Intermediary Perceptions of Investment Readiness in the Social Investment Market

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Abstract

The 'social investment market' (SIM) in the UK is a growth area due to the governments' focus upon building up the supply-side element of the market over the last decade, often through the direct financing of 'social and investment finance intermediaries' (SIFIs). However, this ignores problems that can occur on the demand-side of the SIM, such as a lack of 'investment readiness' (IR) amongst social enterprises (SEs) seeking investment. Indeed, whilst there is now a significant body of policy-based and practitioner research exploring the SIM, there remains a paucity of empirical academic research. The research reported in this paper sought to explore SIFI perceptions of what constituted IR in the SIM. Semi-structured interviews were held with the fund managers (or relevant personnel) at 15 SIFIs in order to explore what they believed constituted IR and how they assessed this. The results indicate that the conception of IR in the SIM is similar to that held in mainstream financial markets. The results are discussed in relation to the prior literature and theories of the SIM.

Introduction

'Social Investment', sometimes also called 'Impact Investment', ultimately seeks to provide finance to social ventures (either debt or equity finance) with an expectation that a social as well as financial return will be generated (Brown and Norman, 2011). In the UK the 'social investment market' (SIM) was estimated to have made a total of £165 million of social investments in 2011 (Brown and Norman, 2011) and this is predicted to grow to around £1 billion in the UK by 2015 (Brown and Swersky, 2012). Indeed, the UK is positively placed to play a leading role in this global growth, due to its depth of social-purpose organisations, its strong financial sector (Evenett and Richter, 2011) and the strong political support for the SIM that has come from successive UK governments (Nicholls, 2010b). Accessing external funding or support through investment contracts or alliances can be beneficial to social enterprises (SEs) as it builds organisational independence and resilience (Sakarya *et al.*, 2012). However, these changes to the SE's core model of mission delivery provide challenges to management teams (Bugg-Levine and Emerson, 2011) that often require restructuring or skill-set injections at board level. An inability to successfully undertake these changes often causes problems for SEs seeking finance from the SIM, as they do not have robust governance structures, skilled management teams and detailed business plans in place (Hines, 2005; Hill, 2011; Howard, 2012). This inability to access finance has led to SEs being encouraged to adopt private sector business practices in order to access social investment from 'Social and Investment Finance Intermediaries' (SIFIs) (Nicholls and Paton, 2009). This perception that social enterprises are not 'investment ready' has been driven by a duality in the SIM, in which SEs cannot access social investment and social investors cannot find 'investment ready' propositions (Howard, 2012). There is a current paucity of academic research into social finance and the SIM in general and researchers have identified a need for more theoretical and empirical studies so that a more detailed understanding of the SIM can be developed (Battle-Anderson and Dees, 2006; Nicholls, 2009; Nicholls and Paton, 2009; Nicholls, 2010a; Moore *et al.*, 2012). Specifically and in relation to this study, there is no academic research that explores in detail what SIFIs define as 'investment readiness' (IR) and the research that does exist around the investment criteria of social investors is methodologically constrained and focuses too broadly on social investors. Indeed, a clearer understanding of the investment criteria adopted by SIFIs would allow SEs (and SE support organisations) to more easily access capital in the SIM. This paper reports research that explored SIFI perceptions of IR through in-depth semi-structured interviews.

Analytical Framework

Social Finance & the Structure of the Social Investment Market

SF and the description of the SIM adhered to in this article is distinct from 'Socially Responsible Investment' (SRI) and 'Corporate Social Responsibility' (CSR). Unlike SRI, SF requires more than the negative/positive screening practices adopted in commercial investments that focus on social, environmental and governance criteria relative to the investee. In relation to CSR, social investment organisations have social impact at the core of their mission, as opposed to as an appendage to it (Geobey *et al.*, 2012; Evenett and Richter, 2011). SF can be defined as being any 'flows of capital that start-up, sustain, or grow individual, group, organizational or sectoral action aimed primarily at generating social or environmental value, often in the form of public goods or positive externalities' (Nicholls and Paton, 2009: 3). SF includes a broad range of investment approaches including 'impact investing', government finance (i.e. Social Impact Bonds) and philanthropic investment through foundations (i.e. venture philanthropy) (Moore, Wesley and Brodhead, 2012). The organic development of the SIM and the organisations operating in this market has led to a diverse and heterogeneous range of views on the future macro-development of the SIM and of the financial tools and models that are operated at a micro-level (Howard, 2012).

Nicholls (2010a) identifies three elements that constitute the structure of the market; supply, demand and intermediation. In the UK the supply-side investors have predominantly been charitable endowment funds, social banks and the UK government itself (Nicholls, 2010a). These supply-side investors seek what Emerson (2003) terms 'blended returns on investment', that is the delivery of both financial returns and social/environmental impacts from their investments. Nicholls and Murdock (2011) identified 'demand-side' organisations as being social enterprises, charities, cooperatives, social businesses and public/private hybrid organisations. These organisations all operate according to a 'double or triple bottom-line', in which a social/environmental mission has to be balanced alongside financial sustainability (Campi *et al.*, 2006). These demand-side organisations seek investment capital either to start-up, grow or sustain their social activity. The social finance market is typical of many nascent markets in that it is made up of a small number of organisations that deliver a heterogeneous range of support, finance options and investment vehicles (Nicholls, 2010a). These organisations operate primarily in the intermediary market, in which SIFIs link social entrepreneurs with investors seeking a social impact (Evenett and Richter, 2011). The focus of the research reported in this paper was upon this intermediation element of the SIM.

A SIFI can be defined as any organisation with or without funds that seeks to match social investors with investees and these include social venture capital, social banks, brokers, advisors and some charitable foundations (ClearlySo, 2011). Brown and Norman (2011) identified 30 SIFI organisations operating in the UK at a local, regional or national level, of which six SIFIs accounted for 90% of investment. SIFIs provide a mixture of debt (loans), quasi-equity (equity blended with debt-based repayments) and equity finance. Generally, SIFIs target higher financial returns for riskier investments (i.e. equity) and lower returns for less risky investments (i.e. secured loans). However, in addition to SIFIs offering such funding there are also venture philanthropy (VP) funds and social enterprise development organisations/brokerages (SEDs). VP replaces the hands-off approach utilised by individuals/foundations giving charitable donations, to a more deeply engaged approach in which the grant provided is secured on a contractual basis that is tied to preferred outcomes set by the philanthropic institution/individual (John, 2006). SEDs also provide consultancy support to SEs (as well as supply-side investors) in the areas of law, accounting, marketing and business development (Nicholls, 2010a).

The Barriers to the Future Development of the UK Social Investment Market

Nicholls (2010a) identifies three possible future scenarios for the SIM. The first posits that the SIM will move into the mainstream financial markets and be absorbed by them as the needs of the investor are given priority. The second states that the *status quo* will persist and that the SIM will remain on the margins of the mainstream investment sector, with investor needs and the ‘logic of gift giving’ achieving a tensional balance (Nicholls, 2010a). The third theorises that the SIM will act as a transformative agent and that the idea of ‘blended-value’ would be exported over time to the mainstream finance sector, which would in-turn drive systemic change that would see social and environmental return calculations built into *all* investments due to the primacy of a values-driven rationality. Nicholls (2010a: 90) states that at the present time it appears as if it is the first scenario that ‘is moving towards dominance’, which can be evidenced through the large numbers of actors from the mainstream finance sector that are playing a leading role in shaping the development of the SIM.

There are a number of factors within the UK SIM that are acting as barriers to growth. These include a lack of risk-assessment and social impact metrics, which leads to a ‘fragmentary landscape’ in which information flow is limited and inappropriate financial instruments are imported from the mainstream market (Nicholls, 2009; Nicholls, 2010b; Wood *et al.*, 2012). This lack of information leads to extended due-diligence processes, put in place by risk-averse organisations that increase transaction costs (Evenett and Richter, 2011), and these costs are exacerbated by the high number of investor sources that SIFIs have to utilise compared with an equivalent, mainstream fund (O’Donohoe *et al.*, 2010). These high transaction costs leave less recyclable capital and also may mean that riskier propositions are priced out of the investment market (Geobey *et al.*, 2012). The difficulties inherent in trying to measure social impact (SI) have also led to a lack of information in the SIM, a factor that is complicated by the existence of a plethora of methodologies for measuring SI. Three prominent SI methodologies have arisen in the SIM; namely ‘Social Return on Investment’ (SROI) (Maree and Mertens, 2012); the ‘Impact Reporting and Investment Standards’ (IRIS); and its derivative the ‘Global Impact Investing Rating System’ (GIIRS) (Saltuk *et al.*, 2011). However, the use of SROI has been limited as the monetisation of complex social problems is seen as limited in its effectiveness (Maree and Mertens, 2012); whilst research by Saltuk *et al.* (2011) highlighted that only 20.15% of social investors utilised IRIS or GIIRS.

Another barrier to growth for the SIM has been the perceived lack of demand-side organisations that are IR and the perception of SEs as high-risk investments (Strandberg, 2007). This was further emphasised in more recent research by Howard (2012) that identified a demand/supply gap in the SIM between supply-side investors and demand-side investees. A lack of IR amongst demand-side investees is a factor that will limit the growth of the SIM and that will potentially stifle riskier (but more innovative) early-stage financing. Research that therefore understands what SIFIs define as IR will provide SEs and their support organisations with important information that they can use to develop their organisations in order to access finance from the SIM. Research into investment criteria in the SIM has been carried out, with McWade (2012) identifying five areas of social investor (supply-side) focus. These were (1) the social mission and its centrality to the overall business aims; (2) a solid and concise business plan; (3) a skilled and credible management team/board; (4) the company's financial viability and (5) a clearly defined exit plan. Indeed, McWade (2012) identified that whilst the social mission is important to social investors, this criterion supplements rather than replaces the financial due-diligence that occurs in the mainstream investment market. However, McWade's (2012) analysis was carried out amongst social investors as a whole (high net-worth individuals, institutional investors and consumer depositors) and did not specifically focus upon SIFIs or the intermediary element of the market. This is an important distinction as not only is the SIM in the UK heavily reliant on these intermediaries (Evenett and Richter, 2011), but the pool of social investors that invest in the SIM is extremely heterogeneous. In addition, the participant recruitment and data analysis methodologies utilised by McWade (2012) are unspecified and so the validity of the results is difficult to determine. There therefore remains a need for the evaluation of IR within the intermediary element of the SIM that is rigorous and valid in both its recruitment of participants and the analysis of the interview data. However, the lack of academic research on the SIM first requires an examination of the mainstream finance literature around IR in order to develop a clear conceptual understanding.

Investment Readiness

Government interventions aimed at increasing 'small and medium-sized enterprise's' (SMEs) access to finance are usually targeted at increasing the availability of supply-side capital (Mason and Kwok, 2010). In the UK there has been a focus upon developing the supply-side of the SIM, as the government has sought to create a market and regulatory framework for SF through legislation and direct/indirect funding (Nicholls, 2010b). This has resulted in the neglect of problems on the demand-side of the SIM (such as a lack of IR amongst SEs), although this focus is now shifting through such schemes as the 'Investment and Contract Readiness Fund' (ICRF) (SIB, 2013). Gregory *et al*. (2012: 6) define IR as "…an investee being perceived to possess the attributes, which makes them an investible proposition by an appropriate investor for the finance they are seeking." The process of seeking investment and becoming IR begins at the point that the entrepreneur/enterprise realise that their personal resources, or those of their organisation, are insufficient for their start-up, growth or sustainability needs (Silver *et al.*, 2010).

Prior research identifies the quality of a potential investee's business plan as being crucial to the IR of an SME (Howard, 2012), with investors often being frustrated by the poor quality of the business proposals submitted for funding (Mason and Harrison, 1999; Paul *et al.*, 2003). The viability of a business proposal involves an examination of the capitalisation of the business, the management team in place, return versus risk analysis and the quality of information held and provided by the business (Mason and Harrison, 2001; Mason and Kwok, 2010). In a study of debt and equity investors, Mason and Stark (2004) identified that debt financiers (bankers) placed more emphasis on financial data than did equity financiers (VCs and business angels). This is possibly due to the lower margins on debt-finance investments, which force bankers to minimise 'Type One Errors' (lending to businesses that subsequently fail), as well as a debt-financiers' reduced ability to monitor an investment in the same detail that an equity investor could (Mason and Stark, 2004). Research has also shown that there are also high rejection rates of business proposals by equity investors, usually directly related to poor business proposals that do not meet investment criteria (Mason and Kwok, 2010). Despite this, there are also numerous rejections of good business propositions that are otherwise IR. This is because in markets where imperfect information exists, investors need to balance risk and this leads to 'investment ready' businesses being declined capital (Deakins *et al.*, 2008).

The characteristics and skill-sets of the entrepreneur and their management teams have also been shown in prior research to be extremely important in accessing finance and being considered IR. Indeed, the suitability of the entrepreneur, which relates to a critique of their business skills, expertise, projections and personal qualities such as integrity (Mason and Harrison, 2001; Kollmann and Kuckertz, 2010; Mason and Kwok, 2010) has been shown to be extremely important in investor decision-making processes. Muzyka *et al.* (1996) suggests that investors, as well as assessing the entrepreneur(s), are also concerned with the management team of a potential investee organisation, which is often more important than analyses of the market, product and deal structure. However, Vasilescu (2009) also argues that it is just not the quality of a management team, but also the way that it is structured that is important to investors. A management team could be of a high quality and possess a good skill-set, but if that is not complemented by a coherent and appropriate structure then investors may be deterred. This has particular relevance for SEs seeking to access the SIM as research has shown that concerns over entrepreneurial/management skill-sets, as well as governance structures, are two of the main reasons for investors declining SE investment opportunities (Hill, 2011).

The impact that the personal characteristics of the entrepreneur(s) has upon the chances of successfully acquiring investment has also been shown to be important in prior research. Bank loan officers were shown to make subjective evaluations around a potential investee's character, with favourable characteristics viewed as conformity, low risk-taking propensity and professionalism (Wilson *et al.*, 2007). This has also been evidenced as taking place in the equity investment sector, with the evaluation of 'soft data' and the use of intuition forming an integral part of the VC investor's due-diligence process (Zacharakis and Shepherd, 2001). Often intuitive decision-making processes are a symbol of a lack of clear information in a market, as investors have to rely on their 'gut reaction' (Jankowicz and Hisrich, 1987), particularly when funding start-up or early-phase businesses (Ramón *et al.*, 2007; Ferrary, 2010). Indeed, this last point relating to 'gut reaction assessments' has also been shown by prior research to take place in VC assessments of social entrepreneurs (Achleitner *et al.*, 2012). Mason and Harrison (2001) also discuss the negative effect that poor presentational skills can have on a business and how this is particularly crucial in verbal, face-to-face pitches to investors. This importance of the personal characteristics of the entrepreneur could also be significant for SEs seeking investment from the SIM as the passion and drive of a social entrepreneur has been shown to be crucial in successfully seeking investment (Howard, 2012).

The final areas relating to what constitutes IR for SMEs seeking investment has been in the 'market' characteristics of the business proposal, which relates to the market that the SME operates in, as well as geography and sector. Research by Mason and Harrison (2001) has shown that investors are discouraged by businesses that operate in highly competitive markets, as this can not only lead to poor growth potential, but also requires a business to be extremely well-focused and to have a clear and innovative 'unique selling point' (USP). Indeed, for an SME operating in a highly competitive market to successfully access finance, the business plan needs to be extremely detailed and highly developed to avoid rejection (Mason and Harrison, 2001). Research by Champenois *et al.* (2006) also identified that VC investment criteria were often industry specific, with investors looking for organisational skills complementary to that sector. Finally, Deakins *et al.*, (2008) also identified geography as having an impact upon the IR of an SME, with SMEs based in rural areas struggling more than urban-based businesses to access finance. This was perceived to be due to a reliance on localised markets, which could also offer a barrier to SEs as these often operate in localised economies.

Nevertheless, the IR of a potential investee is not solely related to investor perceptions of their business, but also on the entrepreneur's perception/knowledge of the finance market as well. This has been shown to occur in relation to both the accessing of debt and equity finance by SMEs. Myers (1984) developed the 'pecking order' theory, in which entrepreneurs do not attempt to access equity-type finance as they do not wish to give up control of their business. This has also been labelled 'equity aversion' and it has been suggested that this is due to 'information asymmetry', in which the entrepreneur is not aware of or is incorrectly informed about equity investments (Van Auken, 2001; Silver *et al.*, 2010). In accessing debt finance Kon and Storey (2003) and Fraser (2005) discussed the 'discouraged borrower' effect. This is where the entrepreneur or SME are discouraged from applying for debt finance either due to negative prior experiences or a perception that they will be unsuccessful. Indeed, this self-selection process can lead SMEs to 'bootstrap' (sustain without external help) rather than seeking external investment (Deakins *et al.*, 2008). Research on SEs seeking SF has also shown that there is nervousness amongst SEs in seeking growth capital, as many felt that in accessing such investment they would be placing themselves in positions of increased financial and contractual risk. Indeed, Howard (2012) identifies that changing SE stakeholder mind-sets away from seeking grant-funding towards seeking repayable investment are crucial to developing IR (Howard, 2012).

Summary

The prior research outlined above has provided an overview of the SIM in the UK. It has shown that the SIM consists of three elements; supply-side social investors, demand-side investees and intermediary organisations (SIFIs) that link the first two elements together (Nicholls, 2010a). Academic research into the perception of IR amongst SIFIs is urgently required, as whilst there is a significant body of academic research that explores the IR of SMEs (both from a supply-side and demand-side point of view), there is little research that explores IR criteria in the SIM. Indeed, the limited non-academic research that does exist in this area suggests that charities and social enterprises are often unprepared for investment and struggle to make the transition to scalable, commercial ventures (Howard, 2012). Studies into IR can increase collaboration between entrepreneurs and investors and hence create more investment opportunities (Kollmann and Kuckertz, 2010). It is therefore imperative that studies into IR in the SIM are undertaken. The research reported in this paper sought to address this by exploring the perceptions of IR amongst UK SIFI fund managers.

Research Aims

The review of the prior research outlined above has identified that academic research into SF and the SIM in the UK is limited. This is particularly true in relation to understanding the criteria used by SIFIs in assessing SE investment applications. The aim of the research was therefore to explore what SIFI fund managers perceived IR to be, as well as to explore the impact that these conceptions of IR would have on the future of the SIM in the UK. The research reported in this paper therefore sought to explore these two specific research aims outlined below, which were derived from the literature outlined above.

> *Research Aim 1:* What constitutes SIFI conceptions of IR and how does this relate to theories of IR from the mainstream finance sector?

Research Aim 2: What implications do the IR criteria articulated by SIFIs have for the future development of the SIM?

Methodology

Participants and Procedure

An analysis of secondary data was conducted (websites, policy reports and promotional materials) in order to identify SIFI organisations operating in the UK SIM at a national/multi-regional level. This phase of the research identified 22 SIFIs, of which 15 agreed to participate in the research study (see Table 1 below for a breakdown of the sample). The study adopted a qualitative research method, in which semi-structured interviews were conducted with the fund manager (or other relevant personnel) at the 15 SIFIs. These interviews sought to elicit information about the SIFI organisations; participant perspectives of the investment decision-making process; the criteria utilised when carrying out due-diligence; and perceptions around what constituted IR. Participant perspectives on the social finance market and the future of social investment were also sought. The semi-structured nature of the interviews also allowed the participants to discuss any other issues that they felt were important.

Table 1 – Organisational Type & Interview Participant Role

Organisation	CEO	Fund Manager	Senior Fund Employee	**Total**
Ethical Bank/Fund (Mainly Debt Finance)	0	6	2	**8**
Social Venture Capital Fund (Equity Type Finance)	0	2	0	**2**
Social Venture Philanthropy Fund	0	1	1	**2**
Brokerage/Social Enterprise Development Fund (SED)	1	2	0	**3**
Total	**1**	**11**	**3**	**15**

Data and Analysis

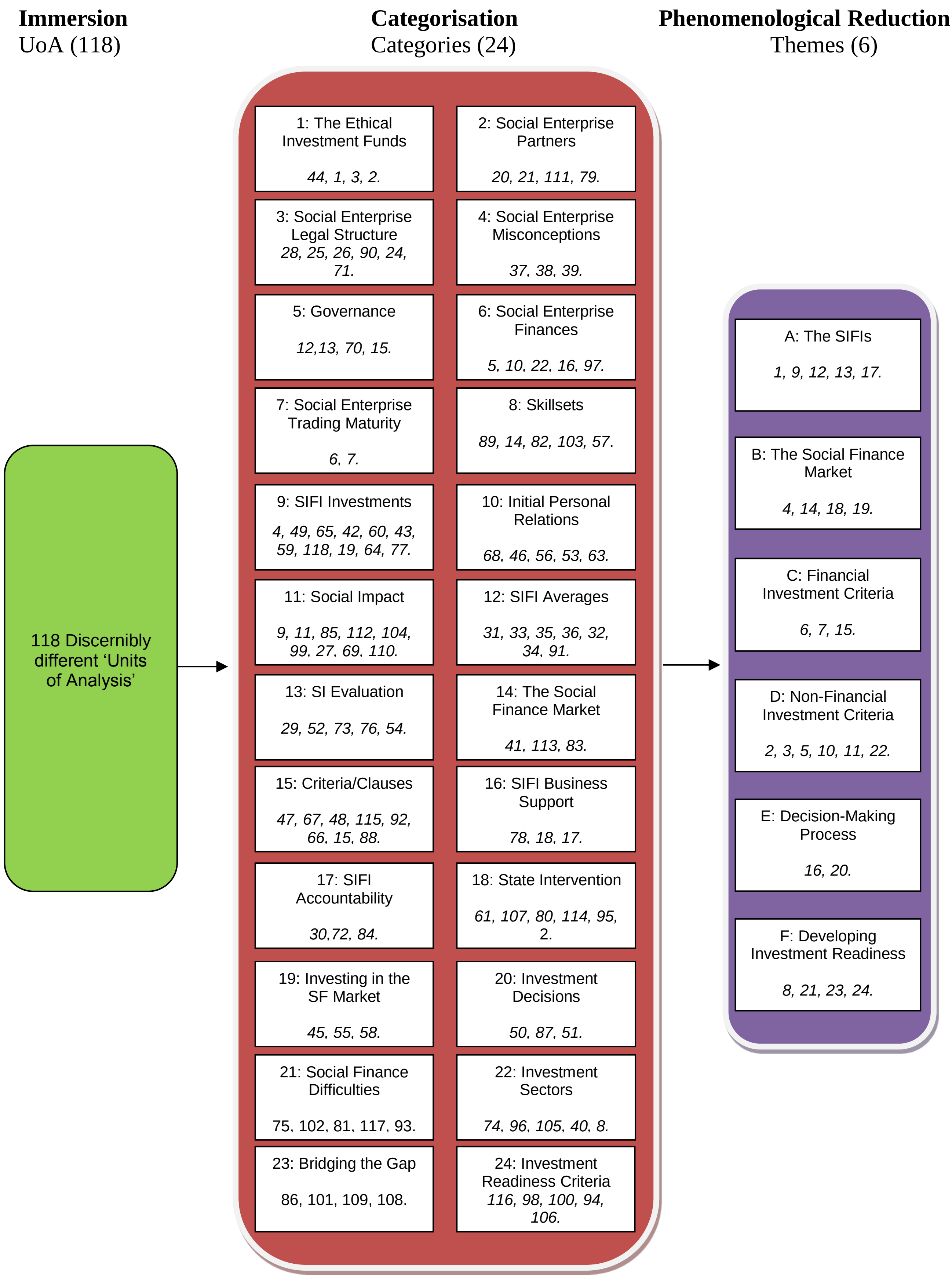
The 15 interviews ranged from 33 minutes in length to 83 minutes in length, with an average interview length of 56 minutes. Out of the fifteen interviews, seven were held in person at the relevant SIFI and eight were held over the telephone and all interview data was recorded and transcribed for analysis.

The method employed to analyse the participant's individual semi-structured interviews collected in the research was 'Constant Comparative Method' (CCM) (Glaser & Strauss, 1967; Lincoln & Guba, 1985). CCM is an iterative procedure designed for the qualitative analysis of text and is based on 'Grounded Theory' (Glaser & Strauss, 1967). CCM has been successfully applied in previous studies across a wide range of disciplines including social venture creation (Haugh, 2007). This method of analysis focuses on a process where categories emerge from the data via inductive reasoning rather than coding the data according to predetermined categories (Maykut & Morehouse, 1994). CCM involves five main stages; Immersion, 'units of analysis' are identified; Categorisation, 'categories' emerge from the 'units of analysis'; Phenomenological reduction, 'themes' emerge from the 'categories' and are interpreted by the researchers; Triangulation, support for researcher interpretations of 'themes' is sought in additional data; Interpretation, overall interpretation of findings is conducted in relation to prior research and/or theoretical models (McLeod, 1994).

Results

Analysis of the interviews identified 118 discernibly different units of analysis (UoA) (e.g. 'Financial Sustainability' and 'Fund Size'). During 'categorisation' these 'units of analysis' were grouped into 24 'categories' and from these categories 6 'themes' emerged through a process of 'phenomenological reduction'. These six emergent 'themes' were subsequently interpreted as 'The Social Investment and Finance Intermediaries', 'The Social Investment Market', 'Financial Investment Criteria', 'Non-Financial Investment Criteria', 'Decision-making Process' and 'Developing Investment Readiness' (see Figure 1 for a diagrammatic illustration of this process). These themes were interpreted as organisational perceptions based upon the opinions articulated by the participants at each SIFI. It is proposed that an examination of these themes will reveal the factors that influence investment decisions within the social finance market, as well as the 'investment-ready' characteristics sought by SIFIs in investees.

Figure 1 – Phases of CCM Analysis for the SIFI Interview Data:



NB. The numbers displayed above in Figure 1 in the 'categories' boxes correspond to the relevant UoA contained in that category. The numbers in the 'themes' boxes correspond to the relevant category contained in that theme.

Research Findings

Theme A: The Social Investment and Finance Intermediaries (SIFIs)

The participants provided overviews of their SIFI related to fund history, legal structure and income-streams. The majority raised capital through consumer-based investor deposits (ethical banks), private-sector investor deposits (SVC funds), endowment funds and donations (SVP organisations), as well as government investment. The legal structure of the funds was also varied with ethical banks operating as charities, PLCs, and Industrial Provident Societies; the SVC funds being run as Companies Limited by Guarantee (CLG) or Share (CLS); whilst the SVP/SEDs functioned as charities or CLS.

> *"I mean structure wise we are a Company Limited by Shares. It is wholly owned…by the* [parent company]*……the* [parent company] *I believe is a Company Limited by Guarantee, and that effectively up-streams it's profits into the* [SIFI] *Foundation, which is obviously a charity."* (P1)

> *"The* [Fund] *is obviously a different investor base, so our investors include the government…some charitable foundations…a number of banks…and a number of high net-worth's."* (P4)

The participants also discussed the different types of investments that they made, which could be split into debt, equity and quasi-equity finance. The participants also discussed the high transaction costs of investing in SEs, mainly due to the need to try and reduce failure rates through rigorous due-diligence.

> *"…the £5 million or so of commitments out of the finance fund is all investment, and that's in the form of loans, quasi equity,* [shares]*…"* (P2)

> *"Well we reckon as a rough figure for every pound we get, 65 pence gets invested, you know we lose under 10%. It costs us about 15% to do the deal, and the rest is sort of social costs, and management costs."* P11)

Theme B – The Social Finance Market

The participants viewed the social finance market as unusual in its demands and needs due to the dual-mission of SEs. Sustainability was seen as a key problem due to the often low-turnovers and profit margins of SEs, the high transaction costs of individual deals and the small-size of SIFIs (relative to the commercial sector). The participants also discussed a perceived demand/supply mismatch in the sector, with finance deals and sizes that were often unsuitable for small SEs. The cause of this was seen to be misunderstanding between the supply and demand sides of the SIM.

> *"…the money is skewed; there is lots* [of finance] *at big levels for low-risk proposals…so you've got a mass of high-risk, small-scale organisations looking for investment. And it doesn't cross, so it's a dysfunctional market…"* (P11)

> *"So I think another problem too would be that some people in this SIM* [SEs], *they almost think that because they've got such a good sort of ethic or impact, they don't have to do the numbers. You know this is great, just support me, I'm doing good……well no it's not like that. It isn't a charitable donation; this is an investment or a loan."* (P6)

Some of the SIFIs also provided funding to other SIFIs in the sector. Additionally, there was also inter-fund cooperation both in assisting with due-diligence procedures and in providing match-funding investments into SEs (usually slightly higher-risk SEs).

> *"So anyway, we invested in these funds to try and do it almost better than us because then our money's pulled in a bigger pool of money…So we tried that approach to say, "Okay, are there growth social enterprises there? Can these guys support it better?"* (P2)

The final area that the participants discussed was the impact that government funding had produced on the social investment market, through initiatives such as the 'Social Enterprise Investment Fund' (SEIF) or the development and promotion of 'Social Impact Bonds' (SIBs). SIBs were also seen as being potentially high transaction-cost investments.

> *"I think the big thing for us is that the costs of running these sort of fund-raising exercises* [SIBs etc.] *and the management, is quite horrendous, they've set so many sort of regulations…the sort of minimum fee of getting them going is usually quite high."* (P6)

<u>Theme C: Financial Investment Criteria</u>

Unsurprisingly, the participants talked about the fundamental need for the SE seeking investment to be financially sustainable and to be able to service the investment provided to them at a reasonable rate of return. There was a desire to see SEs utilising multiple income streams that would not make them vulnerable to contract cancellations. The income origin (public, private or third sector) was not deemed important, as long as it was secure over the medium-term. In assessing the 'sustainability' of a SE's finances, grant-funding was not considered as a viable source of income by most of the participants, although match-funding was a positive aspect that would boost 'investment-confidence'. Overall, there was acknowledgement that the financial investment criteria utilised in the SIM was no different than that used by mainstream private-sector investors.

> *"So obviously a social start, then it's then looking at obviously the financials…if it's debt financing, can they service it, if it's equity or equity like mezzanine finance, is it going to potentially give us a reasonable return…what's the growth potential?"* (P1)

> *"I don't think it's about income, it's about having sustainability of income sources…you want to look at who are your competitors? Have you maintained that level of income? What's the market growth in that particular area?"* (P9)

> *"…a number of the ones we see are other matched-funding, yes, we like to see that."* (P3)

The trading maturity of the SE investee was also seen as very important, as all but one of the funds were not interested in investing in start-up SEs. Indeed, whilst the profitability of the trading income was not crucial, SIFIs were looking for SEs with two to three years of trading history.

> *"…we are not looking for early start-ups, we're looking for organisations that have a proven model, so they may have piloted it and they may be existing, they're probably cash negative at the moment…but not start-up..."* (P9)

The final area that the participants discussed in relation to financial assessments of the potential SE investee was in the area of business plan scrutiny. This would usually take place at the 'second phase' of an application, when the cash-flow projections of the business proposal would be tested. This was sometimes done by external consultancy partners but was usually completed in-house. The market and potential competitors were also factored into this analysis and the due-diligence process often led to conditions being placed on any loan offer (i.e. the appointment of a new finance director).

> *"I mean we would take care, an awful lot of due-diligence really. I mean as you would probably imagine. We are looking through the business plan; we are making sure that the*

social entrepreneur actually understands the figures so he hasn't just delegated it through his account or his finance guy." (P6)

"If it's a good business and we see that it can work but it needs a bit more financial control we have to put conditions on where they need to have either financial training or they need to bring in someone with the skills." (P4)

<u>Theme D: Non-Financial Investment Criteria</u>

The participants also discussed a large number of non-financial criteria that they used to assess potential SE investees. The personal relationship between the fund employee dealing with the application and the social entrepreneur was seen as of paramount importance.

"So you know a mutually respectful and a mutually useful relationship, so the advice or support you try to provide won't just fall on deaf ears. So that sort of two-way mutual respect I think is useful as well as an ability to deliver…as well as decency." (P10)

Interestingly and despite the government's creation of the CIC legal form, the legal structure of a potential SE investee was not viewed as important. The participants did not always even require the potential investees to have asset-locks in place.

"…we wouldn't exclude anybody for a particular legal status but sometimes a legal status determines what the investment will be. So if it's a charity, obviously we can't take shares……So I think it's about, you know, control of mission, control of purpose that we're interested in." (P2)

However, governance was seen as crucial in a SE securing investment. The participants talked about the need for SE investees to have an effective board that is structured properly and operates as a commercial enterprise would. Within this board, there was a desire to see directors who had diverse and complimentary skill-sets, such as financial, marketing and legal acumen.

"We do, we do place importance on people, I think that's quite important to remember, that people make in organisation. The skill-set, well passion is always a good one, they've got to be passionate in what they do. But we also look at the board, that's quite crucial for us, we start looking at the board and the skill set that they have. So we really would like to see someone

> *with financial background or financial-nous really, somebody with legal, you know the usual governance, the usual good governance model."* (P8)

The other major non-financial consideration was a focus upon the social mission and the social impact that the SE sought to make. By far the most important criterion was the need for the investee to be delivering a front-line social mission. The need for the social impact to be scalable along with the financial aspects of the business was also important. In relation to this there was also an acknowledgement of the double-bottom line and the pressure that delivering and measuring social impact had upon financial sustainability, which made the participant funds very open to different methods of measuring social impact.

> *"…when I'm assessing an application, you've got all the normal financials, directors. What business plans are all about? But I actually have to fill in a section, what the social benefits will be…So it 100% has to have the social angle."* (P3)

> *"The only thing that is unique to a SE is that they're trying to balance financial and social objectives, and then we try to help them with, you know, figuring out how to balance that and also how to measure their social impact, you know, what are the best metrics to use?"* (P12)

Finally, the majority of funds did not favour any specific sectors (i.e. health and social care) for investment, although a number of funds did exclude organisations with environmental missions. Additionally, partnerships between SEs and other institutions (i.e. universities), whilst viewed as beneficial, was very much secondary to the financial sustainability and social impact.

> *"Ultimately in the decision, no, because you know the fact that the* [university name] *has invested in a proposition and we're looking at it, the proposition still has the ability to go belly up.* [University name] *may have made a poor decision, so the underwriting strength of the proposition has to stand or fall on its own two feet."* (P14)

<u>Theme E: Decision-Making Process</u>

The participants also discussed the decision-making processes and structures that were in place at their funds. One of the most common processes in place was the assessment of initial applications, followed by an assessment (financial and social) of the business plan. SEs that were deemed to be potential investees at this stage were then supported to develop their business plan further alongside an ‘investment officer’, before the full finance application was sent to the fund’s investment panel where the final decision was made. Interestingly many of the participants stated that the small-size of their funds often meant that there were limited resources (mainly staff) with which to carry out the due-diligence of applications and assist SEs to improve their business plans. This was seen as holding back social investment due to the high transaction costs involved.

> *“So and once it's gone through that stage* [due-diligence], *we then bring it to an internal yes/no meeting of our finance director, chief exec and myself and there's an administrator there, and then if it gets through that meeting, it goes up to our investment panel, which we just call our finance fund panel……And that's where we will, that's the panel that can agree on investments.”* (P2)

> *“Another problem would be resources you know,* [SIFI name] *gets hundreds of enquiries from people who want help, and you know a vast majority of them fall outside what we are reasonably able to deal with because of the amount, or time involved, or the level of development that it’s at, or the number of staff that we have got.”* (P6)

The majority of the participants provided active support to potential investees, helping them to improve their business plans, as well as in agreeing measures of social impact. The recruitment of senior management staff and the placement of non-executive board directors from the fund occurred (understandably) much more prevalently with equity investments. This meant that the majority of participant funds engaged with ‘active investment’, with only one fund acting as an inactive investor.

> *“Yes, these are* [on a] *one-to-one basis* [prior to and post-investment], *absolutely one-to-one basis. It’s a very, very, expensive model that is absolutely crucial in the sector…”* (P8)

> *“When we think that that’s really business critical, yes* [will offer support in developing the management team]*…And quite often our legal* [team] *will say that they need our permission to recruit anyone…so to make sure that anyone coming into a top management level position is someone that we are happy with.”* (P5)

<u>Theme F: Developing Investment Readiness</u>

The participants articulated a number of characteristics that they would view as making a SE more IR, over and above the traditional aspects that have been articulated in the themes above. First, organisational tenacity and resilience were seen as crucial, along with adaptability to changing market conditions and income streams. Second, a social entrepreneur with an articulate vision and a plan of how to implement this (and the experience of doing so) were seen as very important traits. Finally, the participants also talked about the need for the social entrepreneur and board members to genuinely want to undergo the organisational change towards becoming more ‘investment ready’.

> *“I mean, we got one borrower who really got into trouble that fought desperately…I think the last 5 years of trying to get this thing off the ground and build it up…they're not going to lose what they thought was their future.”* (P13)

> *“So investment-readiness is about making an organisation resilient……an organisation should take those initiatives themselves, because it’s a learning element for them to develop. If you do it for them, it is just pointless.”* (P8)

In addition to the organisational structures outlined above, the participants also discussed the social entrepreneur/senior-management skillsets that they felt were important. The participants discussed the need for the social entrepreneur to have ambition, but that this should also be matched by a detailed understanding of the business plan and a propensity towards teamwork. The participants also stated a desire for practical skills and experience over accredited formal qualifications. Finally, the participants felt that there was a current lack of business and financial skills amongst many social entrepreneurs that needed to be addressed in the future.

> *“Well, we look for entrepreneurs who have vision and ambition and so they've got to be, they've got to have a really clear vision for what they're trying to achieve and they've got to be very articulate in getting that point across……they've got to know the sector that they're working in, they've got to have, you know, understand the market.”* (P9)

> *“So in terms of accreditation, I’m kind of totally agnostic, I don’t mind what someone’s formal background is, but very much mind if that then translates into an organisation that has a really robust credible business plan.”* (P5)

> *“We'd look for somebody who's got the, an ability to build a team……have they the ability to form a team around them to do it?”* (P2)

The final area that the participants discussed related to the difficulties that they experienced in working with SEs and the need to bridge the perception/understanding gap between the social investment and social enterprise sectors. One of the main problems identified with working with SEs was their risk-averse nature and the intensive support that was required to get a SE to the investment stage. There was also an acknowledgement that many investors did not understand the social enterprise sector and that this made it difficult to sometimes leverage-in external investment and also led to the promotion of unsuitable investment vehicles in the SIM.

> *"I think the main barrier is that a lot of voluntary social enterprises organisations don't want loans they want grants they're always saying that they need finance but by finance they mean a very long equity that they don't have to worry about..."* (P4)

> *"I think there's now too many investment bankers who've gone from* [established financial firms], *just move into the sector and trying to bring new financial vehicles as they call it, into the sector.....I don't believe that there's a market for these yet."* (P8)

> *"Growing an intermediary sector. Because unless A can find B, the investment doesn't take place...you know, a health related social enterprise, it doesn't know about how to secure investment. So if there isn't investment in the intermediary infrastructure,* [the SIM] *won't happen."* (P12)

Discussion

Research Aim 1: What constitutes SIFI conceptions of IR and how does this relate to theories of IR from the mainstream finance sector?

The analysis of the data outlined above provides evidence of the normative absorption of the SIM by the mainstream investment markets with the needs of the investor taking primacy over those of the investee, driven by a 'means-end rationality' (Nicholls, 2010a). In relation to the financial elements of IR the most important financial aspect of being IR related to the sustainability of a SE's financial income and their subsequent ability to service the investment at a reasonable rate of return (Mason and Harrison, 1999; Mason and Stark, 2004; McWade, 2012). The SIFIs preferred to see multiple income streams that would not leave a SE vulnerable to contract/order cancellations, although perhaps surprisingly the SIFIs were not concerned as to whether this income originated in the private or public sectors. Grant-funding was not considered by SIFIs in their financial calculations, although match-funding from institutional partners or other investors was viewed positively. The SIFI organisations were not interested in funding start-up or very early-stage SEs, instead preferring organisations with at least two years of trading history. This may be related to the information asymmetry within the SIM (Evenett and Richter, 2011), which leads investors to seek investment opportunities where there is more information with which to make a decision. This suggests that the SIFIs within the SIM are 'risk-averse' and seek investment opportunities only where there is detailed information (Deakins *et al.*, 2008). The final financial aspect of IR that was articulated by the participating SIFIs related to scrutiny of the business plan, which offers support to prior research that highlighted the importance of a business plan to securing investment (McWade, 2012). It also provides evidence for the normative institutionalisation of the SIM with mainstream investment criteria, in which the quality of information held in the business plan, the evidence of the capitalisation of the business and the analysis of risk over return are all covered in detail (Mason and Harrison, 1999; Paul *et al.*, 2003; Mason and Kwok, 2010).

The importance of non-financial criteria to a SE's IR was also evidenced through the data gathered from the SIFI interviews. As with mainstream investment, governance issues were crucial in the assessment of the IR of a SE. The main area of governance that the SIFIs discussed related to the skills and structure of the management team. The SIFIs sought investees with boards and management teams that contained individuals with track records in the market/sector and diverse and complimentary skill-sets. This offers support to prior research that highlighted the importance of competent management teams to social investors (McWade, 2012) and also highlights the normative nature of IR in the SIM (Muzyka *et al.*, 1996; Vasilescu; 2009). Interestingly, the SIFI participants did not view the legal structure of a SE as being important in the investment decision-making process or in relation to IR. Indeed, asset-locks were not even required by the majority of the SIFIs and this suggests that government legislation, such as the creation of the CIC legal form (Nicholls, 2010b), have been unimportant in shaping the SIM in the UK.

The importance of the personal relationship between the SIFI and the investee was also articulated by the participants. This was shaped by the perceived personal characteristics of the social entrepreneur, with an ability to take on-board advice, integrity and decency all advocated as positives by the participants. This also highlights the normative nature of the SIM as such personal characteristics are also important in mainstream investment perceptions of IR (Mason and Harrison, 2001; Wilson *et al.*, 2007). This finding also offers support to prior research that suggested that information asymmetry was prevalent in the SIM (Evenett and Richter, 2011), as subjective 'gut-feeling' evaluations of entrepreneurs traits are symptomatic of markets that lack clear information or metrics (Jankowicz and Hisrich, 1987; Ramón *et al.*, 2007; Ferrary, 2010). The final non-financial assessment of IR in the SIM related to the evaluation of the SE's social mission and impact. A frontline social mission was seen as key for a SE in being able to access finance from a SIFI, although this was complimentary to, rather than more important than, financial evaluations (McWade, 2012). Interestingly, there were no standard measures of social impact utilised by the SIFIs, who instead assessed a SE's social mission through intuition. This is in part due to the lack of standardised metrics available for measuring social impact and the perceived problems of those measures that are available (i.e. SROI and GIIRS) (Maree and Mertens, 2012; Saltuk *et al.,* 2011). However, it is also indicative of the 'information asymmetry' prevalent within the SIM as the lack of credible indicators of social performance, as in any market, forces investors to make intuitive, subjective and individual appraisals of investment opportunities (Jankowicz and Hisrich, 1987; Zacharakis and Shepherd, 2001).

Finally, there were other informal indicators of IR within the SIM alluded to by the SIFI participants. Many of these related to the social entrepreneur themselves, with participants articulating a desire to invest in a SE in which the lead individual had a strong vision that they could articulate clearly. Organisational resilience was also seen as important, with staff that could react to and cope with sudden market changes and funding pressures. Perhaps the most important indicator of IR in this area was an organisations' willingness to seek investment finance amongst its owners, management team, staff and stakeholders. There was a perception amongst the SIFI participants that unless the majority of these elements genuinely desired to seek investment instead of grant-funding, then the development of IR capability would be impossible. This suggests that there is an element of 'equity-aversion' (Van Auken, 2001; Silver *et al.*, 2010) and 'discouraged borrower effect' (Kon and Storey, 2003; Fraser, 2005) on the demand-side of the SIM and this offers support to prior research that stated that social entrepreneurs do not wish to lose control of their SEs and/or are risk-averse (Howard, 2012). However, it could also be a consequence of SEs lacking information about the SIM, as well as of social investors and SIFIs offering investment products that are unsuitable for SEs (Evenett and Richter, 2011).

Research Aim 2: What implications do the IR criteria articulated by SIFIs have for the future development of the SIM?

The data analysis suggests that the SIM in the UK remains an asymmetrical market in relation to the information held by investors, intermediaries and demand-side investees (Evenett and Richter, 2011). The SIFI participants stated that on the supply-side of the market, some investors lacked information about social investments both in relation to the financial and social impact performance of SE investees. This is unsurprising as the small, nascent state of the market means that there is a lack of investments from which data and learning can be gathered. Additionally, the lack of standardised metrics for social impact and the lack of trust that the SIFIs had in those that did exist (i.e. SROI) (Maree and Mertens, 2012), denotes a situation in which information on the scalability of social impact is limited. This lack of information on market performance is exacerbated by the non-standard nature of the demand-side of the SIM, in which investee organisations operate according to a ‘double or triple bottom line’ (social, environmental and economic) (Campi *et al.*, 2006). This requires organisations in the SIM, such as SIFIs, to make judgements on ‘blended return’ (Emerson, 2003) with incomplete information on both elements of the return calculation (i.e. social/environmental and financial). This leads to what the participants articulated as the need to remain ‘sustainable’, which can be interpreted as a desire to minimise what Mason and Stark (2004) termed ‘Type 1’ errors (investing in SEs that fail). This offers support to prior research that identified a lack of ‘information flow’ within the SIM (Nicholls, 2009; Nicholls, 2010b; Wood *et al.*, 2012), which in turn leads investors (in this case SIFIs) to pursue detailed due-diligence processes, which increases transaction costs (Evenett and Richter, 2011). The high costs of individual investment deals inevitably leaves less recyclable capital and also leads investors such as SIFIs to ignore riskier (but perhaps more innovative) propositions (Geobey *et al.*, 2012). However, some of the SIFIs were cooperating in investment propositions both in relation to due-diligence processes and match-funding investments. This decreases the transaction costs of individual deals, and promotes networks and information flow between SIFIs. Such an approach, where appropriate, is one that should be encouraged by policy-makers and adopted by SIFIs going forwards. The reduction of risk through inter-SIFI cooperation would allow for the growth of available capital, as well as allowing riskier investments to take place.

The final area that was identified as important in assisting the UK SIM to develop, relates to demand-side organisations understanding of the SIM; what constitutes IR within it; and the assistance that many SEs require in developing credible and robust business plans. Many of the SIFI participants (14 out of the 15) operated as active investors, in which they supported SEs (often intensively) through the pre and post-investment stages. This support ranged from business plan development through to active involvement in the recruitment of senior personnel at the SE investee. Indeed, many of the SIFIs articulated that this support was crucial as without it the business plans and investment proposals of SE investees would not be of a high enough standard to secure investment. This offers support to prior research that articulated the need for IR programmes in developing the demand-side capabilities of an investment market (Mason and Harrison, 2001; Mason and Kwok, 2010). This suggests that government interventions to raise IR in the SE sector (i.e. the ICRF) are important in the future growth of the UK SIM. The data gathered in this research suggest that this IR support is currently being provided by SIFIs, which inevitably drives up transaction costs for investments and leads to less recyclable capital being available for reinvestment (Geobey *et al.*, 2012). The development of funds/organisations that independently provide IR support (independent to SIFIs), or the provision of funding to SIFIs specifically for the development of demand-side IR, could provide an important tool in growing the SIM. Indeed, such support would at least help to reduce the information asymmetry that currently exists between the supply and demand-sides of the SIM (Evenett and Richter, 2011).

Summary

The research reported in this paper has identified that amongst SIFIs the key perceived elements of IR in the SIM relate to financial sustainability; robust governance structures; broad and complimentary management team skillsets; clearly defined and scalable social missions and impacts; and a willingness and desire to seek investment and become IR. This aligns the concept of IR in the UK SIM with mainstream finance concepts of IR, with the additional need to focus upon social impact. Additionally, it offers empirical support to Nicholls (2010a) assertion that the SIM is undergoing a normative absorption by the mainstream investment markets that is driven by a 'means-end rationality', with the needs of the investor taking primacy over those of the investee. This viewpoint states that the SIM is being absorbed into mainstream markets through the utilisation of traditional finance tools and the crossover of financiers from the mainstream finance sector. This future development is also being hindered by the lack of robust, standard metrics of social impact and the still small-scale of the market, which limits the information available to SIFIs and leads to the pursuit of low-risk/large-scale investments. The growth of the SIM is also limited by a lack of knowledge about and desire to seek investment within demand-side organisations that could possibly be overcome through IR programmes and funds. Whilst the research reported in this paper is qualitative in nature, it is unusual in that the results are generalisable as the participant sample involved 15 of the identified 22 SIFIs currently operating in the UK. However, further research to test both the findings presented in this paper and the efficacy of IR programmes would provide additional evidence for the conclusions made.

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