PART II:
Demand, supply and the role of intermediaries

Part II of this report examines the main arguments from the demand and supply sides of the social economy in relation to the development of a robust capital market for social economy organisations. It then proceeds to examine the role of intermediaries to bring financial institutions and social economy organisations together.

Chapter 3 explores the needs and barriers to obtaining finance within the social economy, with an emphasis on the need to create a diversity of financial options and products for the broad spectrum of organisations in the sector. The chapter focuses on the need to develop the capacity of social economy organisations and ensure that organisations are 'investment ready' in order to engage with a capital market. The application of the Standard Chart of Accounts (SCOA) is discussed and the role of intermediaries, organisational forms and a measurement framework are briefly explored as a pre-cursor to subsequent chapters.

Chapter 4 discusses the current supply of capital to the social economy and the scope to expand the sources of investment available to social economy organisations. Methods of accessing capital from sources previously untapped by the sector are explored, with a particular emphasis on accessing funds from the investment corpuses of philanthropic bodies and attracting investment from institutional investors such as superannuation funds. The social investment role of financial intermediaries, mainstream financial institutions, the corporate sector, retail and community investors and government are also discussed.

Chapter 5 discusses the development of intermediaries in the social capital market. Intermediaries play a key role in ensuring that the amount of capital available develops in parallel with organisations equipped to manage the finance. The development of a strong intermediary market will balance the supply of capital and a diverse range of financial products with investment ready organisations. Financial intermediaries are explored in detail and different forms of non-financial intermediaries are also discussed with an emphasis on the role of intermediaries to develop the capacity of the sector.

Chapter 3

Needs and barriers to obtaining finance within the social economy

3.1 This chapter explores the demand among social economy organisations for the development of a robust capital market in Australia.

3.2 The recent Productivity Commission (PC) report on the contribution of the not-for-profit (NFP) sector distinguished between funding and finance. Where funding refers to income that has no obligation to be repaid such as untied grants and philanthropy, finance refers to either debt or equity capital which is provided on the understanding that the investor will be compensated for the use of capital.[1]

3.3 Many social economy organisations have difficulty accessing the capital they require. Some of the key impediments to finance for social economy organisations are the lack of collateral to guarantee loans, the lack of a reliable revenue stream to service debt, the large transaction costs relative to the capital required and the lack of a suitable organisational structure to allow the organisation to raise equity capital.[2] Social Ventures Australia (SVA) informed the committee:

> Over the last eight years SVA has worked with over 100 social ventures with proven track records in tackling the issues behind social disadvantage. By partnering with these innovative, entrepreneurial ventures we know that traditional avenues for capital raising are not available to them. There is limited funding available to the social sector to help grow proven ventures, particularly to support the building of quality organisations though the provision of appropriate infrastructure funding.[3]

3.4 The capital market for the social economy in Australia is 'at an early stage of evolution' and there is much to be done to meet the financial services and product needs of the sector.[4] Social economy organisations need access to capital and labour, and good relationships with their stakeholders, including government.[5] To meet these needs, the market requires a change in mindset from funders, investors and social

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1 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 184.

2 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 187.

3 Social Ventures Australia, *Submission 2*, p. 1.

4 Foresters Community Finance, *Submission 4–attachment 2*, 'Finance and the Australian Not-for-Profit Sector', March 2011, p. 4; Social Finance Pty Ltd, *Submission 21,* p. 1.

5 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. xxxiii.

economy organisations to move the sector from grant dependency towards social investment.[6]

3.5 The PC report *Contribution of the Not-for-Profit Sector* acknowledged the diversity of the sector and the varying needs for capital across the broad spectrum of organisations. The PC noted however, that the capital needs for smaller NFPs were particularly pertinent. The PC made a submission to this inquiry in which it summarised the capital needs of the sector as follows:

> ...access to capital varied considerably across the not-for-profit (NFP) sector. Large NFPs providing services to their members, largely on a fee for service basis, did not appear to face any significant constraints on their access to capital. For large NFPs providing human services, often with substantial funding support from governments, access to capital was also not considered a major problem. In the main this was because of the substantial assets of these organisations that could be used as collateral. In addition, some large faith-based organisations operate an internal capital market for their members. However, for smaller NFPs providing social services, often on a partly government funded basis, capital for start-up, and to invest in new capacity or trial innovative approaches to service delivery, was difficult to access.[7]

3.6 Submitters to the inquiry agreed with the PC report's findings, and argued that smaller social economy organisations suffered greater exclusion from capital markets than their larger counterparts.[8] Foresters Community Finance (Foresters) noted that smaller organisations were predominantly grant reliant, and those that have a local focus or were located in rural and remote areas were typically the most excluded. By contrast, very large organisations with diverse revenue streams with a state or national focus and based in urban areas were the least excluded from capital markets. Foresters argued that 'there is a growing sense that small and medium sized organisations can, particularly if they are locality based, have a deep impact on addressing social and economic exclusion'.[9]

3.7 The joint submission (departments' submission) from the Department of Education, Employment and Workplace Relations (DEEWR) and the Department of the Prime Minister and Cabinet (PM&C) noted the following as the key mechanisms and options for the development of a capital market for the social economy:

- capacity and investment readiness;
- product development and innovation;

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6 Social Ventures Australia, *Submission 2*, p. 3; Social Traders, *Submission 7*, p. 1; JBWere, *Submission 19*, p. 7.

7 Productivity Commission, *Submission 6*, p. 1.

8 Social Traders, *Submission 7*, p. 2; JBWere, *Submission 19*, p. 4.

9 Foresters Community Finance, 'Finance and the Australian Not-for-Profit Sector', *Submission 4–attachment 2*, pp 13, 22.

- the role of intermediaries and networks;
- risk, measurement and metrics; and
- organisational forms and structures.

3.8 The relationship between these factors is not linear, but interdependent.[10] This chapter explores these interrelated issues and concludes with a discussion on the sector's relationship with government.

3.9 The Community Council for Australia (CCA) acknowledged in its submission to this inquiry that access to finance is only one requisite for the social economy, and that it is interrelated with a range of additional components:

> ...the access to finance issue is one of several critical issues the not-for-profit sector (NFP sector) is currently struggling to address. Even if it were possible to instantly provide a broader range of financing products and increase investment and engagement in the NFP sector, there are a number of critical issues relating to workforce, evaluation and measurement, accreditation, regulation, contracting and compliance, relationship with government and community, governance and technology that all remain central to the future of the not-for-profit sector. Many of these areas are also the subject of review and reform creating a challenging environment for the sector.[11]

Capacity and investment readiness

3.10 'Capacity' can refer to the quality of various market enablers within an organisation including leadership, skills and skill development and fluency in the language used by other disciplines. To build demand, the market will need investment ready social economy organisations with a range of skills and capabilities to effectively access capital markets to develop business plans, financial accounts and sound investment opportunities to comply with mainstream financial market requirements in a language that investors can understand.[12]

3.11 The majority of submitters agreed that social economy organisations need to develop skills and expertise for business and financial planning.[13] Social Firms Australia noted that a lack of commercial management experience is a significant barrier to expansion and is 'inhibiting a confident proactive approach to business development'.[14] Whilst lack of capacity may not differ significantly from the

10 Department of Education, Employment and Workplace Relations (DEEWR) and Department of the Prime Minister and Cabinet (PM&C), *Submission 9*, pp 13–14, 17.

11 Community Council for Australia, *Submission 15*, p. 2

12 DEEWR and PM&C, *Submission 9*, p. 24; The Centre for Social Impact, *Submission 27*, p. 4.

13 Social Ventures Australia, *Submission 2*, p. 3; Productivity Commission, *Submission 6*, p. 2; JB Were, *Submission 19*, p. 5; *Submission 9*, pp 24–25; Community Council for Australia, *Submission 15*, p. 3; Social Finance Pty Ltd, *Submission 21*, pp 1–2.

14 Social Firms Australia, *Submission 22*, pp 3, 4.

challenges faced by other small to medium enterprises in other sectors, capacity limitations for social economy organisations can be magnified by a focus on social purpose,[15] less direct revenue, lack of working capital and the complexity of identifying suitable finance options.[16]

3.12 Social Ventures Australia (SVA) suggested that the sector could not compete with the commercial sector to attract and retain quality staff:

> We are a non-profit organisation, so we live and breathe the challenge of maintaining our own funding capacity. I can assure you, with my kind of midlife reincarnation as a social entrepreneur, some of the biggest lessons for me are about the challenges of building a sustained funding base, getting quality people on board and finding the capacity funding to do that.[17]

3.13 A related issue raised by submitters is the tendency for many boards of social organisations to be risk averse and reluctant to take on debt or other non-grant capital.[18] The CCA describes this as a cultural barrier and a belief that fulfilling a civic responsibility requires adopting a conservative approach to financial risk management.[19] The Fundraising Institute Australia (FIA) ties the resistance to non-grant capital to fluctuating income streams:

> ... uncertain income means there is naturally a strong resistance to taking any financial risks by both management and boards. Better business planning by charities can only come about when a critical level of income is assured.[20]

3.14 PM&C noted that the area of investment readiness was of key concern, although some progress was being made across the sector:

> Senator STEPHENS: ...One of the underpinning questions, really, is: are not-for-profit organisations investment ready? Do you see that as an issue in our sector?
>
> Mr Ronalds: I certainly think it is a significant issue on the demand side. I think the number and sophistication of not-for-profits that are able to engage in capital markets is pretty limited. I think it is rapidly changing. We are seeing more sophisticated management either growing up within the not-for-profit sector or moving to the sector from other places that have

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15 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3,* p. 23.

16 DEEWR and PM&C, *Submission 9,* p. 24.

17 Mr Michael Traill, Social Ventures Australia, *Committee Hansard,* 1 August 2011, p. 18.

18 DEEWR and PM&C, *Submission 9,* p. 16; Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 242; JBWere, *Submission 19,* p. 5; The Centre for Social Impact, *Submission 27,* p. 14.

19 Community Council for Australia, *Submission 15,* p. 3.

20 Fundraising Institute Australia, *Submission 23*, p. 3.

> those sorts of skills. We are slowly seeing boards of directors of not-for-profits grow in terms of appetite for risk in this. I think we still have a long way to go both from a management perspective and from a governance perspective. So things that we can do to help that, I think, are well worth looking at.[21]

3.15 The Centre for Social Impact conducted a study on behalf of the Australian Institute of Company Directors, *The Directors Social Impact Study*. The report was released in October 2011 and followed an online survey of 1 912 directors operating in the for-profit and NFP sectors and a number of interviews with survey respondents. The survey results indicated that half of the respondents with experience in both sectors felt that the quality of governance for NFPs was equal to, or greater than for-profit organisations. The report suggests that 'due to the sheer volume of directors who are now operating across both sectors, an improvement in governance [for NFPs] has followed accordingly'.[22]

3.16 Foresters argued that solutions for sustainability and capitalisation of the sector should be addressed by building on the existing strengths of an organisation and that simplistic formulas based solely on training are not the answer.[23] Foresters suggest a model whereby finance is contingent on adequate financial management skills and offer three models:

- capital only model: non-grant capital could be accessed only after enterprises have developed sufficient capacity to manage it, or conditionally based on meeting certain capacity-building objectives;
- capital plus model: enterprises access capital through a capacity building process where, for example, they are guided through a business planning process which at completion, if the plan is deemed to be viable, they are eligible for the capital; and
- capacity-building only model: capacity building alone will lead to the development of skills needed to access capital more effectively from mainstream or specialist institutions.[24]

3.17 The departments' submission noted that capacity for social economy organisations should be developed with an understanding of a social context, and capacity building should not be mistaken as a requirement for organisations to become more 'business-like':

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21 *Committee Hansard*, 1 August 2011, p. 58.

22 Australian Institute of Company Directors, *Directors Social Impact Study 2011*, September 2011, pp 4, 6, 13–14.

23 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, pp 32–33.

24 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, p. 39.

> This requires the capacity to obtain and make good strategic use of finance in a context where profit is not the driver of the business model. Demonstrating business capabilities promotes trust, legitimacy and accountability. This challenge should not be confused with making social economy organisations more 'business-like'.[25]

3.18 Further, capacity building does not lie solely with not-for-profit organisations; financial institutions and intermediaries must be included in the equation 'in order to ensure that the role of capital in all its forms is fully appreciated within the sector'.[26]

3.1 The R. E. Ross Trust has published a document *Inviting Investment in Social Enterprise* which provides 'a step by step introduction for social enterprises to inform experienced business investors as to why there is value in making a financial contribution to their enterprise'.[27] Our Community and Westpac have also developed 'The Community Financial Centre' and offer a range of financial literacy resources to build the capacity of community groups.[28]

Anomalies in financial statements

3.19 The PC report discussed the need for social economy organisations to develop business plans and accounts that meet mainstream standards.[29] As a Community Development Finance Institution (CDFI), Foresters has experienced first-hand the challenge of determining the viability of a social enterprise to repay debt or generate investment based on its financial records. Many financial statements include irregular items or are missing information that would typically be found on the statements of a small business or charitable organisation. Inclusion of line items such as 'sweat capital', or not specifying where grant or certain income is restricted, or not showing where costs were covered in-kind are all issues that can lead to misunderstandings by a financial institution assessing financial statements.[30]

3.20 Foresters argued that both enterprises and financial institutions need to work together to create financial statements that accurately reflect the work of social enterprises:

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25 DEEWR and PM&C, *Submission 9*, p. 24.

26 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, pp 32–33.

27 R. E. Ross Trust, Inviting Investment in social enterprises: A prospectus framework for the social sector, 2007 http://www.rosstrust.org.au/docs/RERoss_Prospectus.pdf (accessed 13 October 2011).

28 Our Community, 'The Community Financial Centre', http://www.ourcommunity.com.au/financial/financial_main.jsp (accessed 13 October 2010), also additional information provided to the committee 21 September 2011.

29 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 189.

30 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, p. 35.

> 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.[31]

Standard Chart of Accounts

3.21 The Council of Australian Governments (COAG) agreed in December 2009 to adopt a Standard Chart of Accounts (SCOA) for NFP organisations receiving government grants. The Australian Centre for Philanthropy and Nonprofit Studies (ACPNS) at the Queensland University of Technology developed the SCOA which was formally approved by COAG for implementation on 1 July 2010. Federal and state governments adopted the SCOA and agreed to an implementation plan to develop a nationally consistent approach to fundraising regulation in order to reduce regulatory burdens and improve public confidence in the sector.[32]

3.22 The ACPNS explained that the SCOA provides a common approach to accounting by social economy organisations, government agencies and other interested parties. It is intended to 'remedy a lack of consistency in accounting categories and terms required by government departments'[33] which fund social economy organisations:

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31 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, p. 37.

32 ProBono News, 'COAG approves NFP Standard Chart of Accounts', Media release, 22 April 2010, http://www.probonoaustralia.com.au/news/2010/04/coag-approves-nfp-standard-chart-accounts (accessed 21 September 2011); COAG website, Queensland University of Technology, Australian Centre for Philanthropy and Nonprofit Studies, 'Standard Chart of Accounts (and data dictionary)', April 2010, http://www.coag.gov.au/coag_meeting_outcomes/2010-04-19/docs/Standard_chart_accounts.pdf (accessed 21 September 2011); Department of Finance and Deregulation, 'Standard Chart of Accounts for reporting by not-for-profit organisations', Finance Circular No. 2011/03, http://www.finance.gov.au/publications/finance-circulars/2011/docs/Finance-Circular-2011-03_National_Standard_Chart_of_Accounts.pdf (accessed 14 November 2011).

33 Professor Myles McGregor-Lowndes, Centre Director, Queensland University of Technology, Australian Centre for Philanthropy and Nonprofit Studies in ProBono News, 'COAG approves NFP Standard Chart of Accounts', Media release, 22 April 2010, http://www.probonoaustralia.com.au/news/2010/04/coag-approves-nfp-standard-chart-accounts (accessed 21 September 2011).

> It is a tool designed primarily for small to medium nonprofits which typically do not have an accounting department or a sophisticated accounting system. Larger nonprofits have adopted the data dictionary component of the standard chart of accounts aligning their systems to comply with a consistency across the sector.[34]

3.23 It was put to the committee that government departments have requirements of social economy organisations that do not align with the SCOA. Both Matrix on Board and Our Community argued that the governments' take up of SCOA is lagging:

> Ms Nettelbeck: I wish I was seeing it more from government departments, as in I wish more of them were taking it up sooner, but still in some parts of the country nonprofit organisations are told they have to acquit and they have to give these lines which are different to the standard chart of accounts.
>
> Senator STEPHENS: Still?
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> Ms Nettelbeck: Still. So, we go out there and say, ‘Actually, why don’t you tell them about the COAG agreement’, and send it back up the line. I think a lot has changed and a lot has moved and a lot of nonprofits have taken it up. I think it is probably going to take another four or five years for it go through the whole system, but it is one of the most significant changes that we have been able to make—or that everyone has made—to help reduce red tape, and it has been well received and it works well when everyone does it.
>
> ...
>
> Mr Moriarty: ...following on from what Ms Nettelbeck says, the standard chart of accounts is probably the best thing that has happened in such a long time in the not-for-profit sector. Governments, state and federal, are still incredibly slow in doing it. When they are putting up their grant applications they are still asking community groups to put it into an old format rather than following the new standard.[35]

Committee view

3.24 The committee urges Australian governments, through COAG, to issue a reminder to all departments and agencies about the agreement to implement the Standard Chart of Accounts in funding agreements with the not-for-profit sector.

Product development and innovation

3.25 Social economy organisations need the right type of financial product for the relevant phase of growth and development. The current difficulty, however, is the

34 Queensland University of Technology, 'Standard Chart of Accounts', https://wiki.qut.edu.au/display/CPNS/Standard+Chart+of+Accounts (accessed 21 September 2011).

35 *Committee Hansard*, 9 September 2011, pp 59–60.

limited number of financial products available to them.[36] They need access to finance from a range of sources including government, philanthropic and commercial lenders and each type of investor needs to offer innovative products to meet the specific needs of the sector. JBWere emphasised the importance of using the appropriate mechanism of finance and that '[p]oor decisions or choices could result in severe consequences for the Not for Profit entity and investors alike'.[37]

The need for funding diversity

3.26 One of this inquiry's terms of reference relates to the types of finance and credit options available for social economy organisations. The social economy comprises small, medium and large enterprises residing in both the for-profit and NFP sectors. There is no single legal entity that applies to social economy organisations. Moreover, social economy organisations will enlist hybrid models to achieve their social objectives. It is not surprising therefore that the sector calls for diversity in funding options.

3.27 Social economy organisations are often significantly undercapitalised and struggle to access mainstream sources of capital, particularly non-grant and non-gift capital.[38] While grants and gift capital to the social economy sector can help stabilise cash flows and provide a revenue diversification tool,[39] a number of submitters to the inquiry argued that growing grant and gift capital has been the focus within the sector and that this has resulted in a lack of coordinated discussion about viable capital alternatives for the sector.[40]

3.28 New approaches to capital are required to shift the culture 'away from a culture of philanthropy, paternalism and dependence towards one of empowerment, entrepreneurship and initiative'.[41] A Harvard Business School Social Enterprise Initiative forum noted that 'in order to garner the capital necessary to foot the bill for social change, not-for-profits need to think less about traditional grants and more in terms of innovation, and so do the organisations that fund them'.[42]

3.29 The departments' submission highlighted the need for capital within the sector, and noted the PC report's findings 'that it can be difficult for not-for-profit

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36 Christian Super, *Submission 12,* pp 2–3; Social Finance Pty Ltd, *Submission 16,* p. 1.

37 JBWere, *Submission 19,* p. 5.

38 Social Ventures Australia, *Submission 2,* p. 1; Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3,* p. 5.

39 Christian Super, *Submission 12,* p. 6.

40 Foresters Community Finance, 'Finance and the Australian Not-for-Profit Sector', *Submission 4–attachment 2,* p. 5; SENTECH, *Submission 18,* p. 2.

41 United Kingdom Social Investment Taskforce in *Submission 9,* p. 12; JBWere, *Submission 19,* pp 2, 7.

42 DEEWR and PM&C, *Submission 9,* pp 16–17.

organisations to plan beyond short term funding cycles and much time and resources are invested in securing grants'.[43] A common concern raised by submitters is that the immediate priority for most social economy organisations is the programs and services they provide to their communities, meaning that there is often little focus on planning for the long term and financial stability, and even less focus on developing innovative approaches to financing. Any surplus income is spent immediately to improve service provision, redirected to other urgent services, or held short-term in reserve as liquid assets for future program enhancement.[44] The FIA elaborated:

> A continuing dilemma for the charity sector is the uncertainty of their income stream which is largely reliant on donations and government funding. This factor, coupled with the driving force for charities – that is, to better meet the needs of the communities they serve, inevitably places limits on planning for the long term.[45]

3.30 In addition, many social economy organisations are of the belief that should they accumulative wealth or assets, they will no longer be deemed in need of philanthropic or government support. Dr Ingrid Burkett of Knode Pty Ltd comments:

> Unfortunately, there is still a hand-to-mouth culture in many places and a fear of actually owning assets and building up equity in an organisation that that will turn funders away. I think, in fact, the opposite is true; we should reward organisations who demonstrate their long-term commitment to achieving impact by building organisational capacity to respond innovatively. We are not talking here about building fat-cat organisations, but building strong, interdependent organisations who are able to link impact and financial sustainability. I would really like to see a bit more activism from within the not-for-profit sector around sustainability rather than just increasing grant revenue.[46]

Forms of capital

3.31 A number of innovative financial products are currently being explored within the sector in Australia. These include:

- alternate ways of structuring grant capital to encourage long term viability and sustainability in the sector (see chapter 8);
- utilising patient finance, or long-term loans in recognition that social economy organisations do not yield high profit margins;
- debt capital with 'soft-terms'; and

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43 DEEWR and PM&C, *Submission 9*, p. 16.

44 Community Council for Australia, *Submission 15*, p. 3; Fundraising Institute Australia, *Submission 23*, p. 3.

45 Fundraising Institute Australia, *Submission 23*, p. 3.

46 Dr Ingrid Burkett, Managing Director, Knode Pty Ltd, *Committee Hansard*, 9 September 2011, p. 31.

- equity capital with reduced financial returns, or equity-like investments structured as subordinated debt or a performance based loan.

3.32 Mr Glen Saunders from Triodos Bank told the committee that 'patient' equity investments are a central part of Triodos' lending strategy in supporting the social economy in Europe:

> ...where we invest in entities like SEFA, Prometheus Ethical Finance in New Zealand or New Resource Bank in the US, we expect there is a reasonable financial return for the risk we are taking, but we have taken the stance that we will be a patient investor. We look for a return over something like 10 to 15 years. That should be, to set a benchmark, something like a 10 per cent return over that period. It is very low at the beginning, and as the organisation builds up its resources and so on it becomes correspondingly higher. That is what I would call a soft return from our point of view. We do not try to force the initiatives into that level of return, but that is what we think they should be trying to achieve.[47]

3.33 Foresters warned that patient finance and other 'soft-terms' of finance should not be considered 'a grant dressed up as a loan':[48]

> ...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.[49]

Debt capital

3.34 Hepburn Wind Park discussed the challenges associated with accessing debt finance for its venture. In the case of some cooperatives, debt finance for both construction and operation typically comes from a mainstream bank and has priority over member's equity. The debt funding was given prescriptive terms in order for the lender to guard against the perceived risks of an inexperienced management team and a single asset project. Eligibility for the debt finance required projected income from the venture and the projected percentage of debt to the total cost. Due to the calculated risk of the project's incompletion, a higher interest rate was offered and if the project were to default, the lender could dispose of the assets to recoup their funds or take over the project and complete or sell it. As Hepburn Wind Park noted it its submission '...the banks are reluctant to participate unless the community can demonstrate

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47 Mr Glen Saunders, Triodos Bank, *Committee Hansard*, 9 September 2011, p. 2.

48 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, p. 44.

49 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, p. 47.

significant levels of equity or demonstrate that it has access to additional sources of funding, as an example, government grants or third party guarantees'.[50]

3.35 Hepburn Wind Park was offered operational debt finance consisting of a medium term of 5 to 10 years to be repaid in the form of interest and principal. It relies on the venture producing revenue to cover operational and loan expenses. As a project with an unproven track record, lenders looked for a Debt Service Cover Ratio (DSCR) of 1.5, which is revenue after tax of 1.5 times the annual principal and interest repayments. In addition to a viable DSCR, the venture needed to offer an acceptable debt to equity ratio, or in the case of community co-operatives show 'how much "skin in the game" the community has'.[51]

3.36 Financial institutions face significant challenges to address social economy organisations' needs (such as overdrafts for fluctuating cash flows) while taking into account the possibility of limited capacity to safely hold capital.

3.37 Foresters suggests a number of options to address this tension:

- no interest loans which require rigorous structures and some subsidisation of administration costs;
- low interest loans often undertaken by a mainstream financial institution in partnership with a capacity building intermediary;
- commercial interest loans with special conditions offered within the legal and regulatory frameworks governing credit and lending practices—flexible conditions may be included such as unsecured loans, repayment holidays, or built-in capacity building; and
- above market interest loans with patient conditions often undertaken by CDFIs who need to obtain financial sustainability in their own right—whilst the market rates may be higher, the loan would be based on a long-term relationship and flexible payment plans whilst targeting the specific needs of social enterprises and facilitating access to debt capital.[52]

3.38 Mr Saunders from Triodos Bank raised concerns with the provision of debt capital for social organisations and projects at sub-commercial interest rates. He told the committee that such provision of debt products runs the risk of creating 'a sort of ghetto of low interest returns. If a project cannot manage a reasonable commercial interest rate, the project is probably not strong enough anyway to be invested in'.[53]

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50 Hepburn Community Wind Park Co-operative Limited, *Submission 20*, p. 2.

51 Hepburn Community Wind Park Co-operative Limited, *Submission 20*, p. 3.

52 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, pp 47–48.

53 *Committee Hansard*, 9 September 2011, p. 4.

Equity capital

3.39 A social economy organisation can raise equity capital by offering investors to buy and hold shares in it. The investor in turn receives income and capital gains from the equity investment.[54]

3.40 Foresters, after surveying a number of social enterprises, found there was little understanding or appetite for equity capital within the sector, and that relatively few of the enterprises would be attractive for equity investors looking beyond a social return:

> 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.[55]

3.41 Many Rivers Microfinance argued that 'a well designed and run equity product would leverage and allow significant loan capital to flow into the sector from current financial markets'.[56] The CCA noted that accumulation of assets is rare in the sector. Only 10 per cent of NFPs engage in economic activity and have 'considerable potential to both leverage investment and attract new sources of financing'.[57]

3.42 Foresters argued that to develop the market, education on equity investment is required for both enterprises and investors alike (particularly when legal structures do not accommodate enterprises to hold true equity). A marketplace, or intermediaries, to connect equity investors and enterprises would need to be established, as well as a consistent and comparable means of reporting social returns across the sector.[58] Some innovation for equity capital in the sector includes:

- quasi-equity or equity-like investments where the legal structure is that of subordinated debt, or a performance based loan—rather than dividend

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54 Australian Securities and Investment Commission, Money Smart Website, 'Glossary – equity investment', http://www.moneysmart.gov.au/glossary/e/equity-investment (accessed 24 October 2011).

55 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3,* p. 31.

56 Many Rivers Microfinance, *Submission 26*, p. 3.

57 Community Council for Australia, *Submission 15,* p. 3.

58 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3,* pp 48–49.

repayments, there could be royalty payments when the enterprise reaches particular revenue goals—they are generally coupon based and demonstrate longer term returns than standard debt products;[59]

- patient equity structured as subordinated debt with an expectation of some level of financial return with the rise of revenue for the enterprise, but with an emphasis on the social return—this may be accompanied by capacity building within the enterprise; and
- social enterprise equity, or real equity investments, would require the enterprise to have a legal structure of a company limited by shares, or be a cooperative with shares—it may be structured with reduced financial returns for investors, this approach would allow an enterprise to raise capital at any stage of its development.[60]

3.43 SVA expanded on the concept of quasi-equity investments, and how it would overcome some of the hurdles that social enterprises have in relation to equity:

> The majority of social enterprises in Australia cannot accept equity investments due to their legal form preventing them from disbursing dividends. It is estimated that 50 per cent are incorporated associations and 25 per cent are companies limited by guarantee. Additionally there is some concern of social enterprise management around the loss of control of their organisations. A more appropriate alternative is a quasi-equity investment whereby the financial return is dependent on the operating success of the enterprise. SVA believes that over time, these forms of financing will close the funding gap that exists in the social investment continuum between grants and commercial investments.[61]

Patient finance

3.44 Patient finance can be either in the form of debt or equity, and as the name suggests, it is a long-term investment. Returns, sometimes including retained capital, are contingent on a positive financial performance of the enterprise. The finance is constructed on 'soft-terms' and may allow for capital or interest payment holidays, and deferments.[62] Social Traders agreed that patient capital is required in recognition that social enterprises typically do not yield high profit margins, yet still have commercial pressures.[63]

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59 Community Sector Banking, *Submission 10*, p. 8.

60 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, p. 49.

61 Social Ventures Australia, *Submission 2*, p. 4.

62 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, p. 44.

63 Social Traders, S*ubmission 7*, p. 2.

The life-cycle of capital needs for social economy organisations

3.45 Foresters conducted a study into the different capital needs of a social enterprise at different stages of its life-cycle, including the start-up phase, development phase,[64] growth phase[65] and maturity phase.[66] The study underscored the need for funding diversity and various forms of capital including:

- start-up capital;
- fixed asset capital for acquiring initial assets that are small and essential, replacing poor quality equipment, or purchasing equipment that will build the enterprises viability and sustainability;
- working capital in the form of overdrafts or standby facilities to smooth lumpy cash flows without resorting to an enterprise accessing personal funds;
- growth and development capital for asset development, the attraction, training and retention of staff and acquisition of equipment; and
- sustainability and consolidation capital to build asset purchases and the balance sheets of enterprises, thereby supporting the development of financial sustainability.[67]

Start-up capital and seed capital

3.46 The FASES report noted that the first five years in the development of a social economy organisation holds extensive capital needs including debt finance, philanthropic grants, and contributions from individual members.[68] Social Traders argued that the start-up phase holds the biggest gap in finance availability for a social enterprise.[69] Foresters' research indicates that organisations have cited the importance of loans from friends, family and the founders themselves. A number of organisations also suggested that pro-bono contributions from people with particular skills were crucial, as was a workspace or premises to operate from.[70]

3.47 Hepburn Wind Park argued that capital availability can create time delays in the progress of a social infrastructure project due to the need for available capital before contracts are signed with developers. Without an excess of capital in the early

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64 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3,* pp 20–24.

65 Foresters Community Finance, *Submission 4–attachment 3,* pp 25–28.

66 Foresters Community Finance, *Submission 4–attachment 3,* pp 29–31.

67 Foresters Community Finance, *Submission 4–attachment 3,* pp 32–33.

68 The Australian Centre for Philanthropy and Nonprofit Studies and Social Traders, *Finding Australia's Social Enterprise Sector: Final Report*, June 2010, p. 29.

69 Social Traders, *Submission 7,* p. 2.

70 Foresters Community Finance, *Submission 4, attachment 3,* pp 14–19.

stages of the project, co-operatives cannot guarantee to fulfil contractual obligations, nor can they offer advanced payments that are often required.[71]

3.48 Foresters offered a lender's perspective on providing start-up capital to social economy organisations:

> ...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.[72]

3.49 Foresters suggested two approaches to develop financial discipline within the start-up phase for social enterprises; matched funds and planned loans. The former would require the enterprise to raise an amount of money as seed capital which the financial institution would then match. The latter would involve the development of a business plan, with finance contingent on the plan being analysed and supported by an independent panel. The financial institution would then maintain a connection with the enterprise to develop the business plan over time.[73]

The role of intermediaries and networks

3.50 Social economy organisations often require the assistance of intermediary organisations in order to attract finance and become investment ready. Financial intermediaries play a key role in linking suppliers of capital with social investment opportunities,[74] and offer a diverse range of finance products to social organisations.[75] CDFIs for example, are a form of specialised financial intermediary that tailor their activities to assist social economy organisations to gain access to capital. CDFIs actively build capacity within organisations through each step of the financing process (see paragraph 3.16).[76]

3.51 Non-financial intermediaries influence a range of areas within the social economy including through capacity building, developing the frameworks for the

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71 Hepburn Community Wind Park Co-operative Limited, *Submission 20,* p. 2.

72 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3,* p. 15.

73 Foresters Community Finance, *Submission 4–attachment 3,* p. 15.

74 Mr Christopher Thorn, JBWere, *Committee Hansard*, 1 August 2011, p. 9.

75 DEEWR and PM&C, *Submission 9,* p. xix.

76 DEEWR and PM&C, *Submission 9,* pp 33, xix–xx; Foresters Community Finance, *Submission 4 – attachment 3,* p. 39.

market, fostering innovation, encouraging collaboration and monitoring and reporting on the work of the sector. Intermediaries play a valuable role in offering advice relating to legal and business structures that create avenues to appropriate types of investment and capital for an organisation at various stages of its growth.[77]

3.52 Specialist intermediary organisations, including financial advisors, analysts and brokers and industry associations with a genuine understanding of the social economy are required to support the social economy. At this stage, 'the scale and scope of specialist support for social economy organisations in Australia remains limited'.[78] This was reflected in the evidence from a number of submitters to the inquiry that suggested that the intermediary sector needs to be further developed in order to provide expert advice on the most appropriate form of finance for each stage of a social venture.[79] JBWere commented:

> It is becoming more evident that well-resourced commercial intermediaries need to be established and encouraged if we are to develop a robust social capital market in Australia. These organisations need to be staffed by professionals who understand both the needs of all clients they are trying to serve as well as having the ability and authority to modify or tailor existing commercial offerings for the specific needs of Not for Profit organisations.[80]

3.53 The work of intermediaries and CDFIs is discussed further in chapter 5.

Risk, measurement and metrics

3.54 Internationally, there has been a growing recognition of the need to move beyond economic indicators to develop more holistic measures that include social and environmental progress. The departments' submission acknowledged that the efficacy and success of a social economy organisation cannot be measured in purely economic terms, and must include social measures.[81]

3.55 The sector needs common terminology and metrics systems for measuring social impacts in order to facilitate analysis and performance comparison, establish track records and offer potential investors an assessment of the risks and returns related to different investments.[82] Social Traders commented:

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77 The Centre for Social Impact, *Submission 27*, p. 7; Ms Juanita Pope, Senior Lawyer, PILCH Connect, *Committee Hansard*, 9 September 2011, p. 52; DEEWR and PM&C, *Submission 9*, pp 32–33.

78 The Centre for Social Impact, *Submission 27*, p. 7.

79 Productivity Commission, *Submission 6*, p. 2; DEEWR and PM&C *Submission 9*, pp 13, 32; JBWere, *Submission 19*, p. 8; Social Finance Pty Ltd, *Submission 21*, p. 1.

80 JBWere, *Submission 19*, p. 6.

81 DEEWR and PM&C, *Submission 9*, pp 33–34.

82 DEEWR and PM&C, *Submission 9*, pp 13, 34; Social Finance Pty Ltd, *Submission 21*, pp 1–2.

> It's easy to say that social enterprise makes a difference, but it's much harder to prove it. Anyone running a business or program needs to know if they are achieving their mission and objectives. This is an issue that affects the whole not-for-profit sector but as social enterprise increasingly attracts grants and support from philanthropy and government, there is a need to understand its real benefits.[83]

3.56 The challenges associated with measuring social outcomes, however, are a significant barrier to greater and more effective investment in social economy organisations. The financial costs of reporting and measuring may place undue burdens on social economy organisations and thereby impact on the quality of service they are able to provide their clients.[84] In addition, focussing on milestones or achievements, rather than on the quality of the service provided when measuring success may provide a skewed result.[85]

3.57 Creating a standard or uniform set of measurements presents a significant challenge given the varied work of the sector. Triodos Bank, which invests in a wide variety of projects, has experienced this challenge first hand. The bank initially used internal qualitative assessments for each project. As the bank has grown, however, these assessments became untenable:

> We are [now] looking for limited forms of measurement. We invest in a huge range of projects. How do you measure social return on an ecological and affordable housing project alongside a renewable energy project? We think it is inherently impossible to do that. What we are trying to do at the moment, with our intensive project internally, is to develop simple measures that give reassurance that we are really doing what we say we are doing. We think that there is a lot of academic interest in this area, and we are sceptical that you can turn qualitative matters into quantitative measures on a credible basis.[86]

3.58 Social impact measurement can be critical to the structure of certain financial products. In the case of performance based loans for example, it would be advantageous to develop consistent and comparable means of reporting social returns. Social impact bonds (SIBs) require a baseline outcome and set targets to measure the achievement of outcomes and impacts (see chapter 6).[87]

3.59 The PC report recommended that Australian governments implement a reform agenda for reporting and evaluation requirements for organisations in the delivery of government funded services based on a common measurement framework. In

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83 Social Traders, 'Measuring Impact', http://www.socialtraders.com.au/measuring-impact (accessed 12 September 2011).

84 Christian Super, *Submission 12,* p. 6.

85 Christian Super, *Submission 12,* p. 6.

86 Mr Glen Saunders, *Committee Hansard,* 9 September 2011, p. 5.

87 DEEWR and PM&C, *Submission 9,* p. 34.

consideration of the diversity of the sector, the PC recommends that the framework 'embody the principles of proportionality, transparency, robustness, flexibility, and relevance'.[88] A more detailed discussion on this issue is in chapter 7.

Organisational forms and structures

3.60 The lack of access to equity capital for the vast majority of social economy organisations has been cited as a considerable barrier to accessing finance.[89] Social economy organisations in Australia take a variety of legal forms including co-operatives, community associations, companies limited by guarantee and proprietary limited companies. A legal form defines the parameters by which an organisation can raise and service different forms of equity and debt finance. It also determines the governance of an organisation, and directs the compliance duties of a chief executive officer or board.[90] In its submission, Foresters outlined the challenges presented by social enterprise legal structures as twofold:

- the legal impositions surrounding the types of capital that can be accessed (whether that be market capital or grant capital); and
- the imprint a legal structure can make on the cultural and governance legacies of an enterprise that in turn can influence what types of capital they seek to access.[91]

3.61 The legal form chosen by an organisation can also affect tax concession arrangements.

3.62 In relation to legal forms, the PC report noted that the only social economy organisations that can access equity capital are cooperatives, a small number of not-for-profits which are companies limited by shares, and incorporated associations in Queensland.[92]

3.63 A number of new legal forms have been established internationally that aim to introduce greater flexibility for social economy organisations and investors. Some of these bring a greater focus on the social purpose of an organisation, while others open up access to equity and other forms of capital. These new models are discussed further in chapters 8 and 9. In the Australian context, the PC considered that addressing

88 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, pp 107–108.

89 Social Ventures Australia, *Submission 2*, p. 4; Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 193.

90 DEEWR and PM&C, *Submission 9*, p. 29.

91 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3*, p. 38.

92 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 193.

organisational structures which allow equity raising is less important than developing a sustainable market for debt financing.[93]

3.64 Given the extent of the impact a legal structure can have on the operations of a venture, organisations should be given assistance at the start-up phase of a venture to make an informed decision about an appropriate legal structure. The role of intermediary organisations such as Our Community and PilchConnect, which links not-for-profits with pro bono legal services, is vital in this area.[94]

Relationship with government

3.65 Following the development of the *National Compact: working together*[95] (see chapter 1), there has been considerable discussion in the sector on how the compact will be applied within the sector. Submitters argued that government should build relationships, rather than contacts, when engaging with social economy organisations, as a bureaucratic approach can lead to compliance burdens and dysfunctional contractual relationships. Concerns were raised relating to the shifting of social service delivery costs to the sector and the planning limitations created by short-term contracts, both of which constrain financial innovation and sustainability in the sector and exacerbate difficulties surrounding staff recruitment and retention and infrastructure development.[96]

3.66 Father Brian Lucas of the Catholic Bishops Conference and Mr Trevor Ruthenberg of the Lutheran Church commented on the limitations of short-term government contracts:

> **Father Lucas:** ...a funder has to make the prudential decision: if you are going to lend money over a five-year, 10-year or 15-year payback horizon, will the cash flow support that? If you are at the mercy of some change of government fashion then prudentially that is impossible. So, much of the welfare sector, as Harry Herbert has said, is at the mercy of tender processes, short-term contracts and consistent changes of approach in that sector according to the whims of government policy.
>
> **Mr Ruthenberg:** When you get on the ground and you start delivering a service, irrespective of whether it is in town or in a remote Aboriginal

93 Productivity Commission, *Contribution of the Not-for-Profit Sector*, January 2010, p. 193.

94 Foresters Community Finance, 'Financing Social Enterprise: Understanding Needs and Realities', *Submission 4–attachment 3,* p. 38; DEEWR and PM&C, *Submission 9,* p. 30.

95 Australian Government, *National Compact: Working together*, 17 March 2010.

96 YMCA, *Submission 1,* p. 3; Community Council for Australia, *Submission 15,* p. 3; Fundraising Institute Australia, *Submission 23,* pp 4–5; Father Brian Lucas, General Secretary, Australian Catholic Bishops Conference and Mr Trevor Ruthenberg, Executive Officer, Lutheran Church, *Committee Hansard,* 23 September 2011, pp 9, 23–30; Mr Sandy Cameron, Manager, Policy and Research, Cape York Institute for Policy and Leadership, *Committee Hansard,* 23 September 2011, p. 33; Dr Thomas Calma, Director, Australian Indigenous Leadership Centre, *Committee Hansard*, 23 September 2011, p. 39.

> community, it takes time to develop reputation and trust and connections. To be looking over your shoulder consistently to determine whether you are going to have funding next year is incredibly debilitating, especially when you are looking for quality staff and the people who care.[97]

3.67 The government's *National Compact: working together* (see chapter 1) to work with social economy organisations to strengthen the capacity of the sector and 'collaborate on workforce strategies to improve attraction, retention, development and recognition of paid workers and volunteers in the sector'.[98] The committee notes the PC's recommendation that compacts between the government and the sector should be supported by well documented plans of action.[99]

3.68 Chapter 9 discusses these themes further, along with the role of government as an investor, regulator and an advocate for change.[100]

Conclusion

3.69 The development of a robust capital market for social economy organisations goes beyond a sole focus on the creation of financial products. The interdependence between capacity, the role of intermediaries, product development, measurement, regulation and the sector's relationship with government illustrate the need for broad sweeping policy initiatives to support the sector and catalyse a capital market.

3.70 This chapter has examined the demand side of the equation with calls from social economy organisations for innovative financial products, further development and support of intermediaries, tools for measuring social return and improvements to the regulatory environment. These issues will be discussed in further detail in subsequent chapters. The supply side of the sector will be addressed in chapter 4.

3.71 A recurring argument presented to the committee was the need for social economy organisations to build their capacity and become investment ready. The committee recognises that an increased flow of capital to the sector needs to be matched by capacity growth in social economy organisations. Without improvements in financial management and planning, the resources invested into the sector are at risk of mismanagement. Further, the inappropriate allocation of various forms of capital could result in dire consequences for investors and social economy organisations and in turn the communities they serve.

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97 *Committee Hansard*, 23 September 2011, pp 29–30.

98 Australian Government, *National Compact: working together*, March 2010, p. 4.

99 Productivity Commission, *Contribution of the Not-for-Profit Sector*, (Recommendation 14.2), January 2010, p. liii.

100 Mr Paul Ronalds, First Assistant Secretary, Office of Work and Family, Department of Prime Minister and Cabinet, *Committee Hansard*, 1 August 2011, p. 55.

3.72 The committee concludes that the proposed Social Finance Taskforce (see chapter 2) would play a key role in managing this emerging capital market and the interdependence of building capacity, supplying suitable financial products and encouraging intermediaries to flourish in the sector (see chapter 5). The taskforce would also align the current regulatory reforms with the social investment agenda, and ensure that legal forms are also considered in social investment terms.