

Social Enterprise

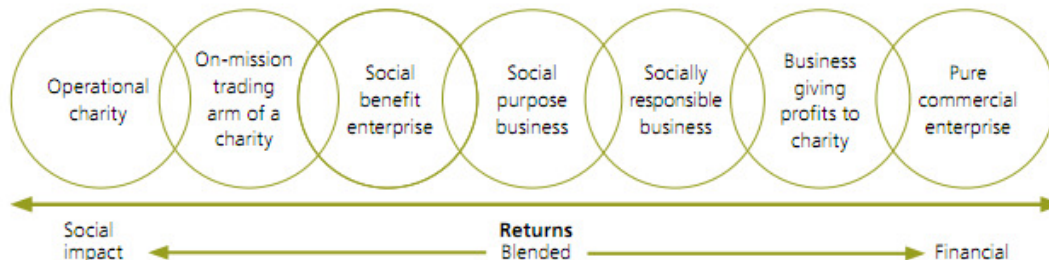
Social enterprises – businesses whose primary focus is on tackling social issues rather than generating profits – are playing an increasing role in addressing market failures in the UK economy. However, issues around funding persist and there is scope for the private equity and venture capital industries to play a role in funding and supporting this growing sector.

What is social enterprise?

A social enterprise can take a number of legal forms, and this has led to some confusion around what comprises a social enterprise and how broad or narrow a definition should be. What is clear is that all social enterprises are driven to make a social impact, through measures such as tackling social problems or improving communities and the environment. Another key feature is that they do not focus on distributing profits. Government defines social enterprises as “businesses with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners” (Office of the Third Sector, 2006).

This narrow definition, however, fails to capture the scope of the social enterprise sector. For instance, a company that strives to deliver social impact yet also distribute its profits would not be caught under this definition, yet could in many respects be seen as a form of social enterprise. These so-called hybrid organisations are becoming increasingly prevalent in the social enterprise domain and should be included in a wider definition that captures a spectrum of organisations pursuing social missions.

Therefore it is perhaps helpful if we look at social enterprises on a scale. At one end, the organisations concentrated purely on social returns and at the other, those pursuing a blend of social and financial returns on investment. All of these to a greater or lesser extent could be considered social enterprises.



Source: CAF (2010), *Financing the Big Society*

How big is the sector?

While social enterprise is not a new concept, it has become increasingly established over recent years. Emerging as a response to market failure, where neither the public nor private sector is able to deliver effective ‘social’ products or services adequately, the sector is growing rapidly. There are 62,000 social enterprises in the UK operating in almost every sector nationwide, employing around 800,000 people and contributing over £24bn to the economy (Social Enterprise UK, 2011a). Social enterprises grew during the recession, outperforming their public peers: 56% increased

their turnover from 2008-2009, while only 28% of SMEs increased theirs (Social Enterprise Coalition, 2009). Median annual turnover of social enterprises has grown from £175,000 in 2009 to £240,000 in 2010 (Social Enterprise UK, 2011b).

Who funds social enterprises?

Social enterprises typically receive their capital in the form of return (debt, equity) or no return (grants) instruments via philanthropists, foundations, charities, government grants and investment funds, banks and social venture capital. Yet despite the array of investors and the amount of capital currently present in the social investment market, there was only £190m worth of investment into the sector in 2010. This compares unfavourably to £55bn of small business lending and £13bn of individual giving (ClearySo, 2010).

The growth and sustainability of the sector (and consequently the success of social goals) is threatened by this lack of investment, and 44% of social enterprises cite lack of or poor access to finance as the most significant barrier to growth (Social Enterprise UK, 2011). The sector continues to be heavily reliant on government funding and philanthropy, with 39% of social enterprises relying on government funding for over 50% of their income (The Young Foundation, 2011).

These funding issues exist on both the demand and supply side. Investors are wary of potentially lower financial returns and are struggling to find suitable propositions to invest in, while the social enterprises themselves are unaware of different funding options or feel that commercial funding is incongruous to their social goals. There is not a 'one size fits all' approach to funding social enterprises. For some, grants and fundraising will remain the best option. But an increasing number of social enterprises, especially in the hybrid form, are trapped between this traditional approach to non-profit funding and traditional for-profit funding (equity and debt).

There are some signs that things are starting to change. A growing number of investors are looking for social returns and will take a lower financial return in exchange for their financial investment risk for such opportunities. The creation of the Government's Big Society Bank (Cabinet Office, 2011) and current proposals by the European Commission to facilitate private investors in supporting social businesses will further boost investment in the sector (European Commission, 2011).

In addition, social enterprises are starting to shake of their 'grant mentality' by opening up to the idea of new types of funding; 4% sought to issue equity in 2010, while in 2009 none of those questioned indicated that they had sought to do this (Social Enterprise UK, 2011).

However, this demand for private sector investment is not necessarily translating directly into investment. One obstacle that is perpetuating the funding gap is a general lack of investment-readiness. Social enterprises need to develop financial skills, as well as a comprehensive understanding of funding options and investors' needs, in order to demonstrate their potential to scale and ability to achieve financial and social returns. Tied into this is the need to measure performance and impact. Being able to illustrate, financially, the value of their work and the impact their work has made on a range of stakeholders is critical to attracting and retaining investors. As social enterprises are able to demonstrate this, a positive momentum will be created.

What role does private equity and venture capital play?

Social private equity and venture capital (PE/VC) could be one funding route to help fill the equity gap faced by many social enterprises today. This is the application of PE/VC principles to support the creation and expansion of commercially sustainable enterprises to achieve a blend of social and financial returns. While traditional PE/VC firms generally look to generate purely financial returns, social investors are willing to accept near-market returns to make a social impact. Again, though there is appetite from the investor side, the greatest barrier to this form of investment is the low level of investable, scalable propositions. Testament to this is the fact that Triodos Social

Enterprise Fund (£3.8m) had to close after two years having only made one investment. Although the fund received nearly 300 funding applications, a significant number of the businesses did not meet their requirements and were struggling to adopt the required commercial approach.

Some organisations such as NESTA and UnLtd Advantage are starting to address the lack of investment-readiness by offering advice and training programmes to get social enterprises up to speed prior to approaching investors. This needs to continue and expand if social enterprises are to tap into available equity finance essential to their growth and success.

Fortunately this has not seemed to discourage social VCs, given the increasing number of them looking to engage with the sector. The key players in the UK market include Bridges Ventures, Big Issue Invest, Triodos, The Capital Fund and Frog Capital. While most are venture-focused, the growing trend to think beyond purely financial returns could encourage a greater number of larger investors into the market, and as the social enterprise sector matures and is able to demonstrate stable market returns alongside its social impact, we may start to see growing VC *and* PE activity in this sphere.

If you have any questions or comments, please email: research@bvca.co.uk

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