Social enterprise finance market

Analysis and recommendations for delivery options

EUROPEAN CENTER
FOR SOCIAL FINANCE

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This analysis aims to identify market failures and gaps in social enterprise finance in Europe, and recommend delivery options for future EU-level financial instruments. The findings will assist the European Commission in designing the investment strategy for EU-level financial instruments for social enterprise finance, and will notably feed into the preparatory work on the InvestEU Fund. Barbara Scheck and Wolfgang Spiess-Knafl at the European Center for Social Finance have been contracted by the European Commission to prepare this analysis.

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1 FINANCING OF SOCIAL ENTERPRISES

1.1 Introduction

In the aftermath of the 2008 financial crisis, social enterprises have played an increasingly important role in Europe. The last ten years have consolidated a nascent eco-system, with actors acquiring experience and developing the market. In the next ten years, social enterprises are expected to continue playing an important role in supporting sustainable economic growth and social inclusion.

Social enterprises display surprising features: banks often consider them too risky, while venture capital funds might consider their business models to be below preferred risk-return-profiles. The financing needs might be too large for microfinance, but too low for most other institutional investors. These features show the need for a dedicated social finance market.

Indeed, this social finance market is emerging, and the emergence can be illustrated with the semantic evolution in this field. Changing vocabularies are an indicator of an emerging market where certain procedures, traditions and terms related to social impact need to be established. As such, social enterprises are interchangeably described as impact enterprises, purpose enterprises or social businesses among many other terms. The same applies to the financing of those social enterprises. For this study, we will use the term social finance to describe the financing of social enterprises. Other terms being used are impact finance, impact investing or sustainable finance.

One common denominator seems to be shared values. Although the industry has experienced significant inflow of capital, so far there are few signs of mission drift, unrealistic promises or fraudulent behaviour.

This analytical report will look into current developments. The first chapter will discuss regional differences and general observations. There are some general trends such as a certain hybridization of the financial structures as well as technology-driven developments. This analysis will discuss better data availability, blockchain technology and disintermediation.

The second chapter will present an institutional mapping of the social finance market. Social enterprises currently have different options for their financing needs encompassing a wide range of instruments. It will focus on growth and expansion capital that is usually funded by debt, equity, mezzanine capital or hybrid capital. The institutions involved are social venture capital funds, banks, crowdfunding platforms, business angels and incubators, accelerators, market-makers and investment-readiness programs.

The third chapter will discuss the imperfections of the market. These imperfections concern the sustainability of funds, the economics of matching supply and demand, a lack of intermediaries, asset misallocation, the still limited capital absorption capacity, impact dilution, low confidence in investment returns and a certain reliance on debt funding.

The fourth chapter will analyse the market gaps based on a country-specific calculation of demand and supply side volumes. The last chapter will suggest delivery options to reduce the imperfections discussed above.

We realize that there are imperfections for certain financial instruments while others are more easily accessible for social enterprises. Therefore, financial instruments like credit card debt, account overdrafts or leasing agreements will not be part of this analysis. In addition, this analysis will not cover high-quality asset-backed financing instruments. These high-quality assets could be

receivables from highly rated public authorities or real estate such as buildings used for social purposes. Banks are usually inclined to fund such asset-backed investments regardless of the type of enterprise.

1.2 Regional and country-based overview

Europe has distinctively different markets when it comes to social finance with regard to the level of maturity and thus the number of actors as well as investments. In addition, the different countries have their own legacies. East-European countries still face challenges related to their communist past while Italy, France or Belgium have deep-rooted social economy traditions.

Geography and size also play a role. Cyprus and Malta are small island economies with specific challenges and they need to set up distinct ecosystems. Other islands such as the Azores or the Greek islands might also need to establish separate structures specific to the islands. Smaller countries in continental Europe such as Slovenia, Croatia, Lithuania, Latvia or Estonia might be too small to establish their own internal social enterprise finance market infrastructures.

National legislation and initiatives are underway. For example, Latvia has launched a €12 million program for social enterprises. The Irish government has backed the creation of the Social Finance Foundation, with just under €100 million being provided by the Irish banking sector in the form of non-repayable equity and low interest loan funding. Portugal Inovação Social, a new institution being endowed over the next five years with an allocation of €150 million from the European Structural Fund, is focusing on social enterprises. The Swedish government has implemented a National Social Enterprise Strategy in 2018 and earmarked a specific budget for social enterprises.[1]

Nevertheless, cross-border activities in the form of investments or co-investments are still rare. This is a phenomenon well-known from the venture capital market. These cross-border activities constitute a significant potential for the social finance sector as there are countries that have a surplus of investment capital and are looking for more investment opportunities, while others display a shortage of available funding and a variety of investment-ready social enterprises.

1.3 General trends

1.3.1 Clear road to sustainability

So far, the industry[2] has displayed an interesting pattern. When the first intermediaries entered the market in the early 2000s, there was no clear path to sustainability. There was little willingness to pay for services, the absorption capacity had to be developed and investors to be convinced of the business case.

Over the last 15 years many pillars have been developed and added. There is now a widespread understanding of the industry, the financing options and the lines of thought and requirements of investors. Professionals can now interact in conferences, networks and other settings.

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[1] Those are some examples of national initiatives. Further examples can be found in the national mapping studies (e.g. European Commission 2016a,b or European Commission 2018a,b).

[2] The term industry is used in this report in reference to the social enterprise market ecosystem, which comprises several actors: social enterprises, intermediaries, investors, support organisations.

From a policy perspective, the industry has solid business plans with clear paths to sustainability. Investment managers can raise funds, crowdfunding platforms have generated solid demand and banks are building their portfolios of loans to social enterprises. Based on our experience, we estimate that most models can reach a break-even point within 3-5 years from their launch.

EU-level funding has been instrumental in developing the sector through different interventions. Grant funding has enabled the launch of dozens of projects as well as the ongoing work of networks. Guarantees helped to improve the risk-return profile for banks and equity investments helped to capitalize social venture capital funds.

1.3.2 New forms of transformation and hybridization of the funding structures

Another development concerns new forms of transformation. Traditionally, there were clear alignments: individuals either invested in funds or deposited money in saving accounts which were subsequently transformed into loans or equity investments. This model is still valid for large parts of the industry. However, there are new forms of funding structures emerging.

One interesting trend is that philanthropic contributions are being transformed into loans. We Share Ventures is using donations from funding members to provide loans to social enterprises. In other cases, depositors or savers give up part of their return to subsidize the financial costs of social enterprises. The 90/10 model in France is one such model where individuals earn market-rate returns on 90% of their assets while up to 10% of their assets earn only small returns thus subsidizing enterprises in the social economy.

1.3.3 Interest from institutional investors

The last years have seen institutional investors entering the field with the emergence of billion-dollar funds aimed at financing social enterprises. Impact-oriented investors can choose between real estate, ETFs (exchange traded funds) and SRI (socially responsible investing) funds among others.

This interest is driven by demand from institutional and private investors. Insurance companies, pension funds or family offices are increasingly searching for investment opportunities with intentional impact objectives across all asset classes. That being said, despite singular examples (such as PGGM from the Netherlands), the overall investment volumes remain very small.

Potential investments are still too small for institutional investors often requiring investment sizes exceeding one million euros. They also prefer fixed-income products with an investment rating or external appraisal. Moreover, there are no established impact measurement standards and processes yet, which hinders the identification of “true” impact investing possibilities.

Mutual funds in general are a popular investment vehicle as they require limited financial knowledge by the investor, provide access to a diversified portfolio and enable smaller investments. Amongst this growing investment trend, a number of retail funds has emerged that are labelled “impact”, “ethical” or “social” but which fail to fulfil certain criteria.[3]

[3] In a non-public study analysing 100 mutual funds listed in standard databases (Forum for sustainable and responsible investment and Morningstar) and categorized as “impact”, “sustainable”, “ethic”, “social”, “purpose”, etc. only two fulfilled the requirements of the impact investing definition – i.e., having a positive financial return, intentional investment impact and a measurable impact. This highlights the risk of impact dilution with a variety of providers entering the market.

1.4 Technology-driven developments

It is reasonable to assume that new technological innovations will also be adapted by institutions in the social enterprise finance space. There are various developments which might be relevant.

1.4.1 Better data availability

In the last years there was an observable increase in the availability, quantity and quality of data as many approaches have been built on the measurement of impact.

Social enterprises implement social impact measurement tools and use them for internal as well as external purposes. Social finance intermediaries are also measuring their social impact and are often required to do so by their funders. Some government agencies and private organizations publish unit costs.[4] In addition, there are new frameworks (e.g. the Social Reporting Standard) which help to standardize the data.

The availability of data enables new business models and contributes to a trend described below in the subchapter on "Disintermediation". New financing schemes can also be developed where cash flows are linked to the impact of the intervention. These schemes which rely on impact-related data can be summarized as social outcomes contracting or payment-by-result schemes covered in chapter 2.6.

One noteworthy example to improve data availability is the series of country reports titled "Social Enterprises and their Ecosystems in Europe". [5] They contribute to a better understanding of local ecosystems and how they function.

1.4.2 Blockchain technology

The blockchain technology itself is a relatively simple combination of cryptographic tools to build a database where information can be stored. In its simplest form it is an application where users can record transactions. In the context of social business models examples include supply chain transparency, distribution of food in refugee camps or tracking of the outcomes of working with homeless people.

Using this principle, the underlying technology also enables the creation of cryptocurrencies which are basically an information in a database. Well-known cryptocurrencies include Bitcoin or Ethereum whose market capitalization fluctuate wildly and reach tens of billions in market capitalization.

The combination of a database combined with its own currency enables something called smart contracts. Those contracts pay out a certain sum when a previously specified event takes place. It is also used as a fundraising mechanism. Recent years have seen a wave of initial coin offerings (ICOs) which had issues with fraudulent business cases and unrealistic expectations. Regulatory changes have improved the situation in this field since then. New legal framework also made it possible for the assets to be more like securities in the traditional sense. Examples include equity shares, revenue share agreements or mezzanine capital which are stored on a blockchain.

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[4] See also the EVPA policy brief written by Barth and Boiardi (2018).

[5] Country reports are available at: https://ec.europa.eu/social/main.jsp?catId=952&intPageId=2914&langId=en

Given the relatively recent emergence of this sector it is difficult to consider potential scenarios. However, we observe significant efforts to comply with anti-money laundering regulations and tax regulations and that there is much interest in the corporate sector to implement new schemes. In addition, reduced transaction costs, tradability and transparency might contribute to a further dissemination.

1.4.3 Disintermediation

A third related development is a certain disintermediation in the field. The common practice in finance is for investors to pool their assets in an entity and the entity manager decides which enterprises to finance. The manager might be a loan officer at a bank or an investment manager at a fund.

New business models are developing configurations contributing to a certain disintermediation in this field. This means investors can select the enterprises they want to fund and use dashboards or platforms to inform themselves.

Kiva is certainly a pioneer of this model. The organisation is rooted in the microfinance sector and offers a dashboard of (zero-interest) investment opportunities where investors can select the individual schemes they want to finance. Similar approaches are used by crowdfunding platforms.

Better data availability and the reduction of transaction costs will contribute to a further diffusion of disintermediation. It also links the investors closer with the final beneficiary.

2 INSTITUTIONAL MAPPING

There are various institutions that offer financing instruments for social enterprises. Each of these institutions has its own set of risk and return profiles as well as institutional logic outlined and described below.

2.1 Social venture capital funds

2.1.1 Introduction

Social venture capital funds apply the model of traditional venture capital to the funding of social enterprises. It has proven to work well as it helps social enterprises to grow and these funds provide valuable advice in addition to financial support.

However, the traditional venture capital model has certain implications. It puts an upward pressure on the fund sizes to cover the relatively high operating costs with a management fee of approximately 2% and is increasingly met with reservations.[6] In addition, funds are usually closed after a few years, which implies that investments have to be exited after 5-7 years.

The first social venture capital funds in continental Europe were established as early as 2003 with Oltre Venture, BonVenture or Phitrust as just some examples of these funds. The second generation of social venture capital funds has combined incubation and acceleration services with investments. This combination has allowed investments that often start at around or below €100.000 potentially being increased in subsequent investment rounds. The third generation of social venture capital funds has started within different investment fields and has expanded its services to also offer equity investments. For example, Belgium-based Crédal started as a loan fund and is now offering access to crowdfunding and equity investments.[7]

It will be interesting to observe how these three models develop further and how they will interact with traditional venture capital funds. There is an increasing number of co-investments by more established funds with traditional venture capital funds. This could either imply a more general shift of businesses towards social objectives or an impact dilution.

2.1.2 Fund development

The following non-exhaustive table shows seven established European social venture capital funds. They all follow a commercial approach and have been established between 2006 and 2012. In total, they manage between €17 and 150 million. This analysis shows interesting developments and mechanisms.

Every fund is on a growth trajectory increasing the fund sizes over time. This is in line with development seen in the venture capital industry (e.g. as discussed by Harris, Jenkinson, and Kaplan, 2014). BonVenture in Germany serves as a good example of this progress. Its first fund had

[6] There are certain clauses and provisions which favour investors (e.g. liquidation preferences, dilution rights, control rights) and put pressure on the entrepreneurs in order to exit after a few years.

[7] We notice also another parallel development: For example, FEIS Bizkaia (Spain) is a public social venture capital fund, which could be a pioneer for the sector combining public and private capital to foster social change. Public venture capital funds are already widespread across Europe.

a fund size of €5 million, while the current fourth fund intends to raise €40 million. This pattern is recognizable across all funds. This development also led to an increase in investment sizes.

Interestingly, there are newly established pure-play social venture capital funds and they all start with roughly similar amounts for their initial funds (usually single-digit million fund sizes). Subsequently, they can all be expected to follow a similar growth trajectory (table 2).

The funds have also been supported by initiatives following the objectives of the Capital Markets Union. The introduction of the European Social Entrepreneurship Fund (EuSEF) label in 2013 through the EuSEF regulation[8] allows fund managers to market the funds across the European Union.

According to the European Securities and Markets Authority (ESMA, 2019) there are currently 11 funds registered as European Social Entrepreneurship Funds (EuSEF) in Europe.[9] They are listed in six countries and have been registered between 2014 and 2018. The European Venture Capital Funds (EuVECA)[10] label has been met with much stronger demand.[11]

[8] Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds.

[9] The funds are Big Issue Invest Social Enterprise Investment Fund II LP (2015, United Kingdom), Big Issue Invest Outcomes Investment Fund L.P. (2015, United Kingdom), BIG ISSUE INVEST OUTCOMES INVESTMENT FUND L.P (2018, France), BonVenture III GmbH & Co. KG (2014, Germany), MRI-Pilotfonds GmbH & Co. KG (2014, Germany), BonVenture II GmbH & Co. KG (2014, Germany), CREAS IMPACTO, FESE, S.A. (2018, Spain), Epiqus Työhyvinvointi I Ky (2016, Finland), Epiqus Kotouttaminen I Ky (2016, Finland), PHITRUST PARTENAIRES (2014, France), Pymwymic Impact Investing Coöperatief U.A. (2018, Netherlands).

[10] Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds

[11] According to numbers from the European Securities and Markets Authority (2019) there have been a total of 262 registrations between 2013 and July 2019.

Organisation	City	Year of foundation	Fund Sizes	Returns	Stage	Average investment size	# of investments
BonVenture	Munich	2003	Fund I: €5.1 MM Fund II: €10.6 MM Fund III: €23.3 MM Fund IV: €40.0 MM	BV I (2004) & BV II (2009): capital preservation MRI-P (2014): IRR of 2-3% BV III (2015): IRR goal of 3-5%	later stage start-ups in the growth/expansion stage	€1-2 MM	50
INCO	Paris	2012	INCO Investissement (2012) AVIVA Impact Investing France (2014) NovESS (2016) ~€150 MM in AuM	-	Across lifecycle including acceleration	€100.000 - €5MM	72
Ananda Ventures	Munich	2009	€80 MM in three funds Fund 3 (2018): €50 MM	"above target"	late start-up and expansion stage	€2-3.5 MM	21
Oltre Venture	Milan	2006	€43 MM in 2 funds	3-5%	Start-up, early stage and expansion	€500,000 - €2 MM	19
SI2Fund	Brussels	2012	€17 MM	Single-digit return target	early-stage (non-seed) or growth phase businesses	€250.000 - €1.5 MM	-
Den Sociale Kapitalfond	Copenhagen	2011	Den Sociale Kapitalfond Invest (2018): €38.7 MM	-	small and medium-sized companies with growth potential	-	2
Phitrust Partenaires	Paris	2006	€29.5 MM in 2 funds	-	Profitable and growing SMEs	€100K and €800K	20 to 25
Social Impact Ventures	Amsterdam	2014	Fund I: €19 MM	-	Proven business model	€500K - €3 MM	10

Table 1: Social venture capital funds with investment track record

Source: Company websites and publicly available information such as presentations, newsletters, databases or news articles

Organisation	City	Main Sector Focus	Year of creation	Fund Sizes	Returns	Average investment size	# of planned investments
Credal	Brussels	None	1984	€10 MM	2% planned	Max €400.000	25
FEIS Bizkaia	Bilbao	Social inclusion, health, culture, education	2013	€1.6MM	-	Max €450.000	6
FASE	Munich	None	2013	+€20 MM	-	€ 100.000-500.000	>40
Mustard Seed Maze	Lisbon	Tech	2015	target size €40 MM	20% IRR or 3x MOIC	pre-seed: 25-50K seeds and pre-series A: 150-300K series A/B: 500k-1.5M	35
SEFEA Impact	Padova	None	2016	€ 55 MM planned €2.5 MM invested	-	€ 300.000 - € 2.000.000	5
Tilia Impact Ventures	Prague	-	2018	€1.7 MM	-	-	10
Helenos	Brussels	Inclusive Finance	2017	€10 MM	-	-	-
Creas Impacto	Madrid	Health, environment, education, social innovation	2018	€25 MM	-	€ 500.000-€ 3.000.000	15

Table 2: New generation of social venture capital funds

Source: Company websites and publicly available information such as presentations, newsletters, databases or news articles

2.2 Banks

There are two types of banks involved in the financing of social enterprises. The first group comprises commercial banks usually listed on stock markets which have established services for social enterprises. Examples are Erste Bank or BNP Paribas. The second group includes banks which refer to themselves as community banks, ethical banks or social banks and are organized in networks like FEBEA (Fédération Européenne des banques Ethiques et Alternatives) or GABV (Global Alliance for Banking on Values). Examples are GLS Bank, Crédit Cooperatif or Triodos. Both groups provide loans to social enterprises.

It might be interesting to consider why there are not more banks that explicitly target social enterprises. A reason for this might be that the financing of social enterprises needs dedicated units within the bank as these business models are different from other enterprises. A loan officer at a bank might have difficulties understanding the nature of their businesses, the hybrid income structures or the reliability and predictability of philanthropic resources.

As of October 2019, 31 EaSI social entrepreneurship guarantees and counter guarantees have been provided to banks. This equates to a well-balanced portfolio of guarantees across Europe involving 16 countries. There are three commercial banking groups which have benefitted from EaSI guarantees. This leaves space for other banks to offer similar services.

It is interesting to note how banks that target social enterprises are spread across the countries and are not concentrated in the main capital cities as commercial banks use to be. The headquarters of the social banks which are beneficiaries of the EaSI guarantee are Brussels, Copenhagen, Lappeenranta, Paris, Lyon, Padova, Bologna, Utrecht, Warsaw, Mondragon, Pollenca, Barcelona, Soria and Sheffield. This implies a local embeddedness and their understanding of their local community institutions, being local banks.

An analysis of the business models of the final beneficiaries published on the website of the EIF reveals a wide range of business models. Examples include organic food shops, co-working spaces and kitchens, work integration, mobility services or child care facilities.

2.3 Crowdfunding platforms

Crowdfunding platforms use technology to link demand and supply of financing for social enterprises. The three platforms we use as examples – Bolsa Social, LITA.co and One Planet Crowd – have raised more than €60 million and have roughly 35,000 members on their platforms. The average investment size is €140.000 - €300.000.

Name	City	Regional focus	Year of foundation	Raised	Members or investments	Average investment size	Number of investments
Bolsa Social	Madrid	Spain	2014	€2.7 MM	4,900 members	€ 200 000	14
LITA.co	Paris	France, Belgium, Italy	2014	Above €20 MM	4,500 individual investors, 100 institutional investors	€290 000 (Median)	+50
One Planet Crowd	Amsterdam	Netherlands	2012	Above €40 MM	25.000 investors	€140 000	+280

Table 3: Crowdfunding platforms (commercial capital)
Source: Company websites

Investments on these platforms have the following characteristics (based on 71 investments analyzed). The average investment amount is €470,000, while the median investment amounts to €212,000. The average equity stake sold on Bolsa Social was 18% for €200.000 which implies an average pre-money valuation of €900,000. The analysis also showed that most projects were close to consumers (e.g. marketplaces, clothing, farming, education or fair entertainment).

Technological developments might support further development and the platforms might also be an option for retail investors to invest directly in the future.[12]

2.4 Business Angels

Business Angels are individuals investing out of their private wealth into entrepreneurial ideas or start-ups at a very early stage. Statistical data can only be found for traditional business angels, but this might give an indication since business angels might also be inclined to invest in social enterprises. According to numbers from The European Trade Association for Business Angels, Seed Funds and Early Stage Market Player (2018) there are 337,500 investors which closed 39,990 deals in 2017. The average investment per business angel is €25,400.

UK, Germany and France are among the more developed markets with the highest volumes of business angel investments in enterprises. Central and Eastern European countries are still in a very early stage of development which may be shown by them having the youngest average age for business angel investors.

[12] Reputation risk management is an important topic for crowdfunding platforms. In general, they have developed good strategies to manage the reputational risks of bankruptcies and are transparent in communicating the investment risks.

In general, policy measures can support business angel activities by way of co-investment schemes or tax breaks. At a European level, there is a co-investment scheme by the EIF: The European Angels Fund (EAF), advised by the EIF, provides equity in the form of co-investments for business angels investing in innovative companies. These investees are not necessarily social enterprises but comprise all kinds of SMEs. EAF has a volume of €320 million and more than €200 million have been committed to some 80 selected Business Angels resulting in a portfolio of 340 co-investments.[13] Nevertheless, business angels are often not interested in these support schemes as they might be perceived to be too complex and bureaucratic.[14]

Tax breaks are offered in many countries in order to incentivize angel investments. Evidence on their effectiveness is, however, still inconclusive.

2.5 Incubators, accelerators, match-makers and investment-readiness programs

There are organisations which work on the demand side of the market, helping social enterprises to become ready for investments, getting them started or accelerating their growth. These are either referred to as support organisations, investment-readiness programs, incubators or accelerators. There are basically four business models in this field: the fund model, the academic model, the impact hub model and the exclusive model.[15]

Some incubators might have concluded that they need to organise funding themselves or some funds might have concluded that they need to run their own incubation and acceleration programs. This fund model serves both the demand and supply sides and needs good governance structures in order to avoid conflicts. Paris-based INCO, a catalyst for social and green start-ups, is such an example that has created a network of incubators running programs in 35 countries.

Across Europe, universities are engaged in the provision of training to students interested in creating social enterprises. It might be a natural fit with their research and teaching activities. In a recent project, Koç University, together with Mikado Consulting and Ashoka Foundation Turkey, conducted business model development training and an investment readiness program for social enterprises.[16] Another example is the Munich-based Social Entrepreneurship Academy created by four Munich universities.

There are some organizations in the field that run investment-readiness, incubation and acceleration programs on top of their regular activities. The Impact Hubs which can be found across Europe regularly run such programs often sponsored by foundations, companies or development agencies.

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[13] More information can be found at https://www.eif.org/what_we_do/equity/eaf/.

[14] The Financing Agency for Social Entrepreneurs has been working with business angels and is setting up a co-investment fund open for business angels and institutional investors.

[15] The typology is based on the second edition of "A Recipe Book for Social Finance" available at: https://ec.europa.eu/social/main.jsp?catId=738&langId=en&pubId=8251&furtherPubs=yes . One might add corporate incubators. They are run by bigger companies or foundations that aim to support a new cohort of entrepreneurs. Examples are usually consumer good companies that react to changing customer demands.

[16] The project received a grant from the EaSI program, aimed at developing social finance markets.

The last category, the exclusive model, is focused on specialized programs which exclusively deliver investment-readiness programs. The description above shows that there is a constant demand for these programs but also highlights that most need some form of cross-subsidization. This implies that the exclusive model is difficult to operate sustainably.

In addition, there are match-maker intermediaries working with social enterprises to fundraise and structure investments. The business model is typically based on an advisory fee. The Financing Agency for Social Entrepreneurship or ClearlySo are leading intermediaries.

2.6 Payment-by-results schemes

One rather new financing mechanism is represented by the so-called payment-by-results schemes. In these funding constructs, an outcome payer commits to fund the intervention once it has proven to be working and impactful. This means that payments are contingent on the independent verification of results (also called ‘outcome-related payments’).

Often these outcome payers are public bodies that run programs for the sector in which the intervention takes place. A private funder enables the intervention by providing the upfront payment, with the expectation of a financial return, to be covered by the outcome payer upon success.

A variety of instruments have been developed in this area, for example, social impact bonds or development impact bonds. In the UK, the use of these schemes has been largely to achieve cost savings for social service expenditures. In continental Europe, however, this has been more of a method to increase effectiveness of service delivery and develop new approaches. The overall evidence on the subject is still inconclusive. Definitions, objectives and expectations are heterogeneous and clear results are still missing.

It is unclear if there is a role for public institutions in the financing of these contracts. One rationale for the development of these instruments is that private investors take the risk and push for more innovation. There might be some support needed in the provision of these services, or for a future European Fund to back social impact bonds.

3 IMPERFECTIONS

Evidence indicates that social enterprise activities generate market returns for investors, alongside significant social returns; however, consequential growth of those activities seems to be hampered by sub-optimal allocation of financial resources.

This chapter will outline the reasons driving imperfections in the social finance market that can be observed at the moment.

3.1 Investment sizes for equity investments

The second chapter discussed the upward pressure on social venture capital fund sizes as they need to have a certain fund size to cover operating expenses. It showed that social venture capital funds in Europe aim to reach more than ~€30 million in assets under management. These fund sizes generate enough fees to cover the operating expenses but also reduce the incentive to invest in smaller ticket sizes.[17]

A small team needs to screen potential investments, analyse interesting cases, negotiate investments, support investees, monitor the industries and develop exit strategies. It seems thus unlikely that funds can analyse many investments with overall financing needs below €500,000 which would increase the total number of investments in the portfolio. This pattern can be found across the European Union. Countries in CEE might have different costs but the same mechanisms apply. This implies that there is a gap in the supply of smaller equity investments.

This tendency towards larger investments is mitigated by the different models discussed below. Integrated business models might reduce this pressure on the fund level growth and debt finance providers, especially those with a background in microfinance, have developed efficient ways to provide loans of smaller amounts.

3.2 Lack of intermediaries and low capital absorption capacity

There is currently a trend towards integrated business models. Banks or loan funds are developing equity instruments, investment advisors are setting up complementary investment vehicles, and incubators and accelerators are fundraising in order to be able to invest in their cohorts of social enterprises.

These integrated business models are usually able to create lower transaction costs. A loan fund might have an existing pipeline of investment opportunities and can use available analytical capacities for due diligence and investment processes. They can also improve the functioning of the markets due to reduced coordination requirements.[18] This development

[17] Funds in general (e.g. hedge funds, venture capital funds or private equity funds) have various growth pressures as well as barriers. The personnel fluctuation at funds is usually limited and to promote junior-level employees there is a need for additional funds, while an increase in fund size might limit the universe of investment opportunities.

[18] Integrated business models might also pose challenges in terms of conflicts of interest. Intermediaries might work with social enterprises on the demand side but also advise or manage their own investment funds. So far, this seems to be well managed across the industry.

might also be driven by the fact that there is a lack of intermediaries and existing market participants need to offer additional services.

This lack of intermediaries can also be linked to a low capital absorption capacity. On a micro-level, it seems that any abundance of capital might not find its way into the social enterprise finance market due to a lack of intermediaries that might help to channel those funds.

3.3 Debt reliance

On a European level, there are more intermediaries in the debt sphere than in the equity finance area. There are several reasons that can explain this trend toward debt.

Debt capital does not need to rely on exit strategies for its investments. Social enterprises just repay the loan that is involved. In addition, debt finance intermediaries are also able to provide loans at lower amounts as their business model is more standardized and a loan officer can manage more cases than an investment officer at a fund.

Social entrepreneurs often state that they prefer debt capital given that they do not have to give up shares as well as control and voting rights. Debt capital is also more flexible in structuring repayment profiles. It can be repaid continuously or at the end and can also be linked to the success of the company when used as mezzanine capital.

3.4 Economics of matching supply and demand

Markets need mechanisms to match supply and demand. In this context, the social enterprise finance market needs two forms of intermediaries. Those that work with both sides of the market ("match-maker") and those that make social enterprises investment-ready ("demand side").

Based on our experience, there at least a few dozen intermediaries in Europe working with social enterprises to make them investment ready and a few matchmakers helping social enterprises to structure their financing needs.[19] Examples can be found throughout Europe, but the economics of these business models always remain difficult. There is a limited willingness or ability among the social enterprises to pay. Large companies or public agencies have funded programs in the past and will most likely continue to do so. Equity shares in return for the investment-readiness support might be an option, but some social enterprises have not even been incorporated at the time of funding.

From a policy perspective, two aspects are noteworthy. These organizations are important for the functioning of the market, but both types have difficult business models to run sustainably.

[19] 13 of them have been funded by the recent EU-funded Action to boost supply and demand in the social finance market. Investment readiness support means that social enterprises are supported to develop business models and business plans, create structures suitable for investments and have an understanding of the requirements of funds and banks.

3.5 Asset misallocation

Foundations are a driver of social change. In Europe, over 140.000 foundations exist with combined annual expenditures of more than €56 billion, and with the top 50 European foundations representing an aggregate pool of money in the range of €147 billion.[20] However, foundations only use a small part of the available funds for the support of social purposes - namely the returns from investing their endowments.

Given the current situation in capital markets and low interest rates, models such as mission-related investments are being discussed more widely. This is an investment strategy where the social objective of the foundation is being included in the investment process, in a best-case scenario aligning both towards the same mission. This could constitute a significant resource for the social finance market in Europe.

3.6 Low confidence in investment returns

Institutional investors usually rely on the track record of fund managers when they decide to invest in funds. This is driven by the uncertain nature of investment management, which depends on experience, networks and knowledge.

Fund managers in an emerging field face the problem that they have little track record and investors have limited data such as past performances on which to base their decisions. This results in a common feedback that investors have low confidence in expected investment returns of intermediaries. Investment managers may present the prospect of positive financial returns in the fundraising process, but investors remain sceptical.

[20] Donors and Foundations Networks in Europe (DAFNE) and European Foundation Center (2019): https://www.efc.be/knowledge-hub/data-on-the-sector/philanthropy-faq/.

4 MARKET GAP ANALYSIS

The demand for equity and debt capital in each country depends on different input factors and assumptions.[21] The variables determining the demand for social finance include:

1. Number of social enterprises
2. Percentage of commercial business models
3. Country-specific maturity of social enterprises
4. Debt and equity preferences over the company life cycle
5. Country-specific financing need

The key input is the number of social enterprises per country. This analysis has relied on data from the European Commission country reports on social enterprises and their ecosystems. The analysis has focused on social enterprises that do not follow a purely commercial business model. The results correspond to that particular market segment. The estimates do not cover the broader market of profit-oriented impact-driven enterprises

Three databases were used to calculate the supply of debt capital to social enterprises across European. The sample included the guarantees provided through the EaSI program and published on the website of the EIF as well as all GABV and FEBEA members.[22] The calculation of existing equity financing comprises capital invested by social venture capital funds and equity crowdfunding platforms as well as equity provided by ethical banks and cooperatives.

The following tables show the funding gap as well as a split in equity and debt capital for all countries participating in the EaSI program. The sensitivity tables show the influence of a change in the proportion of commercial business models and in the average lifecycle funding multiples. The total funding gap for social enterprises across Europe is in the range of €514 million to €1.388 billion per year.

		Proportion of commercial business models				
		30%	40%	50%	60%	70%
Average lifecycle funding need (multiple of national earnings level)	3,0	359,8	389,2	452,9	521,7	593,4
	4,5	413,6	**513,9**	**620,1**	**731,9**	877,3
	6,0	509,9	**652,1**	**805,9**	**1 042,8**	1 279,7
	7,5	612,2	**798,8**	**1 093,2**	**1 387,6**	1 682,0
	9,0	720,1	1 028,7	1 380,6	1 732,5	2 084,4

Table 4: Funding Gap (in € million)

[21] More details on the steps and assumptions can be found in the appendix. The numbers are based on country-level calculations and might not sum up in case there is a national non-transferable surplus.

[22] Data was given in three different formats (total loan portfolio, annual loan provision and loans provided to social enterprises) and annualization factors were used to make them comparable.

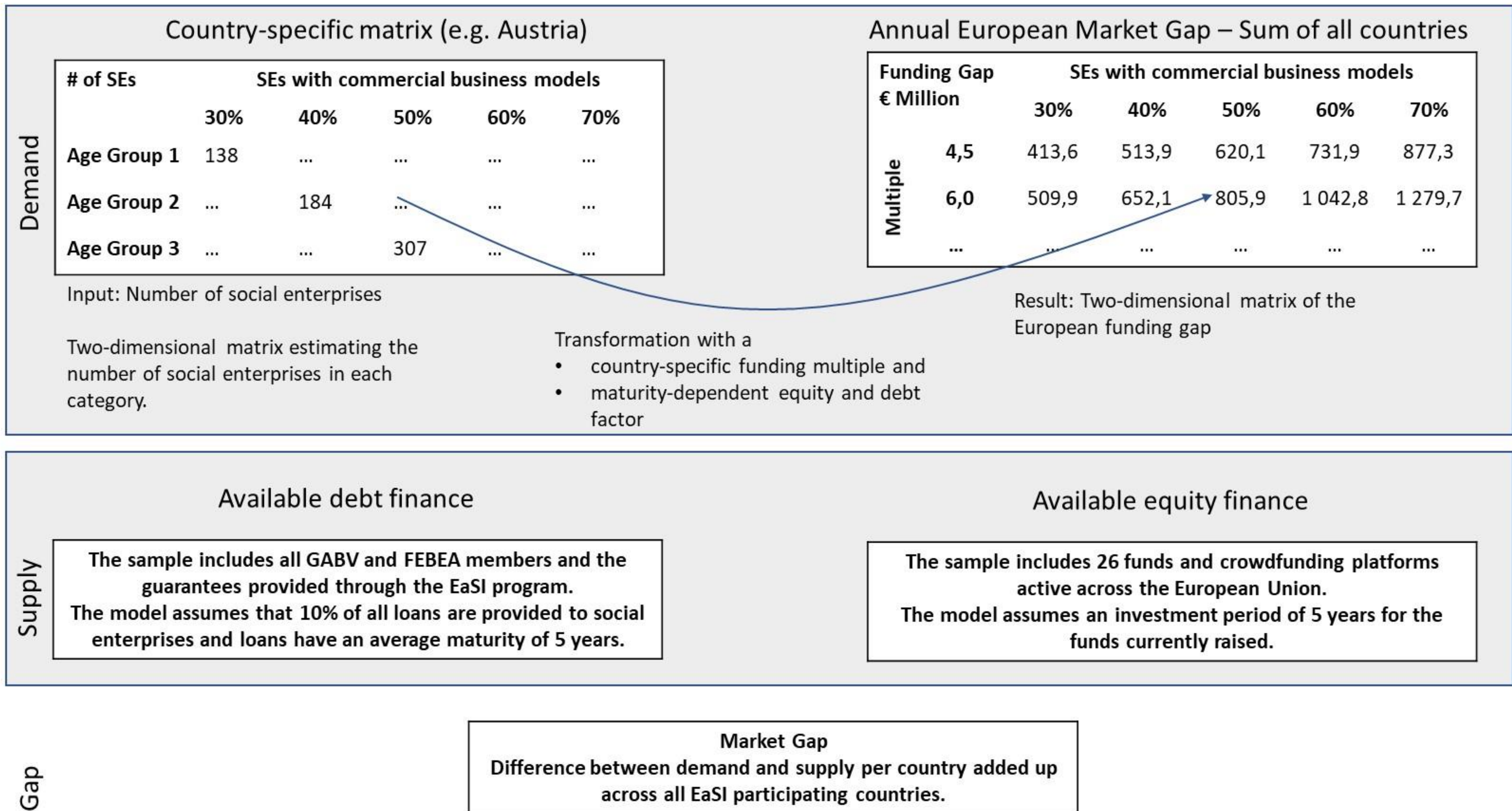

Figure 1: Calculation of European market gap

The annual funding gap for social enterprises in terms of debt amounts to €321 million to €783 million per year.

		Proportion of commercial business models				
		30%	40%	50%	60%	70%
Average lifecycle funding need (multiple of national earnings level)	3,0	238,6	261,0	289,0	340,2	393,3
	4,5	265,8	**320,5**	**395,1**	**470,0**	545,0
	6,0	310,7	**406,8**	**503,4**	**600,1**	729,1
	7,5	375,2	**493,5**	**611,9**	**782,5**	973,5
	9,0	440,2	580,2	766,1	992,0	1 217,8

Table 5: Funding Gap for Debt (in € million)

The total annual funding gap of social enterprises for equity amounts to a range of €230 million to €605 million.

		Proportion of commercial business models				
		30%	40%	50%	60%	70%
Average lifecycle funding need (multiple of national earnings level)	3,0	141,2	155,7	180,3	212,7	246,4
	4,5	176,8	**230,3**	**285,2**	**340,2**	395,3
	6,0	239,1	**315,2**	**391,6**	**470,0**	550,6
	7,5	302,8	**400,4**	**501,7**	**605,2**	708,6
	9,0	366,7	488,5	614,6	740,6	866,7

Table 6: Funding Gap for Equity (in € million)

The analysis and the calculation of the funding gap are based on current data and might evolve over time. The development of the market gap is subject to factors on the demand as well as on the supply side.

The development of the demand side depends on the number of social enterprises as well as their funding needs. It is plausible that similar or even higher numbers of social enterprises will be created in the future given the sustained interest in social entrepreneurship. We might also observe an increase in business model relying on innovations which require higher amounts of capital. Examples are those business models relying on digital technologies.

The development of the supply side depends on factors such as the development of the capital absorption capacity, the availability of investment capital and the number of intermediaries entering the market to finance social enterprises.

The following table shows the range of the funding gap depending on the annual change of the funding gap. The average funding gap estimated for the period from 2021 to 2027 amounts to €6.7 billion.

Annual Change	Lower bound	Upper bound	Average
-10%	2 413	6 515	4 464
-5%	3 255	8 790	6 023
0%	3 597	9 713	6 655
5%	4 393	11 863	8 128
10%	5 363	14 481	9 922

Table 7: Sum of the funding gap (2021-2027; in € million)

5 DELIVERY OPTIONS

5.1 Introduction

Each delivery option has its own mechanics. Grants, for example, enable the growth and development of new business models. Any form of grant support should thus help to lower transaction costs and open new funding sources for social enterprises. Equity increases the capital base and serves as a signal to other investors. First-loss pieces reduce the risk for hesitant investors and crowd-in additional capital. Loan guarantees reduce the risks for lenders, expand the capital available and reduce the costs of borrowing for social enterprises.

5.2 Grants

The previous chapters have outlined the following aspects:

- (Initial) lack of economics for certain business models
- Innovation in the financing of social enterprises needs initial support
- Relatively high transaction costs
- Instruments should engage and target a broader group of intermediaries

There are several promising initiatives to boost demand and supply of social finance across Europe as well as across borders. Examples include partnerships that combine the demand and supply side, build the investment pipeline for investors, help to develop corporate venture capital funds or cooperative incubation funds.

Innovation on the demand as well as the supply side might include virtual accelerator models, the use of artificial intelligence, blockchain applications, the integration of crowdfunding platforms or transnational approaches that try to replicate existing models. Innovations might also lead to an expansion of cross-border initiatives and the development of retail investment opportunities.

There is also the need to have more equity investments at the lower end of the investment sizes. Crowdfunding platforms tend to have lower investment sizes given regulatory requirements, which limit individual investments. Social venture capital funds can also target those lower investment sizes with a transaction cost support program. Specific grant programs could also support investment-readiness programs as well as match-maker intermediaries facing the challenges discussed in chapter 3.4.

Initiatives could also target intermediaries that might be interested in entering the social enterprise finance market. Traditional investors or commercial banks might be among this group.

There are some ideas on how to use non-cash related measures. It seems that there is a certain information asymmetry and lack of data in the market. It might be interesting to have a European equivalent of the US-based news site ImpactAlpha. It features deals and developments in the sector and contributes to transparency and the exchange of information. There is also a need for independent labels or certificates to assess the impact of intermediaries.

5.3 Equity

We have discussed in previous chapters how the economics of focused social venture capital funds put upwards pressure on average investment sizes, which is contrary to policy objectives supporting smaller investment volumes.[23]

New hybrid models combining equity and debt funding have a leaner cost structure and can work cost-efficiently on lower ticket sizes. Having a debt capital mindset, these organizations will be more likely to fund stable business models. Organizations that combine acceleration/ incubation services with investments also tend to invest in smaller social enterprises with an open-ended investment size.

Delivery options should focus on the capitalization of existing funds with proven track records in managing funds and delivering returns as well as innovative or integrated models. Investors trust the due diligence processes of the EIF and see it as a signal of approval. Over the coming years it will remain important to assess also the additionality of investments, i.e., the question whether the social enterprise would have received funding otherwise (e.g., from traditional venture capital investors) or if the fund investments generate additional impact.

First-loss pieces are one additional tool to help new funds or funds with an untested model to mobilize additional capital. Fund managers often have problems convincing investors to invest in their fund and a first-loss piece might limit the downside of investors and help to crowd-in additional capital. First-loss pieces might be a solution to address investors' low confidence in investment returns.[24]

5.4 Debt

The loan guarantees enable banks to provide loans to projects that would not be financially viable without them. The feedback is highly positive, and the guarantees are essential to increase lending to social enterprises.[25]

The social banks might not be able to cover the market gap themselves and it might be interesting to target commercial banks or mainstream cooperative banks more specifically. Some commercial banks might not even be aware that they are already funding social enterprises.

One recommendation for more delivery options will be to increase the number of commercial banks profiting from this guarantee as commercial banks already finance a large number of non-commercial and innovative concepts. Commercial banks might have a bigger risk appetite as suggested by research (Pache and Santos, 2013).

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[23] Moreover, we can observe something like reduced additionality for some funds. Some are investing in ventures that have received other funding anyway.

[24] It is already part of the EIF funding strategy. One quasi-equity fund (mezzanine capital) is in negotiations to receive a guarantee for the portfolio.

[25] Banks seem to be indifferent to whether they prefer uncapped or capped guarantees as it only depends on the price structure and the internal cost of capital.

6 CONCLUSION

This analytical report confirms that social enterprises represent a growing phenomenon and that imperfections in the market for social finance are a barrier hampering their development. The report identifies an important funding gap at European level for this sector, and proposes a number of delivery options. These options could be implemented by means of the InvestEU programme.

Taking into account the role of social enterprises in promoting circular economy, sustainability and innovative solutions to social and environmental problems, it can make sense to further support their development in the context of the recently announced European Green Deal Investment Plan and Just Transition mechanism (European Commission, January 2020).

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APPENDIX

This appendix contains additional information on the calculation of the market gap.

A market gap analysis has several challenges as it has to use a range of assumptions and scenario / sensitivity analyses. For the analysis, we have made assumptions on the topics discussed in detail below.

Use of commercial capital

There is a relatively broad spectrum of finance options for social enterprises. It can include high-quality asset-backed funding (public contracts, grant agreements, etc.), credit card debt, bank overdrafts, equity and even grants. Within this report, we focus on commercial capital in the form of equity and debt capital provided by institutions in the social enterprise finance market.[26]

The following table shows the types of finance applied for by social enterprises over the last 12 months. The data is from two surveys in the UK from 2011 and 2017. The type of finance is relatively stable over time.

Type of finance	Applied (2017)
Grant	82%
Loan	24%
Overdraft	7%
Mortgage	3%
Equity	5%
Leasing / HP	4%
Other	9%

Type of finance	Applied (2011)	Success rate (2011)
Development grant	61%	61%
Loan	25%	56%
Overdraft	7%	43%
Grant / funding	7%	57%
Specific grant / funding / trust	5%	40%
Equity	4%	75%
Mortgage	3%	67%
Lottery	2%	50%
Contracts	2%	50%
Local authority	1%	0%
Other	10%	90%

Table 8: Type of finance - Application and Success rate
Source: Social Enterprise UK (2011, 2017)

It also shows that there is a relatively large share of social enterprises that do not have a commercial business model. In the UK, 46% of social enterprises have annual turnovers of below GBP 100,000. These data points indicate that not all social enterprises have a commercial business model and it can be assumed that the range for those using commercial capital will be between 30% and 70%.

[26] Some forms of capital are easier to acquire which is also confirmed in interviews and observations. A pre-financing agreement with a local bank backed by public contracts might be relatively easy and inexpensive and there does not seem to be a need for intervention. The same applies for real-estate financing, leasing agreements or credit card debts.

Average investment sizes

The average investment amount is difficult to estimate across the European Union. It gets even more complicated to estimate it over the complete lifecycle of a social enterprise.

Social Enterprise UK (2017) report that 37% of social enterprises applied for investments in the range of GBP 10,000 and GBP 50,000. The overall median amount was GBP 80,000.[27] Two loan funds from Western Europe provided loans roughly worth €20 million to organizations with an average of below €100,000 for funds, with some requiring as little as €6,000. Belgium-based Crédal has provided loans to 38 social enterprises in 2018 with a total sum of €2.1 million.

Numbers from The European Trade Association for Business Angels, Seed Funds and Early Stage Market Player (2018) might also give an idea in which range investments might be. The average investment for a mainstream enterprise is €182,000 in 2017. The numbers for the years between 2013 and 2017 have been between €165.000 and €184.000 and are mostly for Western European countries. The average investment per Business Angel Network is €1,5 million and the average investment per business angel is €25,400.

Data sources including equity crowdfunding platforms and social venture capital funds as well as conversations with social enterprises all suggest that in most cases, a few ten thousand Euros are sufficient to start a business and there might be a need for additional fundraising after a proof of concept or once the social enterprise has gained some traction.

For the market gap analysis, we use multiples of national mean earnings data from Eurostat to adjust for different GDP levels across the European Union. National mean earnings also reflect the high proportion of personnel costs for social enterprises.[28] This approach might underestimate capital expenditures but reflect the high amount of personnel costs in this field.

The case of a Belgian social enterprise illustrates the calculation which is linked to the multiple of national mean earnings levels.

Age	Multiple	National mean earnings	Total funding need
0-4 years	1,5	47 527	71 291
5-9 years	2,0	47 527	95 054
10 years+	2,5	47 527	118 818
Total			285 162

Table 9: Lifecycle funding needs

Split between debt and equity capital

The age structure of social enterprises is important for two reasons. Start-Ups and younger enterprises are more likely to need equity while older enterprises are more likely to use debt financing. Thus, age distribution is another important input variable for the model. The following tables show the age structure for social enterprises in Germany and the UK.

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[27] The capital raised was 25% lower. Interestingly, they find an increase in the amount sought by social enterprises in their bi-annual survey of social enterprises in the UK.

[28] At the mid-point we assume the following financing needs for three countries that we selected for illustrative purposes: Hungary (€61,000), Spain (€173,000) and Denmark (€363,000). Excluding real estate, leasing and bank overdrafts, those numbers seem to be reasonable estimates.

Age (yrs)	Percentage (Germany, 2012)		Age (yrs)	Percentage (UK, 2017)
1-2	8%		0-1	4%
3-4	18%		1-3	21%
5-9	26%		4-5	14%
10-15	9%		6-10	22%
15-19	11%		11-20	17%
20-29	20%		>21	23%
>30	8%			

Table 10: Age structure for social enterprises in Germany and the UK
Source: Spiess-Knafl (2012), Social Enterprise UK (2017)

We assumed that this is a normal age structure and adjusted it for those countries that have a high or low amount of social enterprises, measured relative to the population. A low density of social enterprises implies that there should be a higher number of newly established social enterprises.

Age distribution	Age Category 1	Age Category 2	Age Category 3
	More than 1 SE / 2,000 inhabitants	Range of 1 SE / 2-5,000 inhabitants	Less than 1 SE / 5,000 inhabitants
0-4 years	20%	25%	30%
5-9 years	20%	25%	30%
10 years+	60%	50%	40%

Table 11: Age distribution of social enterprises – model assumption

The age structure is important as it determines the amount of debt and equity capital social enterprises will request over the lifecycle in the calculation model. Consequently, we assume a higher dependence on equity in the first five years, an equal split between 5 and 10 years and a strong reliance on debt once the company is more established.

Age distribution	Equity	Debt	Financing need in each phase (multiple of mean earnings)
0-4 years	70.0%	30.0%	1.5x
5-9 years	50.0%	50.0%	2.0x
10 years+	10.0%	90.0%	2.5x

Table 12: Age distribution and debt/equity split – model assumption

Country-specific analysis

This analysis relies on the number of social enterprises per country which is weighted with the factors described above to calculate country-specific demand for social finance. The numbers are based on the national mapping studies published by the European Commission.[29]

[29] The numbers are based on pre-final working papers. The mapping studies can be found online (at https://ec.europa.eu/social/main.jsp?catId=952&intPageId=2914&langId=en. For the countries where data is not available yet, this analysis used an unweighted average of countries considered to be similar.

Only two countries were analyzed differently. For the UK, there are existing analyses by Joy et al. (2011) and Heny and Craig (2013). The EIF also bases its analysis on these numbers (Torfs and Lupoli 2017). We follow this calculation and assume that the UK market gap is €126.4 million per year with a split of equity (40%) and debt (60%). This is equivalent to €2,777 per year and social enterprise in the EIF calculation.

Italy has a vibrant ecosystem for the financing of social enterprises but mechanisms for social enterprise are difficult to trace. Local banks seem to be quite active in providing loans to social enterprises and capital increases are driven by cooperative members.[30] We thus assume an annual funding gap of €2,000 per social enterprise which is in line with the European average and multiply it with the number of Italian social enterprises using a similar split of equity and debt.

Risk of underestimating

There is a risk that we are systematically underestimating funding needs. This may be driven by the larger investment sizes. Some recent investment examples might illustrate the point. A US-based company managing a fleet of drones to deliver medical supplies has raised $190 million. Another US-based learning platform raised $130 million in a recent Series C. Some real estate projects or childcare facilities are also above the ranges we expect and used for the market gap analysis.

However, on average as well as after excluding high-quality asset-backed financing instruments as discussed above, the investment ranges should reflect realities which social enterprise face across Europe.

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[30] European Commission (2016a) illustrates the financial power of capital increases in social cooperatives: “A recent analysis conducted on financial budgets of a representative sample of more than 7100 social cooperatives found that, […] as a reaction to the reduction of margins, the typical practice of allocating profits to reserves has been replaced by capital increases – usually directly provided by worker-members – which grew by 59.1 %, rising from EUR 258 million in 2008 to EUR 410 million in 2013.”.

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