up Phase – Beyond Grant Cultures

Key Challenges and Realities
- High degrees of risk, sweat equity and personal sacrifice that goes into the start-up phase of social enterprises;
- Starting with the enterprising culture: the importance of starting well as an 'enterprise', developing an appropriate blend or mix of income for the social impact that is intended.

Key Needs
- Access to Start Up support and capital
- Better understanding of the lifecycle roles of grant, gift, debt and equity capital…as start-up is a very tricky capital raising and cultural exercise!
- Financial systems that separate and track restricted and unrestricted income.

The interviewees all told start-up stories that highlighted personal risk-taking and sacrifice – as the following example illustrates.

> *"We started with nothing, no one was prepared to give us any money. We had lots of interested and enthusiastic people but they weren't prepared to actually put some money on the line apart from a few people who (became our customers)…. I actually slept in the forest for a week because some of the money didn't come through straight away….(and) I wasn't actually paid for the first couple of years. Everyone else was paid – I think everyone started on $10 an hour, then $12 an hour and now we're all presently on $15 or $17 an hour. Then last year when we started to get a bit of financial difficulty and I had about $5000 in my bank account and I put $4000 into (the enterprise) to get us through Christmas".*

What was also evident was that this phase involved the greatest levels of struggle to obtain capital – in any form. Many of the interviewees cited the importance of loans from family and friends, or loans from the founders themselves. Sweat-equity was identified as an important component of the start-up phase, though few of the people involved expected to receive financial returns from this contribution (as they may if it were a commercial enterprise). A number of the interviewees also suggested that social capital, relationships and pro-bono contributions from people with particular skills were crucial in establishing the enterprises. The following quotes illustrate some of the challenges involved in finding the capital to begin the enterprises.

> *"We have had some personal loans from friends and family who have invested in us and given us some loans at a very affordable rate. And now in order to grow it and keep it going we have had to get a loan from my grandfather who is very generous. My mum and dad have helped us a bit as well because we have found it next to impossible to get the bank to loan us money. I guess we have put our own money into the (enterprise) in that we have chosen to be on a very low rate of pay. Our investment is the loss of the money that we would have had if we went and got a real job, or a normal job. But that is not more than any other small business. A lot of small business owners are like that, putting in long hours, working their butts off. We haven't come into this for (personal profit). A lot of what we have and what we have achieved is thanks to all the people who are with us along the way who believed in what we are trying to achieve and kind of help out at a lower rate and all the tradesmen who have helped us pretty much for cost or just helping out for free, we have had a lot of help to get to this because we are trying to do something significant in terms of social change"*

> *"So that we could start, I lent (the enterprise) $8000 and the NEIS program partially funded my wage. I knew I would be able to get it back, although I suppose it was a risk but it was just a risk I was willing to take. I would have kissed that money goodbye if we hadn't been able to continue, but that was okay, that was just a decision I made. I was fairly confident that I would get it back. I guess we also put a lot of time in. If you were calculating all of the money you are letting go when you could have been working elsewhere it would be a lot more than that".*

"(The founder) just got a lawnmower and a couple of pieces of equipment, got his own car together and started running around pushing contracts. He built up the business mostly on his own sweat equity so he did a lot of free work and he let that money go into the business to build its capital. It sounds like it was a bit of a hard slog but he pulled it off and I understand he did a lot of networking to build the business. He (also provided) a no interest loan to the business, to be paid back at a certain rate, monthly. And then of course obviously if the business is more profitable then he would like it paid back sooner."

The importance of organisational support was identified as critical for this start-up phase. Almost half of the enterprises spoke of the key contribution of the NEIS scheme in the very early stages which not only covered the wage of the founder, but also provided training and a supported opportunity to develop a business plan. Contributions such as a workspace or premises from which the enterprise could operate were identified by many of the enterprises as crucial, as were free or reduced cost ''back-end" services such as book-keeping. Some of the enterprises were developed out of larger social service or community organisations. In these cases the patient support of the 'anchor' organisation during early stages was identified as playing a key role in the longer term success of the enterprise.

A number of interviewees spoke of the difficulty of obtaining start-up grants or loans and identified a gap in capital for this phase of enterprise development. The following example illustrates this.

"There are huge gaps (for start-ups). Something like small no interest loans, like $5000 no interest loans would be fantastic sorts of products. For a lot of new enterprises that's easy enough debt – like you don't want to be going to more than $5000 especially when you are at the new enterprise stage but something that is under $1000 is not really enough to get very far. Also there is very little in the way of start-up capital in grant form for social enterprise and there actually is for small business. But for social and community enterprise they still don't really fit, but the government has a lot of start-up capital grants for small business so there is a real gap there (because) there is practically nothing around (for social enterprises)".

In Foresters experience this type of lending at such an early stage of an enterprises' development involved very high levels of risk for the financial institution or funder. Unless there are provisions to work alongside the enterprise to build capacity and offer technical assistance, then the failure rates of loans can be extremely high. Seed capital grants are also not readily available, probably for similar reasons. However there may be creative ways in which grants could be developed that may help to bring some greater 'discipline' into the process and prepare enterprises for other forms of capital by offering the opportunity to develop a financial track-record. Two such ways are outlined in the box below.

Matched Funds
The enterprise raises an amount of money as seed capital, which is then matched either through a grant or a gift. This could demonstrate that an enterprise has the capacity to raise money and make them more attractive to funders or philanthropists.

Planned Loans
Loan Capital that is linked with the development of a business-plan – where the loan is only given when the business plan is analysed and supported by an independent panel. The loan could also be predicated on a continued connection with the organisation who worked with the enterprise to develop the business plan. This model is used successfully in a number of places in the UK and the US (see for example, East London Small Business Centre http://www.goeast.org/).

The Grant Culture as a Distinguishing Feature between Social Enterprise and Social Business

Research internationally has found that any shift from grant to non-grant capital in the form of either debt or equity involves some difficult cultural changes in enterprises (see for example, Brown and Murphy, 2003). This is not to suggest that there should be any shift imposed on enterprises nor that any one form of capital is somehow better than other forms. They can each play a part for particular purposes and at particular times, and all have both strengths and weaknesses. However, there was some evidence in the interviews that certain enterprises had a preference for grant capital over other forms, and that there was a level of fear particularly about debt capital (and very little knowledge or understanding of equity capital – a point to which we will return in a later section).

> *"We are not so keen on debt. I guess I've got a personal aversion to not liking to be in debt. That is just a personal thing. I know it can be useful for your business in sort of technical ways".*

> *"I suppose I'm scared of going into debt when I'm not quite sure if our product is going to sell".*

There was an important difference here between those enterprises who talked about a definite preference for grant capital and those enterprises who identified themselves much more clearly as 'businesses' and saw grant capital as undesirable in terms of achieving their aims. The quotes below reflect the former position.

> *"Well to be honest we'd rather get a grant than a loan to buy the equipment because it is not easy at this stage of the business to get a loan and be committed to paying it off. So I'd love to get a grant rather than a loan. If we have to go to the loan then maybe not for all of it but only for some. And if it's a loan, then without interest or very low interest would be best. It would also need to be flexible. I'd also be interested in some help to smooth the cash flow – some bridging finance perhaps"*

> *"For the renovation to happen there was no way, if we didn't have access to those grants, that we would have been able to do the renovation. The renovation was really important for the business to continue to grow and to be open to opportunity and possibility and also we just would not have been able to generate the income, the way the business is run now, to pay for a renovation like that. And I doubt there is any financial institution that would give us a loan given what our general financial position is. Without access to those grants I think it would be difficult for the organisation to grow, we would just sort of be in the same spot where we were just managing and just getting by".*

> *"I think grant applications for (non-profit social enterprises) are probably the first option. And if that's not possible and the need is urgent, then you ask for a loan. The loan I think would have to be a fairly sizeable loan to warrant the effort behind it. Normally the lending institution would require some sort of security or guarantees from the directors of the management committee. So it would be for something that is fairly large and income producing".*

Some of the enterprises interviewed were very clear that grants were an anathema to their approach and argued that there was little place for grants within their businesses. The quotes below reflect this position.

> *"We actually have it written into our Constitution that we are not able to receive any ongoing funding for any of our operational expenses from Government or any other party, but we can apply for one off grants. But in terms of running the business we need to do that off our own backs".*

> *"Because money can tend to spoil you a bit, I'm really cautious about social enterprise (and 'free money'). I think that although social enterprises have an environmental and a social cost that they build into their plan as it were, we still need to stand beside a regular enterprise and say: "We did it and we incorporated these things without any real advantages, why can't you?". Whereas if we did it with a lot of subsidies they can say, "well you did it because you got support like (grants) and no interest loans". However that being said I recognise the need for different kinds of finance for social enterprise".*

This difference between enterprises points to a deeper distinction which needs further exploration. The enterprises that spoke about a preference for grant capital over debt capital were smaller in terms of turnover, earned less of their overall income and were more likely to be aligned or associated with a community or social service organisation. On the other hand, those enterprises that spoke about the need for a non-grant approach to their business tended to have larger turnovers, had a high degree of earned income and were independent businesses. In many ways this distinguishes social enterprise from social business (as outlined in the table below). Although many people are now using the terms interchangeably, there is some value in speaking of social enterprise and social business in slightly different terms based on the following traits/characteristics/ elements. Making this distinction can point to those 'enterprises' that are more likely to seek and obtain non-grant capital in the form of either debt or equity. It should be noted that these differences are not seen as definite or applicable in every case and are indicative only.

Characteristics	Social Enterprise	Social Business
Origins – where and how did the entity start?	Often started with a **charitable intent**, by people working from within the third sector who have an enterprising orientation.	Often started with a **business intent**, by people working from within the private sector who see an opportunity to create social impact.
Size / Scale	Usually smaller turnovers	Usually larger turnovers
Funding / Capital	Often have **blended funding** – some grant, some earned, the balance between the two shifts over the course of the lifecycle of the enterprise	Rarely seek or attract grant funding – much more likely to **concentrate on earned income** and commercially oriented capital.
Balance between social and commercial objectives under pressure	Tend to **skew more towards social objectives** if under pressure.	Tend to **skew more towards commercial objectives** if under pressure.

Table 2: Key differences between Social Enterprise and Social Business

If we were to categorise the enterprises included in this research across this distinction, there would be four of the enterprises interviewed that could be seen to be social businesses. They had a very different relationship to grant capital (having accessed very little other than for specific projects). In addition, they were much

more likely to have accessed some form of loan (either from a financial institution or in the form of a personal loan from family or friends). Finally, they also had in place much more sophisticated financial management and governance systems which would make it more likely that they could attract further non-grant capital.

The implications of a grant culture on long-term viability
Although there was some evidence in the interview data that social enterprise managers and boards had a level of fear about non-grant capital, there was also a recognition that grant and non-grant capital may have different functions within the lifecycle of an enterprise. So, many of the enterprise managers recognized that grant capital should not support the operational parts of the enterprise, but may be necessary to support things such equipment purchase in the start-up phase, or employee support costs when the purpose of the enterprise is employment of people who have experienced long-term unemployment. In examining the financial records of the enterprises involved, it is clear that some (particularly those who are employment focused) will need a level of grant or philanthropic funding, or a close support relationship with a partner community sector organisation, for long periods of their lifecycles. What is key to distinguishing these organizations as social enterprises, however, is that an appropriate mix of grant and non-grant capital, and of earned and grant income is planned for from the beginning their development. Given the diversity of purpose and impact of the enterprises involved in this study, there could be no definitive ''correct'' mix that could be generalisable across all enterprises. The appropriate mix would need to be based on an assessment of each individual enterprise, its purpose, its impact and its business model.

An examination of the financial records of the enterprises demonstrated that their verbal reports regarding percentages of different types of income were quite accurate (indicating a good knowledge of their financial position). Overall, as shown in figure seven, while a small number (3) of the enterprises remained over 70% grant dependent, most earned at least 50% of their income. Interestingly, most of the more heavily grant funded enterprises were, legally speaking, non-profit incorporated associations.

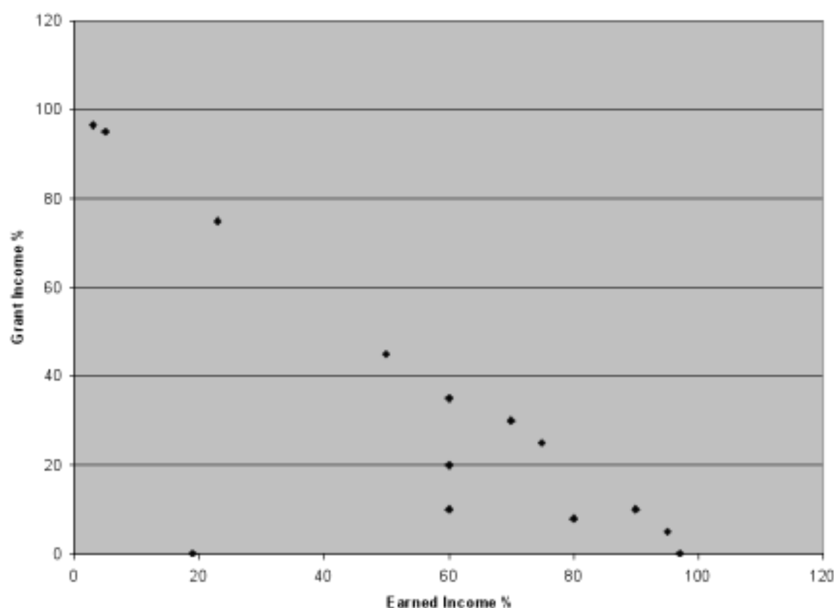

Figure 7: Percentages of Earned and Grant Income as Reported by Social Enterprises
(note: some of the enterprises received other income apart from earned and grant, so not all the figures here represent 100% of the enterprises income).

While it is not possible to draw any generalisable conclusions from this (because of the very small sample size of enterprises engaged for this research), it could signal potential cultural and structural legacies of utilizing legal structures that are predominantly of the third sector. These organisations have necessarily developed around grant funding and it is possible that using these legal structures within the context of enterprises, could make it more difficult to develop cultural and structural strategies which lead towards greater levels of earned income. Further, in examining the work of the three organisations in this study that are most reliant on grant income, there could be arguments made that they are more akin to enterprising third sector organisations than social enterprises (although they all currently self-identify as social enterprises and have received support as such).

Development Phase – Towards Viability

Key Challenges and Realities	**Key Needs**
• Challenge of managing cash flows • Building financial capacity • Balancing social and financial objectives • Acknowledgement of blended value, income and costs	• Importance of working capital • Linking capacity and capital: how do social enterprises build financial capacity? • Transparent and real documentation of costs and impacts.

As enterprises begin to establish themselves and earn income, other challenges start to emerge. For many, managing cash flow highlights the importance of securing regular sources of income and developing robust financial management systems. In addition, the key differences between managing a social enterprise and a commercial enterprise can often generate some tensions at this stage when the pressures of meeting both social and financial objectives start to build. Finally, for many managers and key workers the development phase signals or reinforces the need for adequate financial management skill and capability levels within social enterprises. Each of these challenges of the development phase of the social enterprise lifecycle are examined below.

Managing cash flow:
One of the key challenges of the development phase is that of managing cash flow (and for some enterprises this continues to be a challenge across their lifecycle). The examples below highlight some of the difficulties managing cash flow.

> *"I guess managing cash flow is the biggest issue. ….The cash flow fluctuates a lot. And it's been getting worse with the way customers pay. A lot of customers have decided to go on a one-month pay cycle, so we'll do the work for the month and will get the money so we will have a lot of money at the start of a month and in the middle of the month it will just be all gone. And then it will top up again when we get to the end. … We pay the workers fortnightly and so if you come to the middle of the month you have to pay the wages even if you haven't got the money for it. That's the biggest issue".*

The results of very lumpy cash flows can be quite dramatic – particularly in the enterprises that are employment focused and where wages are the core costs. Some of the potential consequences are expressed in the following excerpt.

> *"We try to adjust ourselves with our cash flow problems but it is really very hard (because) of course the highest expense is paying of wages… and what we have to do if our financial situation is not healthy, is to cut down on employment – maybe some hours, maybe some staff, which is very hard. The staff really want to work and of course with the economic situation not being good, rent being very expensive and everything on the increase that is hard – but people still really want to work. So sometimes you have to say 'that's enough hours for today' or 'don't come today, or go because we don't have enough clients' and that's hard.*

In order to address the issues of lumpy cash flows, enterprises resorted to a number of tactics, including using and paying back restricted capital (ie. grant money) as a stop-gap measure, and lending money from key workers or managers, as is illustrated in the following examples.

> *"At one time early on the payroll used to be about three and a half thousand dollars a fortnight and we didn't have that much money in our bank and (manager) was like "where are we going to find this money from? We need to pay people's wages". Apparently there had been some grant money that was coming through that they were able to push to come through quicker and of course that money wasn't supposed to be used on wages and it was paid back, but it helped to get us through at that time. And so it's things like that where you have to get a little bit creative (with cash flow issues)".*

"There has been once or twice when I have had to make my own personal loan to the business just to cover up a few times when we have close to dipping down, and it's written into the books as my personal loan to the business….I guess they are like stopgap measures, but if I didn't have those funds there then I guess we would be in a lot more trouble trying to finds out other options. We pay the workers fortnightly and so if you come to the middle of the month you have to pay the wages even if you haven't got the money for it. That's the biggest issue".

"Not so long ago our cash flow was really low because we had a really outstanding invoice, that had never been paid and so it just sort of caught up with us. We realised that we might get so low that we might not be able to meet a $10,000 wages bill that was coming up in the next week. I happened to be in the position of having quite a large amount of money in my own account and so I just lent (the enterprise) $10,000 for two weeks. Then we got the other money and the $10,000 got given back to me again. So yeah sometimes it is a little bit creative. Lucky I just happened to have money sitting in my account. It has happened before… another director has lent (the enterprise) $5000 and had it paid back to them in a month".

A number of social enterprises identified the need for working capital in the form of overdrafts – that is, capital that can help to smooth the cash flow until monies from jobs and contracts is paid, as discussed in the example below.

"We get paid quarterly for our contracts with the (procurer) and we get paid in arrears – and so sometimes we might be waiting for that quarterly payment from the (procurer) from the work and the bank balance is pretty low and they can be stressful times in terms of how we are going to pay wages, and we have suppliers getting cranky because we haven't paid our bills. So something to tide us over till we get the money for the contracts – which will come! So having $20,000 as a backup would be good if we needed it".

One enterprise had negotiated an overdraft from a mainstream financial institution but the other enterprises had either: tried and been rejected for such a facility; or not tried because they knew they would be ineligible; or had an aversion to any kind of debt capital, as expressed in the examples below.

"We looked at an overdraft a year and a half ago when cash flow was an issue every month. And it was really difficult for us to get that kind of facility with our bank. It was a really painful process and because we're not for profit we had limited equity really because we don't have a lot of things that we can secure that kind of thing against and then it came down to did individual directors want to put their house against it, probably not. So we just muddled through it really. The overdraft was too hard, so a few people personally put up the cash. I mean we gave it back within the space of a week, but it was just easier than having to do that through the bank".

"(When we have cash flow issues), we try to explain the situation (to our staff) that we don't have the money and we don't want to risk ourselves to borrow for paying staff because it's not really a good way to run a business".

The enterprise that had applied and obtained an overdraft facility commented on how expensive the facility was (they paid a broker to organize the facility and were charged interest rates that were close to credit card rates). They used this only as an emergency measure to ensure that suppliers and wages could be paid when cash flow was problematic. Their long-term goal, however, was to reduce the need for such a facility and/or to seek cheaper forms of capital for this purpose.

Not all the social enterprises projected and planned around how to address lumpy cash flow periods. However, a number of enterprises identified that times of cash flow crisis had triggered a much greater appreciation of using tools such as cash flow projections to avoid difficulties into the future. The example below highlights how such projections can help to inform future decision-making and planning.

"We do cash flow projections. It's probably one of the most important things we do. We do the cash flow projection, and mostly it is updated every week looking into the future at least a couple of years at any one time, and take account of all our expenses. Our expenses tend to stay fairly static, they don't change that much. Our biggest cost is wages, that changes but normally we have a fairly basic set of expenses like services and insurance, rent and running costs. We manage our cash flow issues by making sure we have enough assigned and not paying wages that would cause us to run out of money basically at the end of the year. That gets updated more or less weekly to check on our cash position. That may seem a bit excessive but it was born out of a time when we used to have to do that in order to make sure we have enough money to pay the wages next week"

For most of the enterprises wages constituted a significant percentage of costs (between 40% and 70% of the overall expenses) – even if the focus of their business was not employment. The biggest concern for these enterprises from a cash flow perspective was ensuring that the wages could be paid promptly and regularly. All the enterprises identified the need for some form of capital to address lumpy cash flows, but many did not think the instruments currently in place were appropriate or accessible to social enterprises. However some interviewees identified possible stepping stones towards mainstream working capital in the form of things such as:

- No interest or low interest working capital (in the form of overdrafts or standby facilities);
- An overdraft with an interest and fee holiday – where, for example there is no interest or fees for the first two years, but where in 2 years time ½ the capital changes to a grant, and ½ converts to an interest bearing loan;
- A patient overdraft with interest rates, fees and conditions structured in such a way as to suit the needs and realities of the enterprise, with an expectation that the capital would be retained and repaid over the long-term.

What is clear from examining the financial reports of the social enterprises, is that cash flow represents a significant issue and that current instruments and structures are either largely inaccessible or inappropriate to their realities.

Developing financial capacity / capability

As the enterprises have developed most of the key workers or managers identified the need to improve their skills and knowledge of the financial aspects of the business. In the surveys they rated their current skill levels in relation to financial management. Out of a top score of ten, the respondents rated their skills in the range of three to eight – with the majority clustered around five out of ten. The higher scores tended to come from respondents who were from social businesses rather than social enterprises. None of the interviewees came from an education background that included financial management.

"Generally I don't think the social services sector is always good when it comes to strong financial management and we attract very talented people but they tend not to have that background or skill set".

Nearly all the interviewees spoke about learning "on the job" or out of necessity, with gradual improvements in their capabilities over time – as the following excerpt suggests.

> *"I guess the financials is the sort of thing I know the least about. I guess that people who have been there have been able to help here and there. But I know there's a lot more details and information that it would be good if I could get hold of. But I figure that will come. That's the way things have been working out so far… I understand the finances reasonably well now. I know that some people would look at them and see a whole bunch of issues jump out from the page. I'm not in that position yet but I can see more clearly what is going on. Looking at them now I can sort of understand how the different accounts interact with each other and what the profit and loss statement actually means as well as the balance sheet so I'd say I'm average with it now as opposed to completely crap!"."*

Some enterprises spoke of the importance of financial management training and mentoring. Others indicated that while they themselves did not have a high skill level in relation to financial management, other staff or board members did – and that the combination of financial skills and vision was critical to the success of the enterprise.

> *"There are two of us who have been involved – neither of us have a business head. Then we found a third person who was very committed to the idea and had the business head. But … he doesn't have the time any more. He had the business mind that we depended upon. So since that unavailability, that has kind of dislodged us. The good side of that is it has prompted us to recognise that we need to reshape ourselves, to choose carefully the new members of the board and ensure that we meet regularly."*

> *"On the board of directors, there has been a fairly consistent sort of spread of abilities. … I guess the major impact it has is that there are only one or two or maybe three people at best who can assess the financial position and think strategically to create how the financial position might be improved or work for us better. I suppose I feel like the extent to which you know how a business runs is heavily dependent on how well you know the finances. I think it certainly has had an impact in the way or the extent to which individual directors have fully understood the business."*

> *"Our board members now have quite a high level of financial skill and one or two staff also have a high level of financial expertise. I don't think that translates yet across the whole organisation. I think the impacts are being felt in a positive sense."*

Many of the interviewees suggested that in the early stages of the enterprise's development there were tensions as to how much time was spent on the organisation's financial management, and also how much emphasis was put on developing the skills needed to undertake such management. Particularly when there were so many other pressures involved in establishing a social enterprise. All the enterprises, however, had experienced first hand the effects of 'taking your eye off the business' and as a result recognized the need for continual improvement of knowledge and skill around financial management.

The demands of balancing social objectives and financial outcomes

While building the financial capacity of social enterprise managers is often cited as a key task in the enterprise field, it is important to understand this in the context in which social enterprises operate. The demands of balancing social objectives with generating positive financial outcomes is unique to social enterprises and distinguishes their business models from those of a commercial business. For example, when a social enterprise is focused on the employment of people who have

previously been excluded from the employment market, there are often very high support needs which need to be incorporated into the business model. This is illustrated in the excerpt below.

> *"We don't really make that much money. It's always pretty tight around here. Last financial year I think we made a $2000 profit, which was pretty good. I think it's difficult. Our wages expense overall is probably a lot higher than a regular business would be. The people who we employ here and the level of supervision that we provide – in a business this size you could probably run it with four people but we have 21 on our payroll, plus we're employing a supervisor and worker – so we're paying extra for all that".*

In addition, many of the enterprises were focused on industries that are traditionally lower profit businesses and/or that have lower barriers to workforce entry (such as cafes, repair, maintenance and landscape businesses, food distribution and construction businesses). This means that it is difficult to generate large profits even in a mainstream environment, let alone when the business is operating with a social purpose.

What this highlights is the need for an understanding of both the ***blended value*** (Emerson, 2003) created by social enterprise, and the need therefore, in some cases, for continued ***blended income*** (that is, some form of reduced cost capital that will enable those enterprises who have high social impact to subsidise or offset the support costs inherent in achieving such impacts). Further, it is not just income that can be 'blended'. The enterprise manager below identifies the contribution made by grants to the development of assets (in the form of equipment) but also the contribution made by reducing costs (such as having access to free or subsidized space) in order to maximize the enterprises opportunities for creating impact.

> *"Without the assets that we have, we wouldn't be able to run the nature of the enterprises that we do. Through owning key machinery and equipment that we have outright, we don't have to have a consideration for paying loans back, so pretty much whatever comes in through our (procurement) contracts with the council or through our takings (in the enterprise) can be used solely for the day-to-day running of the business. Which is helpful considering that we don't have a great reserve of money. Having the space that we are able to run the (enterprise) from, and without paying rent for the space…. just means that there is a lot of security for us to develop the business knowing that we've got a secure position in the place where we operate".*

Once again, however, it is important that such contributions be carefully assessed in terms of the overall financial viability and sustainability of the enterprise over time. From the perspective of a financial institution, if there are key costs that are not documented in financial records there are likely to be questions asked and assumptions made. It will be important for support organisations and intermediaries working with social enterprises to find ways to ensure that documentation and financial records can reflect blended income without compromising an enterprise's potential to access a range of capital. This is further explored in part three of this report.

Growth Phase – Building Strength and Impact

Key Challenges and Realities

- Managing the bottom lines and building ethical organisations, inside and out
- Ensuring there is the equipment and infrastructure to build growth

Key Needs

- Growth Capital: but what does it mean and what does it look like?
- Debt and Equity capital in different forms

Each of the enterprises identified the need for growth not only to improve their financial viability but also to increase their social impact and their capacity to develop their workforce. Though there were some enterprises who clearly had begun to think of growth as a distinct part of their lifecycle, others identified developmental growth as being a critical part of the whole lifecycle of the enterprise. Many of the enterprises identified the challenges inherent in growth - particularly when it is difficult to find growth oriented capital. The following excerpt illustrates some of the dilemmas, which are further explored below.

"In order to build the business we have to grow but the growth actually hits up against our capacity. But in order to build that capacity we have to grow. It's like we are chasing our tail. So our biggest challenge has been our growth. If we grow too quick for us to restructure or build capacity then we've got the cart before the horse. Because we need that money from (increased sales) to put capacity in behind, when we really should be putting capacity in front of the business, in order to support that growth. So we are continually taking money out of the front of the business in order to put it in behind but we need to keep growing to have that money there, so it's really.... Yes so the cart has really been in front of the horse all the way through".

Growth as an Internal Development Strategy

For many of the enterprises growth was seen as a means to build the internal strength and capacity of the organisation. For example, some saw it as a way towards paying living wages, as the following quotes suggest.

"Growth is important for us at the moment because we are not at the stage where we can afford to pay a realistic living wage, which makes it obviously very difficult to attract and retain staff. You certainly couldn't expect to join (the staff of the enterprise) and at some stage in your career there expect to have a family and buy a house without your partner or some other source providing most of the money. So we would like to get to that stage, and that is very important. It is one of our major goals".

"We are set up as a not-for-profit organisation, so if we start making a considerable amount of money and a profit, that money goes back into the business according to the objectives of the organisation. (We would consider) the opportunity for people working for the organisation to look at increasing their wages and that sort of thing"

Many of the enterprises identified the possibilities that growth could bring for improved wages and conditions for staff, but also increased opportunities for impact in relation to their social purposes. All shared ideas for how some form of growth capital could help them to diversify their businesses and thereby increase the impact that they could generate. For example, one enterprise whose focus is employment spoke of how a diversified program could allow them to address seasonal variations

in work and therefore enable them to provide more stable hours of employment across the whole year.

> *"One of the biggest issues that we are trying to address is the downtime in winter when it is really dry and the work also dries up and that has consequences for the (workers) in terms of how they spend their time and their mental health. So we have been trying to come up with different types of work. We have quite a few things that we are interested in looking at and researching that basically involves different infrastructure. A nursery business for instance would require some land and various equipment and so on. So we are looking at any other future projects that require different equipment and so on. So (we know that) getting finance will be an issue. We've always got funding applications out there but you never know if you're going to get them. If we did have more of a cash reserve and savings we could start … making moves to doing that on our own without being reliant on being accepted for a grant. Whereas at the moment we just sort of get by and we run the business as it has been. But if you had more cash flow and more money in the reserve you would start thinking about what those things are that you wanted to do, and not be limited by having to wait for some money to come"*

Income, Surplus and Growth

The relationship between income and growth was highlighted in a number of interviews. Given that the surpluses generated by the enterprises are generally very modest, there was often little money that could be used to grow the businesses. This has the potential to develop into a negative cycle in some enterprises because, as identified in the quote above, increasing income is reliant on adequate levels of capacity (staff and equipment) and equally, the ability to build that capacity (ie. attract and retain staff and purchase equipment) is reliant on adequate levels of income. This is poignantly illustrated in the quote below.

> *"(For quite a while) we had a very ageing second-hand ute. We were limited as to how many people we could take out on jobs, and we were limited with the machinery that we had to our capacity to (do the jobs). So it was very difficult to request further contracts from the (procurer), it is very difficult to say to the (procurer), "We can do this work", if you don't actually have the machinery to be able to fulfill the contract that you have requested or tendered for".*

Other enterprises spoke of the impact of having been forced to build their enterprises with second-hand equipment, which was fine for the early stages of their development, but was counterproductive to building any kind of growth.

> *"One of the problems we have is that most of the equipment we bought is second hand. Now we are struggling when we have big nights. To have some modern and new equipment of course would be great. Some of the second hand equipment is already broken. And when you ask about the new ones it's big money because it's commercial, but having that will be important for developing our business. I'd say we need around $30,000 to update our (equipment)."*

> *"With capital we could buy new tools and better tools so the guys can do a more efficient job and feel more comfortable. Because at the moment they are out there working with some crap stuff. It's just old and worn out".*

The vicious cycle that the enterprises identified between continued low levels of surplus, poor equipment and reduced capacity for growth is illustrated in figure 8 below.

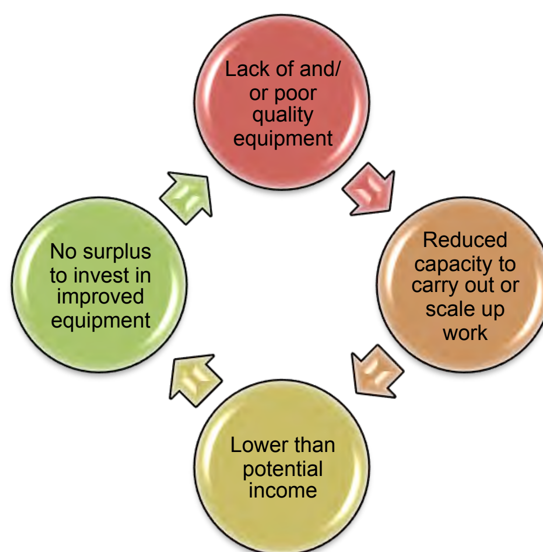

Figure 8: A Vicious Cycle of Income, Equipment and Growth

An examination of the financial statements of the enterprises indicated that many had generated either very low or negative returns over the past three years, making it difficult for them either to invest in the purchase of new equipment, or indeed service loans for such purchases (see table three below for a summary of the profit/loss of four of the larger enterprises). Given that some of the enterprises had experienced losses in one or more of these years, however, it does indicate that there have been reserves or savings generated at some point which have created a buffer for the enterprises.

Social Enterprise	2008	2007	2006
1	n/a	3,800	6,580
2	49,300[4] total (36,300)operating	44,442 (1,130) operating	11,096 n/a
3	3	(55,000)	15,000
4	(38,000)	12,970	n/a

Table 3: Profit / Loss of four of the larger enterprises in the sample over the past three years

The impact of low surpluses or deficits over time is that it becomes difficult to develop the net assets of the enterprises. This in turn leads to difficulties in building long-term sustainability. Though some of the more established enterprises had reasonable net assets (of over $50,000), there were others whose position was much less positive, indeed some seemed to be quite precarious and teetering on insolvency (at least according to their financial statements). Others indicated that there was a degree of confusion between revenue and surplus, with the former including restricted income

[4] This includes some capital grants, which could not be included in any establishment of whether debt capital could be serviced

and not providing an indication of whether the enterprise could actually service a debt. Some saw the ability to build their net assets and savings as a long-term or even an improbable proposition - as the following quotes indicate.

> *"We need all the money we make – you can't save (in a business like this)!"*

> *"We don't have any savings at the moment. It's not in the business plan either. The idea now is that we generate enough cash to deal with our debts, look after our equipment, increase the capacity of the business. So we're only at the stage of looking at how we address our cash flow – so working up to having three months worth of wages is the goal now so that we can always pay out and not have to worry about cash flow issues. But we are not there yet. To make it happen we are changing our services, putting the prices up and increasing our cash flow through. We are tightening up the ways we pull up our debt and overdue accounts and increasing the volume of our work, and doing more profitable jobs."*

What this indicates is a potential dilemma for many of the enterprises - a catch 22 situation in which both cash flow and profitability are precarious and which therefore make growth simultaneously necessary and very difficult if the enterprise cannot access grant capital. As one enterprise manager highlighted, grant capital can often provide the only avenue for building up the infrastructure that is needed.

> *"Just recently we've finalized spending of the largest grant we've received ($100,000 from a foundation). Obviously that amount of money as a grant is going to have a pretty big impact on the organisation. (We used it for improvements, renovations, vehicle and equipment purchase). For the renovation to happen there was no way, if we didn't have access to those grants, that we would have been able to do the renovation. The renovation was really important for the business to continue to grow and to be open to opportunity and possibility and also we just would not have been able to generate the income, the way the business is run now, to pay for a renovation like that. And I doubt there is any financial institution that would give us a loan given what our general financial position is. …Without access to those grants I think it would be difficult for the organisation to grow, we would just sort of be in the same spot where we were just managing and just getting by".*

If, however, the capital needed was not for assets such as equipment or improvements to assets, but rather for ''soft'' development such as attracting more qualified staff or developing the skills of current staff, then such grant capital may not be readily accessible or appropriate. Options for this sort of growth capital beyond building up internal surpluses are currently few and far between as they reach into the arena of equity and equity-like financial instruments. Some of the enterprises had themselves recognized or experienced this difficulty and had developed some strategies in order to refocus their work to ensure that they built strong enough foundations in order to grow if and when they needed to. The following quote illustrates this perspective.

> *"We've been through a very heavy growth phase in the last five years I reckon and in reality we got too big too quickly and around the end of last year, the mid-to-end of last year, we shrunk that a fair bit actually. … we almost halved the core staffing in almost 6 months. In terms of growth I guess our goals aren't so much focused on growth (now), they're very much focused on consolidation and surplus…. (So that) in coming years (we can) continue to build that surplus so as we decide to grow or not we've got a bit of a base to do that".*

Maturity Phase - Towards Sustainability

Key Challenges and Realities	**Key Needs**
• The realities of sustainability…do multiple bottom lines mean multiple forms of sustainability • Impact of weak balance sheets on sustainability	• Large asset development for long-term sustainability • Understanding what sustainability means in the context of the enterprise

All the enterprises in this study continue to address issues identified above as relating to the development and growth phases. Only one[5] was seriously examining the purchase of large assets in the form of their own premises (in conjunction with a number of other organisations rather than on their own). When asked to assess their enterprise in relation to its financial sustainability, most rated themselves between 4 and 6 out of 10. Though overall this would probably be a relatively accurate assessment across the enterprises, what was highlighted in the interviews and surveys was the difficulty of accurately and wholistically assessing sustainability in the enterprises. There is a need to understand more fully what sustainability means in the context of social enterprise. In the interviews four different dimensions of sustainability were evident:

1. **operating sustainability**, which focused on the adequacy of cash flow, liquidity and solvency;
2. **financial sustainability**, which focused on achieving adequate levels of surplus or profit;
3. **balance sheet sustainability**, which focused on building up equity or net assets and savings of the enterprise;
4. **social / impact sustainability**, which focused on building the enterprise to the point of being able to sustain its impact in relation to its social purpose.

These dimensions of sustainability were not directly named by enterprise managers, but were inherent in descriptions of what sustainability meant for them in practice. The first two dimensions were most emphasized (particularly in those enterprises who had difficulties with cash flow adequacy and generating surplus), as the two excerpts below indicate.

> *"To have a really sustainable business running we need to reach about 2 1/2 thousand dollars daily income. This last two weeks we are around 60% of that. I hope we can continue like that".*

> *"Sustainability (for us is about) surplus. So our goals are really about lets have some surplus at the end of this financial year, …but at the very least lets make sure its better than break even".*

Interestingly all the enterprises (even those whose income was largely grant based and those who were a long way from achieving operating or financial sustainability), spoke of their long-term goals to build balance sheet sustainability by purchasing assets such as their premises, farms, land or houses.

> *"We have a dream of having a location, a sign above the door and a staff member to answer the phone – and that dream is still there but it's sort of bruised and battered from the few years of experience – and then there's our uneasiness with the current financial markets and whether our project is relevant".*

[5] Under the previous distinction, we would classify this entity as a social business rather than a social enterprise.

Only a couple of the enterprises had started to work towards this goal by setting aside savings or starting a building fund. However it was a long-term vision for all, and formed a part of their understanding of sustainability - as the following excerpt illustrates.

> *"We are looking at taking a long term view and (owning assets) where we can gradually build up our equity in it for our own …sustainability, and that is a different thing altogether".*

None of the enterprises examined could currently independently hold debt capital that would allow them to purchase this sort of asset - however, a small minority of the enterprises could develop assets in a shared capacity, and others certainly have the potential to build their balance sheets over time (particularly those that we would classify as 'social businesses'). It is encouraging to see that the vision of asset building is present in so many of the enterprises, and that there is an understanding of the importance of balance sheet sustainability over time - even if there is little balance sheet sustainability in most of the enterprises currently.

Finally, though some of the enterprises had been taken through at least one social impact measurement process, only two of the enterprises had invested in ongoing measurement as part of demonstrating their impact sustainability over time. Although all the enterprises spoke extensively about their impact as being the core of their businesses, the current measurement models of impact were not embraced either for financial reasons or because there was little faith that the models represented actual impact.

> *"We don't report on (our impact) to any great extent. It sort of all happens in an informal manner. We exist on very limited resources, we do all the basic things that we can in terms of sustainability but we don't really report, we put out a director's report which accompanies the annual report, which goes to (The Office of) Fair Trading but it is really just a token perfunctory thing. I guess that's one of the things that we probably would have done more of in the past and it was one of the things that got the chop in favour of us generating some sustainable income".*

> *"That is an issue in terms of using (an agreed to impact measurement), in terms of uniformity so that people can understand how these sorts of impacts are being measured, and it would be interesting if there were some other kind of products around to do that. And really it would be good if it was just something free on someone's website so that community groups could use it".*

Use of Debt and Equity Capital

Access to mainstream debt or equity capital amongst the enterprises was limited. Two of the enterprises had accessed capital from finance companies (one for the purchase of equipment and one for a business credit card). The managers of these enterprises understood that the costs and conditions of this capital were onerous and that it was much more expensive than bank finance. However, they also identified that there were actually few alternatives on offer for them, which was both frustrating and had an ongoing impact on the financial management of the enterprises. The excerpt below identifies one of the difficulties.

> *"I know my bank manager, she knows me and my record in business. I have had business loans before but they were all for-profit businesses. When I went and asked for a loan for (the social enterprise) she told me 'no way'- it's a non-profit and there was no way on earth, no matter what I said that we were getting a loan".*

According to these interviewees, the finance companies were:
- more accessible;
- their due diligence was more conducive to the structure of the enterprises and more open to their lack of a track record;
- they were not as concerned with securing the loans; and they
- offered much faster options than banks or credit unions.

> *"Well, the time – the time to approve something was a lot quicker with (the finance company). Whereas with (the Bank), they wanted to tick a lot of boxes and I didn't have the time or the financial capacity, knowledge, within the organisation to tick all of those boxes. So time, they just wanted a lot of info, whereas (the finance company) just wanted the bare bones. How's the business travelling, can it repay itself? Basically it was a low document loan".*

Examining the realities of these loans and the conditions under which they were offered provided a great deal of food for thought about the financial strains of operating and growing social enterprises, the financial pressure that the managers had to put themselves and their enterprises under and the large gap in the market that exists for fair, reasonably priced capital for growing social enterprises[6].

When asked about equity capital only one of the longest standing enterprises indicated that they had knowledge of the opportunities this provided. There was a decided lack of knowledge about equity or its functions and an even greater level of suspicion and fear of this sort of capital than there was around debt capital. In addition, an examination of the financial statements of the enterprises over their lifetimes suggested that, even if they had legal structures that could accommodate traditional equity investments, none of the enterprises would currently look attractive from a traditional investors perspective. Though equity-like instruments may present some possibilities, there are very few current options available and a high degree of education and awareness-raising would need to take place in order for demand for such products to materialize.

[6] To protect the identity of the enterprises involved we have not included detailed information about these capital products. Suffice to say that the interest rates were considerably higher than bank finance, and that the conditions, should there be any defaults, would put considerable financial pressure on the enterprises involved.

Summary of the financial needs and realities of social enterprises

It is clear from the research that social enterprises have different capital needs at different stages of their life cycles. Further, the life cycles of social enterprises are not as clear cut nor as smooth as some models have indicated. This means that social enterprises may need support and hybrid models of capital as they transition across phases of their development.

The extraordinary journeys involved in the establishment and development of the enterprises in this study should be acknowledged. Often their development has involved both personal risk and sacrifice on the part of both managers and workers. The issues involved in exploring how these enterprises can become more sustainable and how they can be capitalized over time are not by any means simple, and we should avoid adopting patronizing and simplistic formulas such as "more business training is the answer". What are needed are solutions that are relational, that build from the strengths that enterprises have developed and that recognise that social enterprises are often synthesized organisations, and therefore may need synthesized solutions. Figure 9 provides an overview of some of the core stages of development and links this to the financial capital needs of social enterprise.

Start-up Capital and Seed Capital:
There is a need for start-up capital that is structured in such a way to ensure that enterprises, in whatever ways they can, have opportunities to develop beyond a grant culture from the start. There is, however, also a need to recognise and accept the differences amongst social enterprises, with some always needing some forms of grant or gift capital in order to achieve their social impact[7].

Fixed Asset Capital:
There is a need for capital to purchase fixed assets over the course of an enterprises lifetime – at the beginning these assets are small and focused on essential equipment. Many of the enterprises identified the negative impact of poor quality equipment on their business development. Although some enterprises had managed to obtain grant capital for these purchases, it was also identified that debt capital for purchases of new equipment may be appropriate. It is important that such assets support the development of the enterprise and help to build its viability and sustainability.

Working Capital:
Currently there are few options available for social enterprises to access real, rigorous but fair working capital (in the form of overdrafts or standby facilities). This is a necessary form of capital identified by many of the enterprises to help to deal with lumpy cash flows, without resorting to accessing the personal funds or finances of individual managers.

Growth and Development Capital:
This capital need was also linked to asset development (in the form of equipment needed to grow the business of the enterprises) but also to 'soft' development agendas such as attraction and skilling of staff. The dilemma of precarious cash

[7] It is also important to understand how asset development can support the development of social enterprises themselves – so, a number of the community organizations who have started social enterprises in the Brisbane region have done so as a consequence of engaging in asset purchases and using this to build the enterprises that have an impact with their constituents.

flows and poor profits highlighted a key dilemma for social enterprises - the necessity and simultaneous difficulty of accessing growth capital.

Sustainability and Consolidation Capital:
Over time asset purchases by enterprises can become larger and can help to build the balance sheets of the enterprises, therefore supporting the development of financial sustainability.

Finally, the analysis of interviews uncovered some of the signposts for developing appropriate, fair and sustainable capital options that meet the needs of social enterprises - including the following:

Restructuring Financial Information in Social Enterprises:
There is a need for some rethinking about how the accounts and financial statements of enterprises could be structured to ensure that they recognize the realities (for some enterprises at least) of blended income but also clearly illustrate the business viability of the enterprises (particularly for debt and equity capital). At present it is very difficult to transparently assess the financial realities of social enterprises. While each situation needs to be assessed on its merits, some kind of framework that could unpick and distinguish support costs, in-kind contributions, restricted and unrestricted income could reduce the transaction costs involved in building a clear financial picture of social enterprise.

Developing Real and Rigorous Non-Grant Capital Options:
There is certainly a need for non-grant capital for social enterprise - however, it is very important to ensure that any capital (grant, gift, debt, equity) is actually structured with the long-term viability and sustainability of the enterprise in mind. There are clearly things that are not appropriate to fund through some of these instruments, and anyone involved in structuring finance or granting to social enterprises should be very mindful of the issues surrounding each of these forms of capital.

Building the Financial Capability of Social Enterprise Managers
There is a need to ensure that financial capability is built in and around social enterprise (not only focused on the capability of the enterprise staff but also of financial institutions and intermediaries) in order to ensure that the role of capital in all its forms is fully appreciated within the sector. There is also a need for rigorous analysis, debate and discussion around the difficulties and realities involved in balancing social impact and financial outcomes. This may be helpful in building a clearer picture of what financial instruments best suit particular life stages and purposes within social enterprises.

These signposts will be further examined in the next part of the report.

Figure 9: Financing Social Enterprise Across the Lifecycle: Different Capital Needs for Different Phases

Part Three: The Challenges of Financing Social Enterprise in Australia

Part Two has outlined some of the financial needs and realities of social enterprise and explored the challenges of these realities from the perspective of the social enterprise managers. Part Three turns to what the key challenges are for financial institutions in finding ways to meet the needs in the context of the financial realities of social enterprises. The major challenges examined here are:

- Understanding and accepting the real costs of social enterprise;
- Coming to terms with the strengths and limitations of the legal structures of social enterprise;
- Connecting up capacity and finance in appropriate and helpful ways;

Each of these challenges is examined below.

The Real Costs of Social Enterprise

As a financial institution one of the major challenges we have faced when examining the financial records of many social enterprises was actually determining the viability of these businesses and their capacity to repay debt or generate investment returns from the financial statements they provided. Many of these statements seemed to be missing information that would typically appear on the statements of a small business or a charitable organization, and/or contained unusual or irregular items that were difficult to understand. Some of these issues are outlined in Table 4 below.

Challenges identified in SE financial statements	Impact for accessing finance
Inclusion of grant or restricted income in surpluses without indication that this was the case;	Grants and restricted income cannot be used to repay debt. Not documenting a separation between operating surplus and total surplus can present difficulties for lenders.
Not including grants paid in advance in liabilities;	Makes it difficult to assess the actual liabilities of an enterprise and to easily distinguish what represents restricted money at a given point in time.
Not indicating in the accounts or in notes accompanying the accounts that there are important costs that were covered in-kind or waived by support or auspicing organisations	Can lead to misunderstandings on the part of financial institutions when they cannot easily see how key expenses that they would usually expect to see in business accounts are being met.
Inclusion of irregular line items in the accounts - such as "sweat equity" on the balance sheet	Can sound alarms for financial institutions and mean that enterprises are dismissed as entirely irregular or too unusual for mainstream capital options.
Structure of the balance sheet suggesting technical insolvency	Would make it highly improbable that any responsible lender or any investor would consider capitalizing the enterprise.

Table 4: Impact of Anomalies identified in Financial Statements of Social Enterprise

One of the key issues facing social enterprises in accessing finance is a full acknowledgement and transparent reporting of the costs involved in the social enterprise. A social enterprise, by its very nature, often has all the costs involved in operating a traditional small to medium sized business **in addition** to a set of costs

that could be termed its impact costs. The latter costs are not widely recognized in social enterprise literature - however they are evident in the financial statements of all the enterprises examined in this study. Impact costs are those that are incurred in order to achieve the social, environmental, or cultural impact of the enterprise (which are not incurred by traditional businesses), which may include things such as supporting the participation of employees who have experienced long-term unemployment; paying extra to ensure that produce is fairly traded or organic; or recycling / using materials that traditional businesses would consider waste; or the costs to the enterprise of demonstrating their impact. For some reason it is often assumed that the impacts that social enterprises drive are either cost neutral or that they are already built into the operating costs. If, however, we separate them out we can develop a much clearer picture of the nature of social enterprises, what it actually costs to deliver the impacts, and how we could structure capital around the enterprises to ensure that their operations are viable, sustainable and even profitable! The double costs for social enterprises to produce goods and services, and to deliver their impacts, are illustrated in figure 10 below[8].

Figure 10: The Double Costs of Social Enterprise

[8] A question mark is included in the figure because there may be particular impact costs linked to specific social enterprises that may not captured by the generic costs identified in this figure.

The ongoing challenge for social enterprises is to find ways to defy the market - that is to meet the costs of both their operations and their impacts. For some in this study this has meant cross-subsidizing (ie. ensuring that the income from operations is able to cover not just operating costs but also impact costs). For others it meant that the impact costs had to be covered by relationships with support organisations, grants or donations.
The implication of this for financing social enterprises is that care needs to be taken both in understanding the financial realities of social enterprise, and in relation to what kinds of capital is offered into enterprises in addressing their needs. For social enterprises this may mean finding ways to structure their financial accounts in ways that demonstrate more clearly what is restricted income, what impact costs are incurred, what portion of their surplus is operational, and what part of their net assets or equity is actually available (either as a reserve or for business development).

For financial institutions this may mean approaching the social enterprise much more relationally than is now the case with business lending. This is necessary to really understand the nature of the enterprise and to enable the financiers to gain a fuller picture of the financial realities of the enterprises than that which evident from a cursory and objective assessment of their financial statements. We will return to this challenge in a later discussion about structuring financial deals with social enterprise.

Strengths and Limitations of Legal Structures

The social enterprises included in this research had a diversity of legal structures - Proprietary Limited Companies (n=4), Registered Partnerships (n=1), Companies Limited by Guarantee (n=3), Non-Trading Co-operatives (n=4), and Incorporated Associations (n=4). Each legal structure presents particular opportunities and challenges for social enterprises in relation to accessing and holding different forms of capital. Some of these are outlined in Table five below[9].

Legal Structure	Challenges	Opportunities
Proprietary Limited Company (Pty Ltd)	• Tax liability • Can be difficult to structure in a ‘for benefit’ clause or social mission • Difficult to access grants or philanthropy	• Ease of setting up and reporting • Relative ease of attracting investment capital and debt capital • Governance structures can be relatively straight-forward.
Company Limited by Shares (Ltd)	• Can be difficult to enshrine the social mission into the structure long term (equity partners may not always share original social vision).	• Capacity to offer and hold equity capital
Company Limited by Guarantee (Ltd)	• No options for equity capital • High establishment and compliance costs	• Can offer some of the benefits of both corporate and non-profit worlds and therefore access to earned income, debt capital, and grants/philanthropic capital. • National registration mean that they can

[9] The advantages and disadvantages of each form of legal structure for social enterprise needs some further empirical research and public debate.

		trade nationally.
Cooperative - **Trading (for profit)** - **Non-Trading (non-profit)**	• Reporting and governance structures can be onerous • Can be less understood by financial institutions and investors	• Can build share capital into the structure • Can join social mission and objectives with democratic governance and a legal structure that draws on the benefits of company law
Incorporated Association (Inc)	• Can be quite difficult to attract non-grant capital • Can be hard to develop a culture that moves beyond grants.	• Can be best where the social mission is much more pressing than the possibilities for business returns.
Partnership	• Can be risky financially for the partners involved. • Can be difficult to access grant or philanthropic capital and to build in the 'for benefit' or social mission (with non-profit intentions) into the structure.	• Can open up possibilities for accessing a wider range of options for non-grant capital.

Table 5: The challenges and opportunities of different legal structures for social enterprises

The challenges of legal structure in relation to finance are twofold:

1. The legalities surrounding whether a social enterprise can access certain types of capital (whether that be market capital or grant capital);
2. The cultural and governance legacies that structures imprint on social enterprises that can influence what types of capital they seek to access.

The legalities of access can be difficult for social enterprises - particularly as they are often seeking hybrid forms of capital rather than the sorts of capital that would be sought by either a traditional small business or a traditional community organisation. Certainly it is the case that a degree of frustration expressed itself in some of the interviews when people identified the limitations of non-profit structures for accessing debt finance, while others suggested that for-profit structures meant access to philanthropy and grant support was often denied. Further, the fact that those enterprises who had accessed debt capital were forced to do so (with only one exception) from finance companies and fringe credit providers indicates that there is a very real challenge in the marketplace for social enterprises.

Some greater levels of information that could help social enterprises to make informed decisions around legal structures in the very early stages of enterprise start-up could also be beneficial in the sector, particularly if this was specifically focused on social enterprise / social business[10].

Over time it may also be beneficial to examine more closely the possibilities of alternative legal structures that could assist social enterprises to raise capital of various kinds more effectively. Although very often discussion of such alternatives is limited to what new legal forms could be developed specifically for social enterprise, there are other possibilities that could assist social enterprises to raise capital without

[10] The Centre for Philanthropy and Non Profit Studies at QUT is currently in the process of writing a handbook for social enterprise which will contain information on legal structures.

having to be restricted to one particular legal form. At this stage there would appear to be three potential options.

1. Creation of **particular legal structures** that could enable social enterprises to fulfill a social purpose but also to capitalize this purpose and to demonstrate a benefit to the community rather than to owners or shareholders. Structures such as the **Community Interest Company (CIC)** in the UK, or the **L3c company** that has emerged in some states in the US are examples of this.
2. Developing **hybrid models** where social enterprises **integrate both non-profit legal entities and for-profit legal entities into one organization** (by, for example, having one entity wholly owned by the other). This can enable social enterprises to benefit from the potentials of both forms of structure (both in relation to accessing capital, but also to fulfilling their mission and purpose).
3. Exploring the potential **of legal structures and entities that exist external to the core of the social enterprise** but enable the enterprise to do things such as raising capital (such as is the case with legal structures like the **Limited Liability Partnership (LLP)** that has been developed in the UK and is now spreading to other countries).

Though legal structures can act as a barrier for accessing certain types of capital, it would be erroneous to think that the development of 'new' or social-enterprise specific legal structures will automatically or simply solve issues of undercapitalization in this sector.

Connecting Capacity and Financing

Though the social enterprise managers all spoke of the ongoing development of their financial capacities, only a handful indicated that they were proficient to a high level in understanding, planning and managing their finances. An analysis of the financial reports combined with an analysis of interview and surveys indicates that many of the enterprises would need support and capacity-building in order to hold either debt or equity capital safely.

In many places overseas this has been addressed through the linkage of capital and capacity-building. In other words, access to capital (in whatever form) is tied to capacity building approaches. There are basically three models that dominate when capacity is linked to financing:

- **Capital only model**: Proponents of this model propose that non-grant capital should be accessed only after enterprises have developed sufficient capacity to handle this or conditionally if they meet certain capacity-building objectives. In other words, they need to get to a position of financial stability themselves before accessing debt or equity capital from a financial institution.
- **Capital plus model**: Proponents of this model argue that enterprises should go through a capacity building process as a pathway to accessing capital. So, for example, enterprises are guided through a business planning process and at the end, if the plan is deemed to be viable, they are able to access capital (grant, non-grant or blended capital).
- **Capacity-Building only model**: Proponents of this model argue that capacity building should lead to the development of skills needed to more effectively access capital from mainstream or specialist institutions.

Given that many of the enterprises included in this study either did not have business plans at all, or suggested that their business plans were out of date or inappropriate to their circumstances, there is some indication that it may be appropriate to engage

social enterprises in capacity building (under any one of these models) as a precursor or condition to finance - particularly non-grant finance. It should be noted, however, that the standardized business plan was not considered entirely relevant or useful by many of the social enterprise managers as it did not take into account their social purpose and therefore their focus not just on viability but also on impact. The development of plans and capacity can, from the perspective of a financial institution, assist in reducing the perception of risk by building understanding and (in the case of capacity-building), relationship with the enterprise involved. This may not be a favoured method when an enterprise is looking for ''fast'' capital (as indicated by some of the interviewees), but may assist enterprises looking to grow into non-grant capital such as debt or equity capital.

Two issues were raised within the capacity-building discussions that were held with social enterprises. First, it was repeatedly noted that the traditional 'business templates' may not be entirely useful for enterprises that are trying to map out and connect their financial / business objectives with their social objectives. For example, while it is clear that social enterprises need some kind of business planning, this needs to be:

- focused on both their financial sustainability **and** their social impact;
- simple and easily updated in order to remain relevant;
- alive and actively used rather than being a shelved tome document.

Unless traditional templates can be adapted and made relevant to social enterprises, they may not help these enterprises to develop, nor to access capital.

Second, accessible and affordable capacity-building is certainly needed in the social enterprise field (as identified by all of the enterprises involved in this research). However, the capacity-building also needs to be relevant to social enterprises (and not merely adding or applying traditional 'business practice' to the social enterprise field). As the field develops it may be helpful to design capacity-building that is specifically drawn from the experiences of and developed by social enterprises for other social enterprises.

In the second phase of this research (to be undertaken in 2010) the links between capacity-building and finance will be explored to a greater extent in an action-research framework

Part Four: Bridging the Gaps: Towards an Ecology of Finance for Social Enterprise

What is clear from this research is that the exploration of debt and equity financing options for social enterprise is about much more than 'add capital and stir'. Not all social enterprises will benefit from non-grant capital immediately, nor should they all be offered this as an option without appropriate due diligence. Further, it is not the case that debt and equity finance could replace grant capital nor that through this addition social enterprises will automatically become more sustainable.

There is clearly a demand for non-grant capital within the social enterprise sector, and currently there are limits in supply and availability of such capital. There are tensions involved in developing connections between the demand and supply sides of this market, which centre on how the capital needs of social enterprises can be met without endangering either the business or the social purpose of the enterprise. In developing ways to bridge the gaps between demand and supply the following issues are crucial:

- Ensuring that ***capital is structured appropriately***, that is, intermediaries and financial institutions structure any capital agreements (whether in the form of grants, gifts, debt or equity) in ways that are compatible with the enterprises' purpose, its viability and its sustainability;
- Ensuring that enterprises have ***access to 'right capital'*** - that is, capital that will assist them to develop but which is appropriate to their particular developmental stage, and will help them to build sustainability over time. This requires a spectrum of responses and appropriate financial instruments that address the specific capital needs of social enterprises and social businesses;
- Developing ***sources of capital*** and a ***financial environment*** that can support the channeling of capital into social enterprises and social businesses.

Building appropriate tools and structures for financing social enterprises is not just a matter of developing 'one-size fits all' approaches, or tweaking current financial instruments so that social enterprises become eligible. Anyone interested in finding ways forward in the arena of social enterprise finance should be under no illusions about how difficult this task is - particularly as the needs of social enterprises are increasingly urgent, whilst at same time it is crucial to ensure that capital will ***actually*** build sustainability and impact and not result in liability and narrowing of agendas.

Appropriate and responsible financing of social enterprise requires a comprehensive understanding of the nature and realities of social enterprises. It may also involve the development of appropriate and relevant financial instruments that can balance financial rigour with an emphasis on ensuring the long-term sustainability of the enterprises accessing this capital. In other words, the financing of social enterprises requires an ecological approach that appreciates the diversity of needs, structures, purposes and realities of social enterprise and the often difficult balance between financial imperatives and maintaining impact.

Structuring Capital Appropriately

The appropriate and responsible financing of social enterprise involves understanding both:

- how capital can help to build both the viability and sustainability of a social enterprise; and
- how financial institutions and funders can structure 'deals' around capital to ensure that the enterprise can 'deliver' social impact over time.

Figure 11 below provides a visual overview of the elements of offering responsible finance into this sector. Given the experience of Foresters Community Finance and the evidence from this study, we argue that capital should be connected with capacity building from the outset. This is not to suggest that this represents a simplistic connection – the capacity building may be very light handed or it may be deeper and involve a more long-term commitment, and it may well involve building the capacity of both the social enterprise and the financial institution. The most appropriate form of capital for the particular developmental stage of the enterprise will need to be determined on the basis of how the form and the purpose of the capital contribute to the building of both the viability (reliable and consistent revenue and cash flow to meet expenses) and sustainability (increasing levels of equity and net assets) of the social enterprise over time. Finally, the purpose of capital and the core reason for building the capacity, the viability and the sustainability of social enterprises is to increase their ability to generate impact and therefore to deliver social (or environmental or cultural) returns.

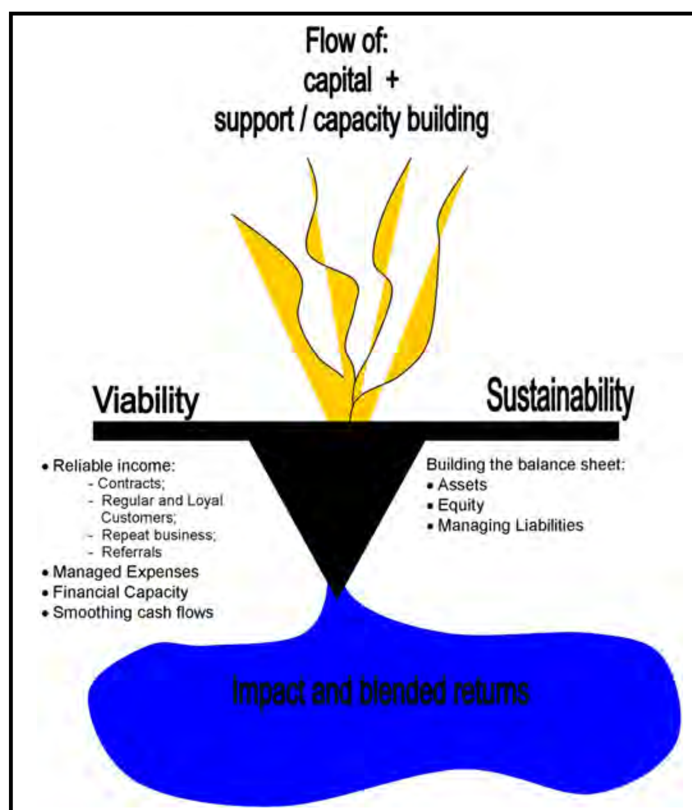

Figure 11: The Elements of Framing Responsible Lending to Social Enterprise

If any capital (whether it be grant, gift, debt or equity) is to be effective in actually building the viability and sustainability of an enterprise, three basic elements need to be in place across both the supply and demand sides of 'the deal'. These are identified in figure 12 below.

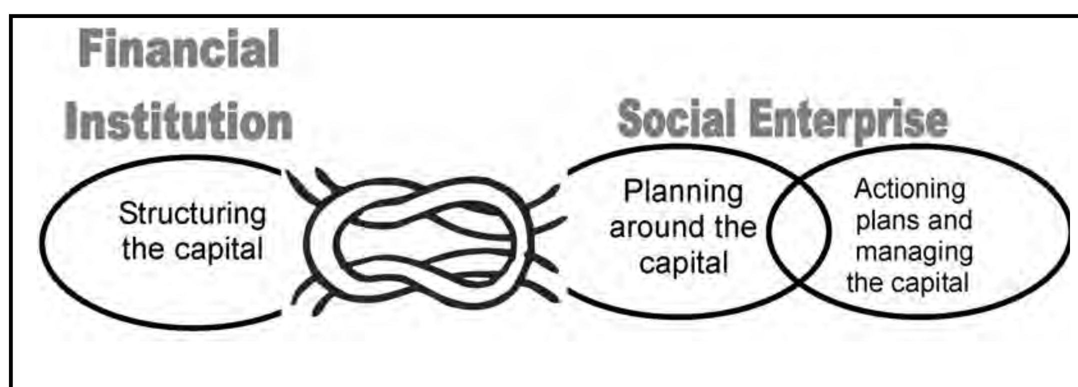

Figure 12: Basic Elements of Structuring the Deal around Capital in Social Enterprise

Essentially what this means is that financial institutions on the supply side must develop an understanding of social enterprise in order to be able to structure the capital (that is, set conditions, fees, returns and timeframes) in ways that will support the development of viability and sustainability in the enterprise. Social enterprises in turn need to develop systems and processes to plan around capital needs (for example, having active business plans in place), and manage the application of capital appropriately (that is, ensuring that good governance and financial management structures are in place).

Given the transaction costs involved in understanding new sectors, and in understanding individual social enterprises, and given the highly regulated financial system in which financial institutions operate, it may be the case that financing this sector requires specialist intermediaries such as Community Development Finance Institutions. Such intermediaries may be able to channel and structure capital in ways that would not be possible within traditional financial institutions. They could also engage in actively exploring mechanisms that could increase the impact and success of capital 'deals' with social enterprise, such as:

- How strong and honest relationships between finance institutions and social enterprises can reduce risk;
- How patience can help to frame conditions for investment that maximize the social impact of capital;
- How a degree of flexibility in terms of conditions, repayments, returns and timeframes (without reducing either rigour or responsibility) can ensure that the enterprise is focused on both its business viability and maintaining its social (or environment, cultural) objectives;
- How having some understanding from the outset about the timeframes and exit strategies for lenders and/or investors can be helpful for both the social enterprise and the potential range of investors;
- How some details about expected returns and impacts (so both financial returns and social returns) can inspire both confidence in investors and discipline in the enterprises.

Figure 13 draws together the elements of this framework for structuring capital deals with and for social enterprises.

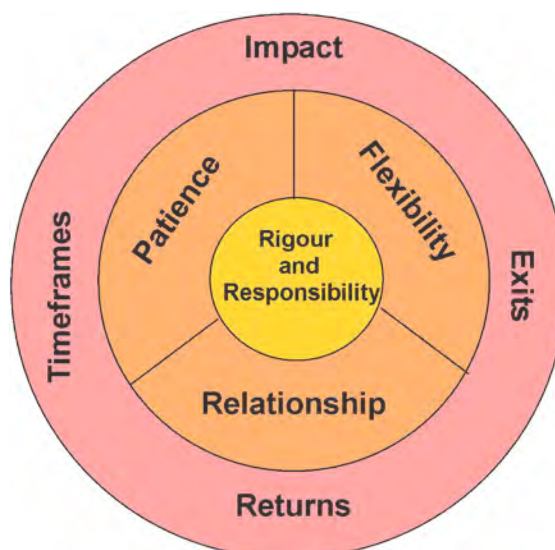

Figure 13: Key elements of Deal Structures in Financing Social Enterprise

The element that has received most attention and which perhaps differentiates financing in this sector is 'patience'. The term 'patient capital' is increasingly used in relation to financing social enterprise. Patient capital can refer to both debt and equity capital, with the central premise being that the investment is long term, with any returns (sometimes including retained capital) dependent on positive financial performance of the enterprise. Carrington (2004;p8) defines patient capital as:

> "Long-term finance used both for start-up and development, on 'soft-terms' (eg. capital / interest payment holidays and deferments), with little ceding of control by the user (in contrast to the typical relationship between a venture capitalist or an individual business angel investing in a wholly commercial enterprise); with sub-market financial returns because of the social and environmental objectives and anticipated returns" (Carrington, 2004;p8).

What is clear from overseas experience is that the elements included in the above diagram need to inform the process and structure of any financial products and services offered to social enterprises, but care needs to be taken that they do not dilute the rigour of the products. So, for example, it should not be the case that 'patience' indicates to either social enterprises or to financial institutions that this is a grant dressed up as a loan. These elements should support real and rigourous financial products and services to ensure that social enterprises have access to an appropriate and fair range of capital that will help them to build their viability and sustainability.

The Notion of "Right Capital"

In order to support the development of social enterprise it is necessary to ensure that access to capital is appropriate both for particular purposes and for the particular lifecycle stage of the enterprise. Decision-making around what constitutes 'right capital' should not be about ideology but rather what is right to achieve a certain purpose, given the financial capacity of the organisation at a given time in its development. The notion of 'right capital' refers to an assessment of how we deliver:

- The ***right type of capital*** (grant, gift, debt, equity, or variations on these);
- At the ***right time*** (for it may be that different types are more appropriate for different stages of the enterprise lifecycle);

- For the ***right purpose*** (ensuring that we are not subsidizing core operating costs to the detriment of long-term viability and sustainability);
- With the ***right impact*** (ensuring that the capital enables enterprises to maximize their capacity to meet their social objectives and achieve social impact)***;*** and
- For the ***right returns*** (ensuring that the returns given to investors help the organisation to maximize their social impact not merely maximizing financial returns).

What is 'right' in relation to each of these areas will differ according the situation of each enterprise. So, during the early stages of the development of a social enterprise it may not be appropriate or responsible to offer debt or equity capital. However it may be exactly what is needed in that circumstance if the conditions around the capital are structured in such a way that they do not compromise the cash flow of the enterprise at that crucial stage. Equally, at certain stages of an enterprise's lifecycle grant capital may be desired by the enterprise but actually may be inappropriate to the development of that particular enterprises' sustainability.

Right Type of Capital at the Right Time

There is no one type of capital that is best or most appropriate for all social enterprises at all stages of their development. Any capital needs to be appropriate to the particular stage of development of an enterprise, and it needs to represent some kind of stepping stone towards ensuring that eventually the enterprise will be able to access a full complement of available capital (including capital from mainstream commercial investors and lenders if this enables them to maximize their impact).

Each of the major types of capital has advantages, disadvantages, best uses and pitfalls for social enterprises at particular times during their development. Some of these are outlined in table 6 below.

	Grant Capital	Debt Capital	Equity Capital
Advantages	▪ Non-repayable ▪ Virtually 'risk-free' (although the move to outcome funding is changing this) ▪ 'Known' form of capital – particularly to those social enterprises who stem from community or welfare sectors.	▪ Flexibility in use - Uses of capital can be much more determined by the enterprise rather than by an external body such as a funder; ▪ Can be long-term ▪ Can assist in building financial discipline into the enterprise and strengthening management and planning	▪ Provision of larger amounts of capital for growth ▪ Returns are based on income ▪ Can be long-term ▪ Can assist in building financial discipline into the enterprise and strengthening management and planning
Disadvantages	▪ Often restricted to particular projects or outcomes which may represent a distraction for the enterprise ▪ Often do not contribute to the development or sustainability of the enterprise itself – solely focused on funding program outcomes; ▪ Often focused on short-term projects rather than	▪ Is repayable under the particular conditions set out in the loan contracts – so requires careful analysis, as these conditions are not always flexible enough to assist enterprises; ▪ Requires that the enterprise maintains adequate levels of income over a long	▪ Can be difficult to structure 'pure' equity arrangement because this requires the enterprises have particular legal structures. ▪ If investors condition their investment with some form of 'control' in relation to the management or governance of the

	long-term sustainability of the enterprise; ▪ Often relatively small and targeted so cannot help to consolidate enterprise development or growth; ▪ Time consuming and bureaucratic application processes with long lead times.	period of time; ▪ Generally requires some kind of loan security; ▪ Often require risk assessments which can be difficult for social enterprises to meet.	enterprise this can create concern about takeover or mission-shifts. ▪ May be significant costs involved in offering stages and in monitoring for investors
Best uses	• Support, participation and impact costs • Infrastructure and development costs • Specific projects • Initial program development	• Purchase of assets and equipment to develop the enterprise. • Use of short-term working capital to smooth cash flow lumpiness.	• For social enterprises that have good scale and income potential but who may lack the capital to develop these. • Soft and untied development costs…eg staff development – can't be financed through debt capital.
Pitfalls for Social Enterprises	• Can lead to some level of dependency and constrain development of 'enterprise' or 'business' focus. • Can detract from development of financial rigour and discipline in the enterprise.	• Not generally suitable for growth stages. • Conditions must be carefully assessed to ensure that debt conditions do not reduce potentials for impact and sustainability.	• Requires careful thought and planning to ensure that the risks to the enterprise are minimised and that appropriate investors will be attracted.

Table 6 : Features of the Major Types of Capital as the are Applied in Social Enterprise

Because of the nature and legal structures of social enterprises the above types of capital are not always applicable in their 'pure' form nor in the forms that characterize them in either charitable or commercial settings. Sometimes they need to be structured in ways that are innovative and that ensure that the financial instrument is appropriate to the purpose for which it is being used. Tables 7 to 9 below outline some of the innovations that have been or could be developed around the three major forms of capital and applied to social enterprises in the Australian context.

Innovations in Grant Capital

Grant and gift capital have been central to the development of many of the social enterprises in the study, but less important to the social businesses. What is also clear, however, is that there are very real tensions around how grant funding can best support social enterprise development, how long grant funding should be accessed and for what purposes, and how cultural issues such as dependency should be addressed within the enterprises. In order to develop an enterprises' viability and sustainability, grant capital needs to be:

- aimed at particular purposes within social enterprises, ensuring that enterprises can cover support and impact costs and develop their infrastructure in order to enable the best possible conditions for making productions and operations viable;
- structured to open opportunities for social enterprises to strengthen their capacity and develop rigour and discipline in relation to financial management and governance, and create pathways towards other types of finance (debt and equity) over time;

The following table outlines some potential innovations that could contribute to the development of innovative grants for social enterprises focusing on ensuring long term viability and sustainability. They are certainly not the only possible innovations, merely examples of potential innovations in this space.

Innovation	Benefit / Purpose	Structure / instruments
High Engagement Grants	o Long-term grant relationships specifically focused on and structured for building capacity and ensuring the long-term viability and sustainability of the enterprise. o Structured to build capacity and stability in the enterprise. - for example, development and maintenance of business plans; - development of appropriate financial management systems. Ensuring that the grant does not undermine the meeting of core operational costs of the business for any length of time.	Treated the same way as traditional grants in the financial records, but the relationship is structured in longer timeframes, with funding focused on building the core of the social enterprise.
Repayable Grants	'Grants' that are structured to mirror more investable and rigorous finance forms such as debt or equity, by including clauses for repayment of some or all of the grant once the enterprise achieves certain financial thresholds or milestones.	Could be structured as subordinated debt or could be treated as traditional grants but with contractual agreements around the conditions of repayment.
Matched Grants	Grants that match the surplus / equity that the enterprise earns over a particular period, thus incentivizing the enterprise to ensure that they make a surplus from trading or production. The purpose could be to build the equipment or asset base of the enterprise in order to assist in the growth and development of the business.	The rules around the grant would need to specify what amount of monies could be matched, and the grant could be treated as a gift or traditional grant in the accounts of the enterprise.

Table 7: Grant Capital: Innovations for Ensuring Relevance and Impact for Social Enterprise

Innovations in Debt Capital

This research has uncovered a tension for social enterprises in relation to debt capital. On the one hand there is a very real need for access to certain types of debt capital (such as working capital in the form of overdrafts and small asset development capital for essential equipment). On the other hand, in examining the financials of the social enterprises, it is clear that many of the smaller enterprises would struggle to safely hold debt capital, so lenders would need to be very careful in structuring any loans to ensure that they continue to be prudent and responsible. Some innovations that could help to address this tension by focusing on how loans could be restructured to suit enterprises with lower revenues and fluctuating cash flows are considered in the table below. It should be remembered, however, that any changes in conditions of loans should not in any way diminish the rigour and seriousness of due diligence, nor in any way give enterprises the impression that the debts are forgivable or are merely grants in the form of debt. Reducing rigour will only serve to reduce the effectiveness of offering debt into this sector over time.

Innovation	Benefit / Purpose	Structure / instruments
No Interest Loans	Enabling enterprises to build their confidence and capacity to engage with debt finance but do so without the burden of interest payments. The conditions and assessments are such that it is clear that the enterprise is willing and able to repay the capital, but there are no interest charges (although there may be a small administration fee).	No Interest Loans are common in the personal finance space in Australia (see Burkett and Sheehan, 2009; Good Shepherd Youth and Family Services www.goodshepvic.org.au/). Foresters Community Finance also has experience of lending at no interest to microenterprises and social enterprises. This sort of lending requires rigorous structures (as even lending at no interest can be irresponsible if the appropriate assessment processes are not in place); and some subsidisation of administration costs as these are not covered in the lending process.
Low Interest Loans	Lending at below market interest rates for the purpose of building the capacity of enterprises in a disciplined lending environment without the fully commercial interest rate burdens. Often in conjunction with particular capacity building programs.	Often undertaken by a mainstream financial institution in partnership with a capacity-building intermediary. The loan is administered by the financial institution and complies with all relevant financial regulatory requirements despite offering below market interest rates.
Commercial Interest Loans but with special conditions	Loans at market rates but with flexible conditions such as unsecured loans, repayment holidays or built in capacity-building processes.	These sort of loans often require some subsidization, and must be offered within the legal and regulatory frameworks governing credit and lending practices. These sorts of loans have often been managed by CDFIs overseas.
Above market interest loans with patient conditions	Lending to social enterprises can be risky and costly for lenders. This form of lending would be for cost-recovery (covering all the transaction costs of the lender and aiming for a sustainable surplus), but with conditions that are focused on assisting the enterprise to achieve their social objectives and impacts. So, while the interest rates and fees associated with this sort of lending may be more costly than other market rates, the conditions would be based on a long-term relationship, where they may be repayment holidays, flexible repayment plans or other 'patient' conditions to the loan.	This sort of lending is often undertaken by CDFIs who themselves need to achieve a degree of financial sustainability but whose purpose is focused on ensuring that sectors who cannot access mainstream finance have access to debt capital that is developed to meet their specific needs.

Table 8: Debt Capital: Innovations for Ensuring Relevance and Impact for Social Enterprise

Innovations in Equity Capital
There was very little understanding or appetite for equity capital amongst the social enterprises and social businesses included in this study. Further, an examination of the financials of the enterprises indicated that there were relatively few (if any) enterprises that would currently be attractive for equity investors unless these investors were primarily interested in social returns rather than financial returns. Nevertheless, if explorations of equity are to occur in the social enterprise space in

Australia (as they have, for example in the US and the UK), then there are a number of key tasks ahead, including:

- the development of a degree of understanding amongst both enterprises and potential investors of the nature of equity and the ways in which it could be structured within social enterprises (particularly when they do not have the legal structures to hold true equity);
- the development of some sort of marketplace or intermediaries focused on connecting enterprises with potential investors;
- the development of consistent and comparable means for reporting on the social returns that are generated through investments (as currently social return mechanisms, though improving, are still contested and difficult to compare across different enterprises).

Some potential innovations in developing equity capital in the social enterprise sector are examined in the table below.

Innovation	Benefit / Purpose	Structure / instruments
Quasi Equity Equity-like Investment	The provision of capital that has equity-like qualities in that it can help to grow the enterprise and provide sufficient capital for this growth without tying the capital to particular purposes. There is an expectation of both social and financial returns on the part of the investor.	Equity-like investments where the legal structure doesn't exist to support equity investments. The equity is structured as subordinated debt, and instead of dividend payments for example, there could be royalty payments when the enterprise reaches particular revenue goals (see for example, Bridges Community Ventures, www.bridgesventures.com and Howard, 2004). The key to structuring such investments is to develop exit strategies for the investors.
Patient Equity	Provision of equity capital for growing and consolidating social enterprise with the expectation of some form of financial return at some point in time when the revenues of the enterprise are sufficiently high. In the meantime the equity holder may play a capacity building role in the governance of the enterprise.	Like the above, this kind of equity is usually structured as subordinated debt (in this case, deeply subordinated), with an expectation that there will be some level of financial return, but with an emphasis on the nature of the social return that can be generated from this capital.
Social Enterprise Equity	The development of real equity investment into social enterprise is possible with the use of the appropriate organizational legal structures. The benefit of this is that the social enterprise can raise capital at any stage of their development.	Real equity investments in social enterprise are possible. However, this requires that the enterprise has a legal structure of ''Company Ltd by Shares'', or Cooperative with shares. May be structured with reduced financial returns to investors, but maximum social returns (for example, this could be a focus for Mission Related Investments - MRIs). Currently relatively few social enterprises are structured to take advantage of potential equity investments, and there are few options for finding potential investors.

Table 9: Equity Capital: Innovations for Ensuring Relevance and Impact for Social Enterprise

For the Right Purpose
What is clear from the examination of the social enterprises in this study is that the notion of 'right capital' for the 'right purpose' is crucial for addressing issues of viability and sustainability in social enterprise. If an enterprise is to have any chance of becoming viable and eventually sustainable, then the business of the enterprise needs to be able to cover core operational costs (as opposed to the support and impact costs) from very early in the start-up phase. While some of the enterprises spoke of the assistance provided by programs such as NEIS (which helped to pay some of the wage costs for the first year of the enterprises operation), what was clear from an analysis of financial information was that any attempts to use grant monies to cover core operational costs (including production costs, wages, on-costs) for any length of time could actually be detrimental to the enterprises' ongoing viability. Using grants or gifts to cover the core operating costs of the enterprise may seem like a worthy thing to do from the outside, but if the *business* of the enterprise (that is, the operations and production) is not viable then it does not matter how much support and subsidy is given to the impact of the enterprise, it will ultimately not succeed. This is not to say that the enterprises need to demonstrate that they are able to earn sufficient money to cover full commercial costs (so they may not be paying wages equivalent to the commercial sector for example), but rather, that they are able to cover the core costs of operating within the context of a viable social enterprise.

This is a difficult point to make, for in an ideal world it would be wonderful for all enterprises with a social purpose to be viable *because of their potential impact*. However, if they are to be viable as social enterprises rather than as enterprising non-profit organizations, then it is crucial that their core business is *viable as a business*. For this reason, after considering the circumstances of the enterprises in this study, we suggest that careful consideration be given to how each of the forms of capital can be directed at 'right purpose', that is, how capital can be structured such that it supports the enterprise to develop solid foundations for viability and sustainability from early on its lifecycle. This is particularly important for grant, gift and philanthropic capital as this is often the most available form of capital in early stages of social enterprise development. The innovations examined in table 7 above go some way to ensuring that grants / gifts are directed appropriately, and figure 14 below outlines how such capital could be directed towards supporting an enterprises long-term viability.

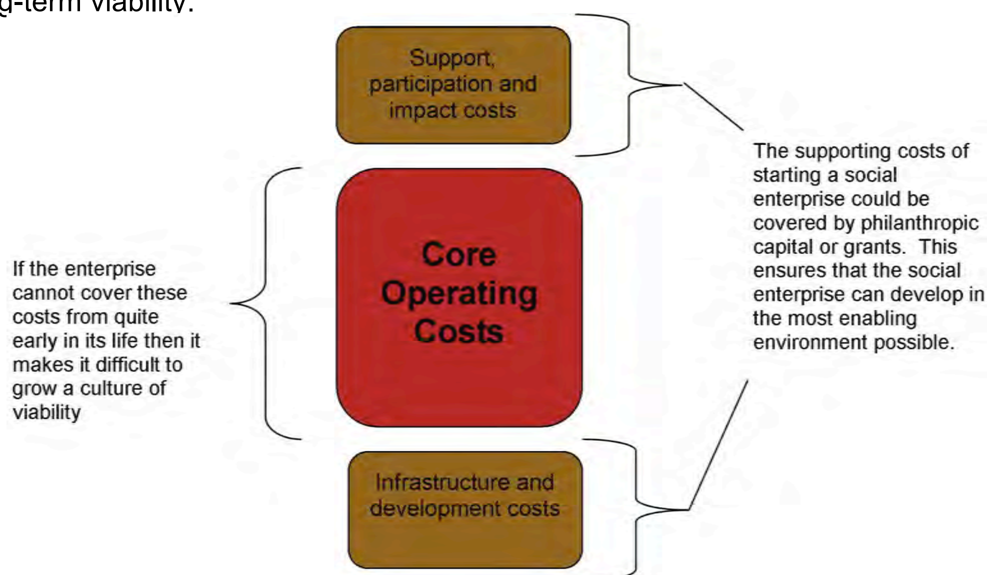

Figure 14: Directing Grant and Gift Capital to where it can most readily build long-term viability

With the Right Impact
It was clear from the interviews and the examination of the financials of the enterprises, that there was a need to ensure that the ‘right capital’ included consideration of the real costs of operating a business for social impact. As previously indicated, many of the enterprises cited examples of how operating as a social enterprise rather than a mainstream business meant that impact costs needed to be accounted for. However they also cited examples of how well-intentioned actions such as providing grants that did not cover the full costs of much needed equipment, meant that they were often reliant on poor quality or used equipment that needed to be overhauled or required continual servicing and therefore led to marked inefficiencies in the business. In order for capital to support the development of social enterprise, then, it is necessary that there is sufficient capital (in whatever form is most appropriate) to ensure that the enterprise is able to function effectively and efficiently rather than providing well-intentioned but insufficient capital which could impact on the viability and sustainability of the enterprise over the long-term.

For the Right Returns
There is no one ‘right return’ when it comes to investing in social enterprise – especially as the returns that are often expected from the providers or sources of capital include both financial and social returns. Of course the type of capital very much determines the sorts of returns that are possible. So, while funders and philanthropists may increasingly expect some demonstration of social return (and therefore impact) in return for their grants and gifts there is certainly no expectation or possibility of a financial return from this type of capital. Debt and Equity capital however, may involve blended returns for investors. Table 10 illustrates the sources and range of potential returns of three types of capital. The actual returns (both financial and social) from each of the types of capital will also depend on:

- the nature of the social purpose and the depth of impact that the social enterprise is directed at (the greater the impact costs the lower the likely financial returns);
- the geographical location of the enterprise, and the socio-economic condition of this locality;
- the ability of the financial institution to structure a suitable product from both an investment perspective and a social enterprise perspective.

Type of Capital	Grants / Gift Capital	Social Finance: Debt and Equity Capital	Commercial finance: Debt and Equity Capital
Source of Capital	Grant Funders and Philanthropists	Social Investors	Mainstream Finance and Investment Market
Types of Returns Expected	Social Returns but no financial returns	Social and financial returns (in the context of a social market) and preservation of original capital investment.	Market / Commercial financial returns (on top of preservation of original capital investment) and no real consideration of social returns

Table 10: Types, Sources and Returns of Capital for Social Enterprise

Sourcing Capital for Social Enterprise Financing

Perhaps the most crucial issues in developing an ecology of social enterprise finance in Australia focus on:

- Where the flow of capital will come from (ie. grantors, philanthropists and/or investors); and
- How we can ensure that it is appropriately and responsibly channeled into social enterprises and social businesses.

Though there are a number of initiatives currently planned or in early stages of development in Australia, there are still relatively few options available for social enterprises seeking non-grant capital. Further, while there have been some explorations of how further capital for social enterprise development could be sought from philanthropists, there has been little exploration of how to access and apply investment capital in this sector. Figure 15 below illustrates the traditional sources of capital that could flow into social enterprise development (though it should be noted that currently investment capital into this space is limited).

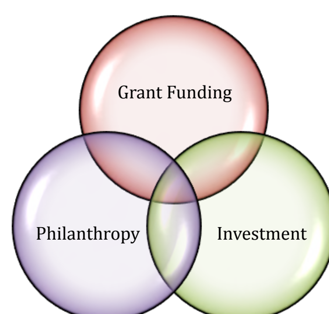

Figure 15: Sources of Capital for Social Enterprise Development

There are possibilities in the spaces between these sources for innovation – so, for example, between philanthropy and investment there is the possibility to explore the potential of Mission Related Investments (MRIs) and Program Related Investments (PRIs) into social enterprise. Further, there are innovative blendings that could be investigated, whereby various funders and financiers could partner to offer capital that is partly grant-based, partly philanthropic and partly investment based, reducing the risks and increasing the potential for both impact and returns. Partnership across tasks could further reduce risks and costs – for example, one body providing a loan, with another underwriting it.

The development of a diverse range of capital and finance options for social enterprises in Australia will require an environment in which:

- current financial institutions, funders and philanthropists have a greater knowledge and understanding of social enterprises;
- specialist intermediaries such as Community Development Finance Institutions are developed that can channel capital into social enterprises and provide any necessary capacity building;
- a diversity of products, services, channels, and sources of support are developed that can help to build a diverse range of social enterprises in Australia (as illustrated in figure 16 below).

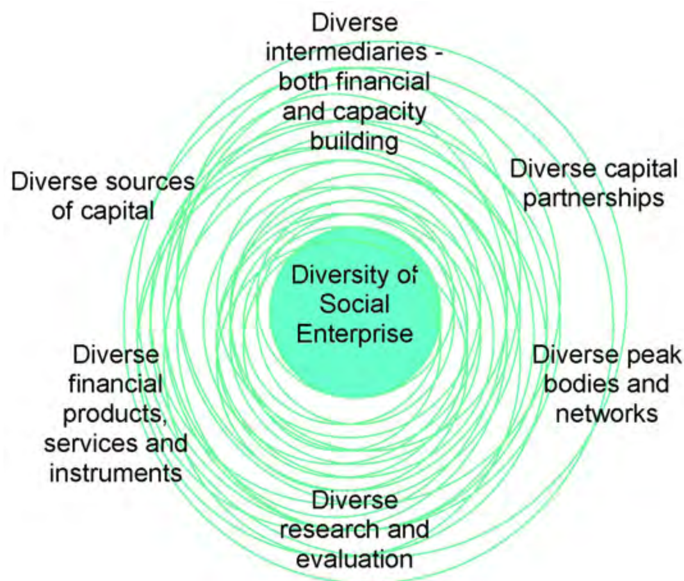

Figure 16: The Diversity Needed to Develop an Ecology of Finance Options for Social Enterprise

Though there has recently been a surge of government grant funding for social enterprise in Australia (particularly through the Federal Government's stimulus spending in the Jobs Fund and Innovation Fund), other sources of capital (particularly debt and equity options) continue to be difficult to access and/or not available to social enterprises. In many ways this is because the sector as a whole is underdeveloped, but it also reflects the lack of diversity in research and advocacy that has informed the development of the sector to date. Further, there has been limited debate within the sector about its overall development, and about how the handful of intermediaries should be structured to best engage with and advocate for the future of the sector. Developing the sector into the future will require:

- greater choice of and competition amongst intermediaries (with encouragement of intermediaries who are of and for the sector and who themselves practice what they preach);
- intermediaries who can move beyond capacity building, support, channelling of grant and philanthropic capital and start to develop skills and expertise around how debt and equity capital can be harnessed in the sector and how real investment could be applied in social enterprises (that is investment where capital is preserved and there are financial in addition to social returns).

The development of a Community Development Finance sector in Australia (see Burkett and Drew, 2008) could stimulate further exploration of capital for social enterprises beyond grants and gifts, and could provide an incentive for other financial institutions to explore, partner and invest in social enterprises. This may mean that a series of stepping stone options (from assistance with grants, through philanthropy, and then onto social investment and mainstream finance options). Developing capital pathways so that enterprises can move on from grant funding and can build their financial management rigour over time will be crucial in fostering a sustainable social enterprise sector in Australia over time. Figure 17 below illustrates how a diverse range of intermediaries including CDFIs could help to develop the sector into the future.

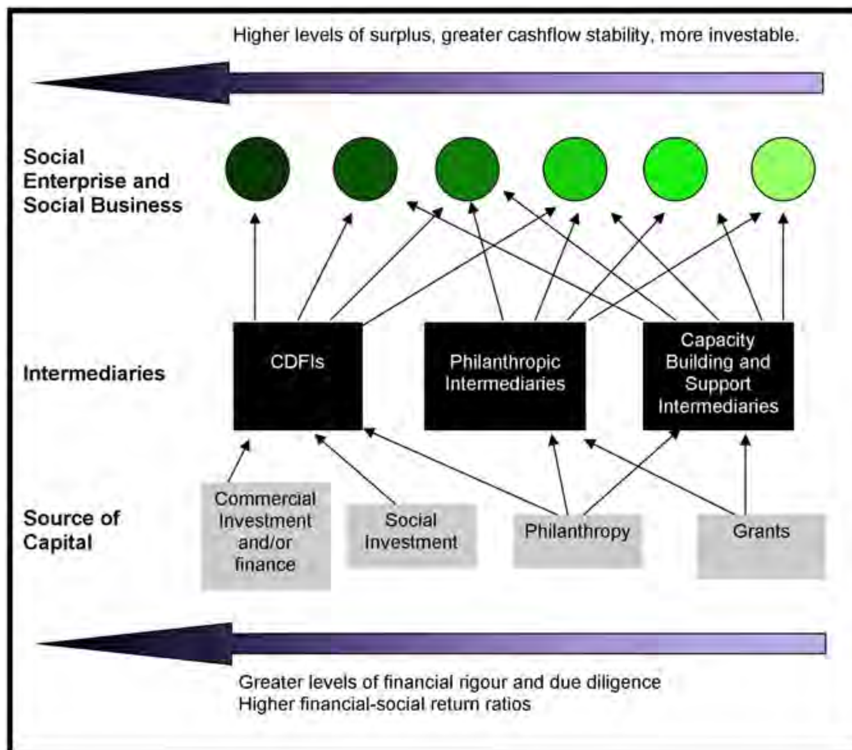

Figure 17: Capital Stepping Stones for Building Viable and Sustainable Social Enterprise

Conclusion

This report has analysed and discussed the findings of phase one of an action research project examining the financial needs and realities of social enterprises in Australia. The financial realities of social enterprises in this study highlight the precarious nature of many of these businesses and the absolute courage and faith of the people who manage and run them for social purpose and impact. The fact that so many social enterprises seem to survive under difficult circumstances when the rate of failure of small businesses in Australia is so high, is something that should be acknowledged and celebrated. However, it is also time for some rigourous and critical debates about the future of this sector and in particular, what could be done to ensure that the sector is able to grow and thrive in the Australian context. Access to fair, equitable finance that is focused on developing the viability and sustainability of enterprises is a crucial part of developing the sector as a whole.

From this first phase of the research, the following learnings will inform and shape the second phase of the project, where particular financial products and services will be developed and tested with willing and eligible enterprises:

- all forms of capital aimed at social enterprise can and should be structured as an incentive to develop capacity, build viability and move towards sustainability;
- there is a need for documentation and sharing of much more social enterprise specific tailored business practice rather than merely adopting practice from commercial sectors. In particular, there is a need for: social enterprise specific business planning templates; structured and tailored assessments of

stages of development and capacity issues in social enterprise; and social enterprise specific financial metrics as a benchmark for performance. These should be developed by social enterprises or at least with high levels of participation from social enterprises;
- there is a need for capital and financial products to be developed with a clear view to their application in social enterprises;
- there is a need for specialized training and support for social enterprises (and stakeholders in this sector) across planning, operational, financial, balance sheet and social impact sustainability.

The second phase of the research will weave each of these learnings into the design and testing of specific financial products and services (across grants, gifts, debt and equity capital). This second phase is due for completion in late 2011.

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- Building the skills and knowledge of the Third and Fourth Sectors;
- Investing in the asset base of the Third and Fourth Sectors;
- Accounting for both the financial and social returns on these investments.