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# Financial System Inquiry

## Second Round Submission from

## Social Enterprise Finance Australia Ltd.

SEFA
INNOVATIVE LENDING

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## Introduction

Social Enterprise Finance Australia Ltd (SEFA) was set-up to provide finance to social enterprises across Australia. SEFA is a for-profit company and is a social enterprise itself, and was one of three recipients of SEDIF (Social Enterprise Development and Investment Funds) funds from the former Department of Education, Employment and Workplace Relations (DEEWR). Formed in 2011, we are making good progress in building a loan portfolio against a difficult lending environment on both the demand and supply sides of the market.

We write in response to the call for second round submissions to the Financial System Inquiry, and in particular the impact investment policy options for consultation as outlined in the Interim Report. In this submission we consider the range of recommended policy options in context of driving the future growth of a relatively nascent impact investment market. We review the following themes:

- The demand and supply equation of impact investment;
- Barriers to accelerated growth in impact investment;
- Policy options for “nascent market intervention”; and
- Detailed responses on the five policy options presented in the Interim Report.

We believe that there are a number of barriers faced by social enterprises in Australia when trying to access finance. These include:

- Imbalance of perceived risk and return in early-stage transactions,
- Lack of funding for capacity building, in particular for early-stage organisations, to achieve investment-readiness and improve access to commercial funding pools,
- Risk-reward mismatch for commercial impact investors; and
- Availability of ‘patient capital’ to provide a first loss piece to attract more risk averse, commercial investors in a blended transaction of social and financial returns.

These barriers are inhibiting the growth of the social enterprise sector, and in doing so preventing significant additional resources from being harnessed to improve outcomes for communities across Australia.

We propose that the policy options targeting supply side are supplemented by demand side initiatives, specifically targeting earlier stage social enterprises that are capital constrained. We believe for a significant segment of the market comprising young social enterprise start-ups, there is a policy requirement with a focus on capacity building for early stage social enterprises.

Barriers to funding will most likely be addressed by aligning investment conditions from the demand and the supply side. A significant barrier for social enterprises is the perceived high risk nature of start-ups in a relatively young sector. To grow the impact investing sector, supply of investment-ready social enterprises and demand of capital have to be successfully matched. However, we have observed that a funding gap around the risk profile of early-stage social enterprises prevents promising social start-ups from “moving up” the organisational development curve to a point where available capital is prepared to fund more mature, less risky investment opportunities. At the same time, several factors prevent this capital from “moving down” the deal stage curve to assist organisations in crossing the gap.

To remove barriers from accelerating growth in the impact investing sector, we propose a staged policy approach that will both de-risk early-stage transactions and remove regulatory constraints which prevent capital from engaging – as such, closing the gap of the market by “moving social enterprise up” and “moving investors down” the deal stage curve. Once the funding chain along the deal stage curve is continuous, market building efforts across the entire impact investing industry can be accelerated.

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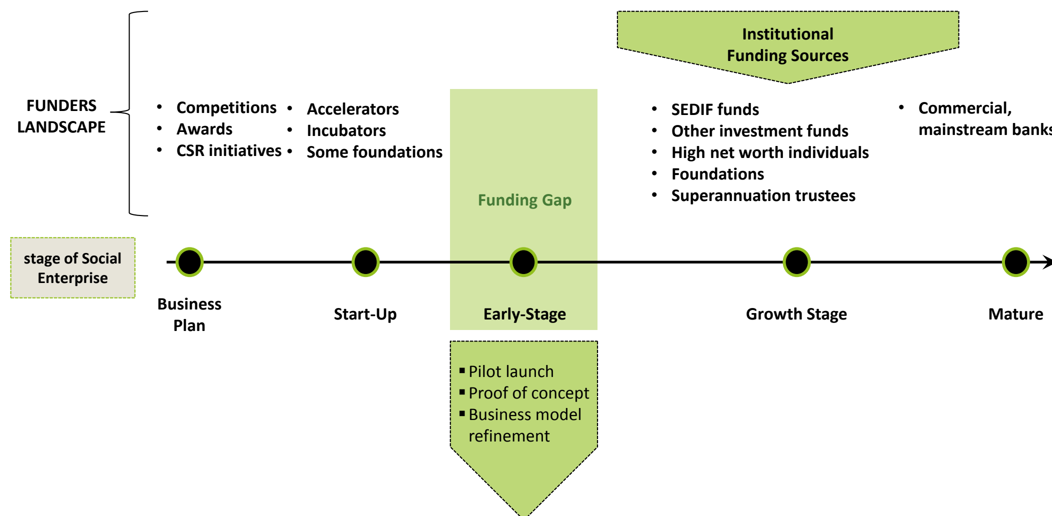
## The Demand and Supply Equation of Impact Investment

Our experience indicates that a significant barrier to accelerating the growth of impact investing in Australia is the lack of options to de-risk transactions to levels matching the risk appetite of commercial funding sources – hence creating a gap for or barriers to funding. This can be exacerbated by a mismatch in return expectations between social entrepreneurs and investors: the social entrepreneur can be primarily driven by social return, versus a primary focus on financial returns from the investor, with the social impact a secondary return.

Unlike commercial venture capital, social enterprises in the early-stage phase cannot, in many instances, deliver attractive financial upside to investors along the development curve. However, such return potential is necessary to compensate the investor for the higher risk level they have taken on. The crystallisation of financial returns may be difficult due to the lack of exit opportunities for investors. For example: trade sales may not occur due to the lack of 'mission aligned' acquirers; legal structures for social enterprises (in particular not-for-profits) inhibit the issue of equity and hence the ability to deliver an appropriate return to investors – both capital returns and income / dividend returns.

When looking at the natural development path of a social enterprise from business idea to maturity, we have identified a funding gap around the risk profile of an early-stage organisation as follows:

Figure 1: Funding landscape across development stages of social enterprises




Business plan competitions and 'kick-start' awards provide small amounts of grant funding to get social enterprise ideas off the ground. However, to progress beyond the business planning stage, social enterprises often require 'patient capital' (flexibility around financial returns in favour of social outcomes) to pilot their concept and test their value chain. There is a clear funding gap at this stage for higher risk concepts. We provide the following examples of barriers to funding for early stage social enterprises:

**Example A**

**Impact Model:** Scalable online platform that donates excess retail products to charities
**Transaction:** Start-up capital, including initial IT set-up costs and working capital
**Barrier to funding:** A not for profit model that does not easily provide for equity-type investor returns.

| Example B | |
|---|---|
| **Impact Model:** | Affordable funeral services for multi-cultural communities. A for-profit model, returning profits to not-for-profit parent |
| **Transaction:** | Capital to acquire premises and provide working capital |
| **Barrier to funding:** | Lack of patient risk capital and a lack of business expertise in a highly competitive industry. |

Many impact investors, such as the SEDIF funds and some foundations, are interested in scaling successful social ventures, but in most cases require a maximum risk profile floor to engage. Their investment guidelines are often prescribed by fiduciary duties, mission statement or constitutions, which are all addressed in policy options as outlined in the review. However, many social ventures require funding to launch additional pilots, to prove their concepts and to further refine their business model. The more support is available at this development stage, the more ventures will mature into organisations that are investment-ready for commercial impact investors.

| Example C | |
|---|---|
| **Impact Model:** | Joint venture café with on-the-job training for unemployed youth (commercial coffee roasting business and NFP specialising in youth at risk) |
| **Transaction:** | $100k working capital and fit-out expenses for new café location |
| **Barrier to funding:** | No equity stake from JV partners; no tangible security for loan |

What are suitable policy options that will create risk mitigation tools needed to close funding gaps and overcome funding barriers?

## Proposed Policy Options

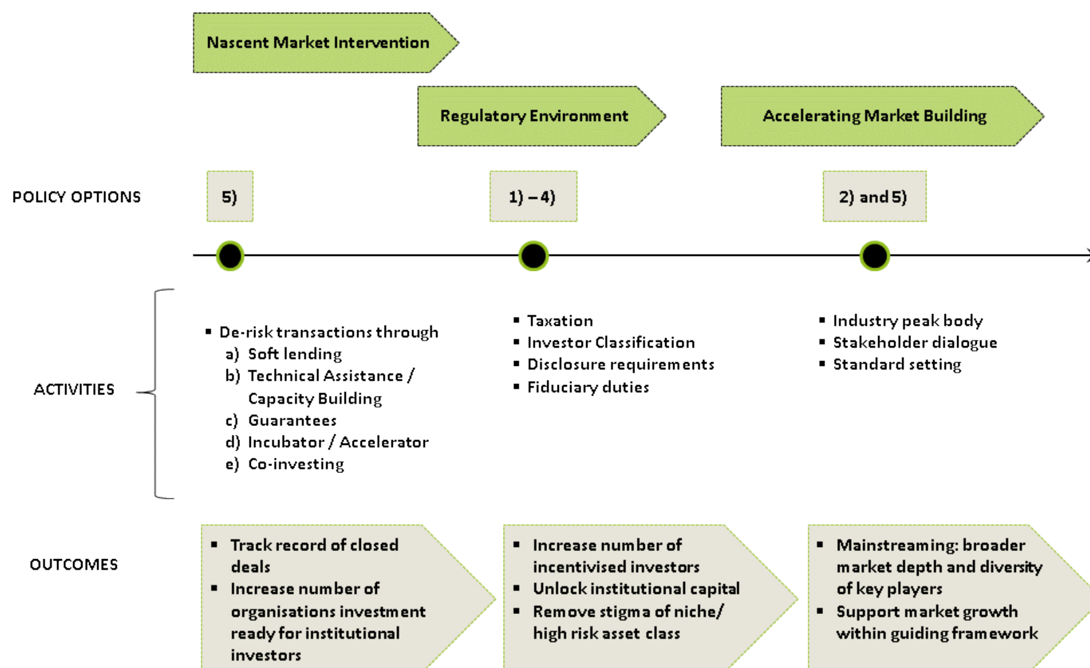
Given that impact investing is such a fragmented, nascent market, we recommend a staged implementation of policy options. Some options are implemented once market development milestones have been met. As such, the first phase of **“nascent market intervention”** is targeted at overcoming the barriers to funding and thus closing the funding gap as discussed above.

There are two major outcomes to this solution:

1) **Provide a feeder for the core/mature deal pipeline to “move up” the development stage curve.**

2) **Prove the concept that early-stage investing is not financially as risky as currently perceived and therefore encourage key investment players to “move down” the development stage curve.**

Figure 2: Time line of recommended Policy Options, associated activities and projected outcomes




**De-risking early-stage transactions**

Firstly, the primary focus of actions should be on de-risking early-stage transactions through a series of *flexible investment instruments.* Instruments should have both a *capital focus* – such as softer lending terms and dedicated accelerator programs which combine funding with business mentoring – as well as a *capability focus* – such as capacity training and technical assistance. Government can undertake a more active role in expanding impact investment by providing risk capital and establishing a social investment bank. Overseas examples of such initiatives include the UK's Investment and Contract Readiness Fund, and Big Society Capital. The benefits of doing so are in aggregating larger amounts of homogenous capital that is prepared to accept higher levels of risk. As a consequence, intermediaries such as SEFA are able to focus their resources on closing deals and building a successful track record for future industry growth.

In terms of the instruments with a capital focus, a 'blended deal' approach has proven to be successful: finance first and impact first investors take up different risk tranches within one deal. Impact first investors are willing to forego financial returns/upside in exchange for a strong social impact. At the same time, finance first investors are prepared to contribute larger amounts of capital in exchange for loss protection from a sub-ordinate impact first tranche. Unlocking impact first funding will help bring earlier-stage organisations across the deal closure line.

**Mobilising capital**

Secondly, once deals have become attractive for all participating investors, either on equal financial terms or on a blended approach using innovative instruments, the next set of policy options should aim at attracting a broader range and large number of investor types to the table. To date, philanthropic foundations often do not invest their corpus into social enterprise. Rather they achieve their social mission purely through donations. However, these investor types as well as high net worth individuals are probably the most likely to move into the funding gap - provided the right incentives in terms of regulatory requirements and tax benefits are in place. SEFA supports proposals for greater flexibility for philanthropic ancillary funds in accessing guarantees or security instead of grants. Such change in regulatory environment can mobilise capital on softer terms.

## SEFA's participation

In our daily due diligence process we come across a number of early-stage organisation that would benefit from risk mitigating policy options to increase the probability of successful deal closure. SEFA would welcome and collaborate within the following areas of activity:

1) Capacity building:
   - technical assistance facility that provides funding for capacity building which will help organisation to improve their business as well as impact model, ultimately enhancing their investment readiness.
2) Risk capital provision:
   - partial default guarantees from both impact first investors and government facilities,
   - co-investors on 'patient capital' i.e. softer terms that provide a first loss tranche in deals where no tangible or assignable asset is available as security.

Potentially, there is a third activity which combines capacity building with providing risk capital:

3) Incubation/acceleration initiatives that link small but higher risk funding with intensive mentoring and/or business consulting.

## Conclusion

SEFA believes that once the sector has successfully de-risked transactions to create an attractive track record for the institutional investor base, the impact investing landscape will achieve the momentum needed for growth. De-risking transactions can subsequently go in hand with changes in the regulatory framework that incentivise institutional investors to unlock capital beyond limited philanthropic pockets.

Against this backdrop, building a functional impact investing industry in consecutive phases with the support from active industry players such as SEFA appears to be a suitable approach to start capturing the untapped potential of this industry for Australia.

Please do not hesitate to contact our team at SEFA for any additional questions about this paper, discussed concepts and proposed actions.

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## Detailed Responses

The below tables provide a detailed summary of SEFA's responses regarding each proposed policy option, using the preferred format of i) costs, ii) benefits and iii) trade-offs.

**1) No change to arrangements – Not Supported**

Costs – protracted sector growth as a result of:

- Slower mobilisation of capital without efficient investment conduits,
- Mismatch between the type of capital being offered and the demand for this capital,
- Lack of track record of existing products,
- Challenges of illiquidity and exit from investment,
- 'Unco-ordinated' market building; and
- Too few investment ready projects and enterprises

**2) Provide guidance to superannuation and philanthropic trustees on impact investment**

Benefits

- **Unlocking capital** by enabling institutional investors to place and manage capital at scale,
- Diversity of investors and types of capital and expectations regarding risk-adjusted rates of financial return,
- Larger volumes of capital; and
- High profile transactions that promote the social investment movement on a very broad scale

Trade-Offs

- Diverting funds from early-stage/smaller deals to more mature/larger deals due to lower risk profile and transaction cost expectations of institutional investors

**3) Classify a private ancillary fund as a sophisticated or professional investor**

Benefits

- Act as 'trailblazers' for other charitable trusts to invest their corpus in mission-aligned areas
- Reduce fundraising costs for intermediaries such as SEFA on mission-aligned investing
- Unlocking capital

**4) Simplify and streamline disclosure requirements associated with impact bonds**

**Benefits**

- **Placing and managing capital**; and
- Potentially accessing retail investor market and raising the profile of social investments within society

**5) Undertake a more active role in expanding impact investment, such as providing risk capital and establishing social investment banks**

**Benefits**

- **Establishing industry/asset class standards** e.g. can encourage impact investing through appropriate investment rules, targeted co-investment, taxation, subsidies and procurement, as well as corporate legislation and capacity development that enable the efforts of investors, intermediaries and enterprises in this space,
- **Creating an enabling environment** e.g. creating and marketing impact investing products that superannuation and philanthropic trustees can buy easily,
- **Building leadership** - creating incentives for industry networks on the demand side to collect, analyse, vet and distribute good, timely information on specific market opportunities to establish and grow specific businesses, maturation, scale and sustainability of industry/asset class; and
- **De-risk transactions** by providing soft lending and/or technical assistance funding; thereby improving deal likelihood and market access for different investor types

**Trade-Offs**

- Between impact and risk-adjusted financial returns / high transaction costs associated with structuring and executing untested investments