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# Financing social ventures and the demand for social investment

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## Abstract

There is a growing interest in social investment and the provision of loan finance to social enterprises. While there has been much discussion on the supply of finance, research on the demand has been lacking. This paper shows that 15 percent of social enterprises are seeking loan finance, with most of these borrowing from high street banks. Only one in five borrowers or 3.6 percent of all social enterprises are approaching social investors (those lenders that have a social mission), Social enterprises without assets that they can use as collateral are shown to be able to seek finance. Just under 60 percent of borrowers have unsecured finance with commercial banks providing unsecured lending to just under half of their customers. Social enterprises appear to be more successful than other types of small business in getting finance, and those more reliant on grants are more likely to succeed in getting finance, as are those with the public sector contracts as their main source of income. This research allows a clear distinction to be made between social enterprises that are not interested in loan finance, those already receiving, and those that are interested but not able to source loans, or are discouraged. Conclusions are drawn for how best to support these gaps in provision without displacing existing finance.

### Keywords

Social enterprise, social investment, loans, repayable finance, social investors, banks

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# Contents

## 1. Introduction

There is a growing interest in the provision of loan finance for social enterprises and other social purpose organisations. These organisations, operating at the intersections of civil society and the commercial world, face particular challenges from having to balance their social mission with commercial objectives (Doherty et al., 2014). These tensions become particularly apparent when examining access to loan finance

The supply of specific investment for social enterprise is expanding with specialist social investment programmes around the world. In the UK there are a range of different social investors who have added support from the wholesale provider of finance, Big Society Capital. In this paper we specifically focus on the use of repayable loan finance that might come from specialist social investors or from conventional sources such as banks. This is distinguished from other forms of finance (sometimes also referred to as social investment) such as retained profit/surplus, grants and investment from owners/staff. Grant finance is not included in the analysis of this paper although it is recognised that for many social investors, loans can be combined with grants.

Social investment loan funds are financed by investors that seek opportunities to lend to organisations that create social value at the same time as generating a financial return (Nicholls 2010). There are a range of different forms of social investment that aim to meet the need for funds that combine financial returns with philanthropy. These range from financial programmes that offer cheaper loans for organisations with social values to forms of philanthropic venture capital.

However, there remain questions over the nature of the demand for loan finance for social enterprises. Much existing analysis of the social investment sector in the UK has focused on the nature of the supply with less attention to the types of finance that organisations want, and whether they can afford debt finance. Analysis commissioned by Big Society Capital suggests a growing demand, centred on expectations of a growing role of social enterprises in public service delivery, changes in commissioning and the ability of social enterprises to develop sustainable business models (BCG, 2013). Evidence of current usage and demand is limited. However, there is evidence that some funds find it hard to distribute resources and find investees (Gregory et al., 2012; Hall et al., 2012). Gregory et al. (2012) state:

> After a number of years bemoaning the lack of access to capital and suggesting that “if you build it they will come” (Sir Ronald Cohen), the emphasis has shifted amongst the experts to regret the absence of investment ready propositions. In the midst of a global credit crisis and with access to finance at the top of social ventures’ concerns, we perversely see significant pools of unapplied capital with slow dispersal rates.

There is therefore greater attention to developing ‘investor readiness’ to grow the demand.

Existing analysis of demand for investment does not distinguish between demand from mainstream banks and demand from social investment finance intermediaries. There are further unanswered questions on the roles of commercial banks with regard to social enterprise and the extent to which social investment is there to fill a market left by banks, or to take a market share from commercial lenders.

This paper will draw on the recent SEUK survey (2013) to identify where there is current use of loan finance. The results will add to debates on the nature of finance for the social economy, the effect of loan finance on social economy activities; and the changing patterns of social enterprise activity. To investigate these issues the following research questions were explored:

What are the types of investment being sought?
Who are the organisations seeking finance?
How successful are social enterprises in accessing finance?
Who are the potential seekers that have been discouraged?

Individual social enterprises are taken as the unit of analysis with specific study of those seeking debt finance.

The remainder of the paper explores key issues around social enterprises access to formal external finance, with a particular focus on their debt finance requirements. The paper examines social enterprise demand for formal debt finance, including types of debt finance required, types of lenders approached, amounts of finance sought and the reasons for requiring finance. The paper also examines latent demand and discouraged borrower issues around why some social enterprises do not approach lenders for the debt finance that they require and examines the success rates of social enterprises in obtaining some or all of the debt finance that they required in the last 12 months.

## 2. Finance debates facing social enterprises: a review

- Social enterprise and finance

Social enterprises are defined by their combination of social mission and commercial orientation (Austin et al., 2006; Mair and Marti, 2006; Doherty et al., 2014). In this way they are an organisational form characterised by hybridity (Billis, 2010) that challenges traditional concepts of economic organising (Wilson and Post, 2013). A key challenge facing social enterprises is the management of the competing institutional logics of social value and commerce (Pache and Santos, 2012) and the need to bridge these institutional fields (Tracey et al., 2011).

Defining social enterprise is particularly challenging as organisations can be located on a continuum between the purely philanthropic and the purely commercial. In all countries there are a range of legal forms of governance that social enterprises can draw on (Smith and Teasdale, 2012). There are further debates over the extent of trading income that identifies an organisation as a social enterprise (Lyon and Sepulveda, 2009). There are also challenges over the meaning of the term 'social'. However, there is considerable comparability in the interpretation of the term amongst social enterprise associations, policy makers and support providers in the UK, other European countries and elsewhere.

With the emphasis on both social and financial objectives, social enterprises differ from other social ventures (Austin et al., 2006). This change is particularly evident as organisations distance themselves from purely philanthropic sources of income, and seek out trading income (Dees, 1998). While most trading social enterprises may not be seeking repayable or loan finance, the management of social ventures that do seek such investment becomes further distanced from a philanthropic model. In such cases a commercial venture is required in order to generate a cash flow and surplus to repay the loan (Lumpkin et al., 2013).

- Small enterprise and access to repayable finance

Evidence from recent studies suggests that access for all types of enterprise (including social enterprise) to both debt and equity business finance since the global financial crisis in 2007/08 has become considerably more difficult and expensive in the UK and that this is holding back potential business growth. Cowling et al. (2012) found that between 2008 and 2012 the average interest rate of bank loans increased by a median of four per cent, whilst additional set up and maintenance costs also increased along with demands for greater collateral. These worsening terms and conditions resulted in a halving of UK business bank lending from £7.4bn to £3.5bn (Bank of England, 2011) and an increasing incidence of discouraged borrowers (Fraser, 2009), with the impacts of the government's Enterprise Finance Guarantee (EFG) for business bank finance appearing marginal (BIS, 2009).

The general evidence from the UK SME FM reported by Cowling et al. (2012) and BIS (2013b) is of a depressed UK debt finance market, with SMEs reluctant to invest in growth and preferring to pay down debts rather than borrow. Furthermore, Bank of England (2014) data on UK corporate bank lending trends demonstrates high borrowing set-up costs and annual management charges with SME borrowing remaining depressed.

Evidence related to the supply of finance has identified funding gaps which have been referred to regularly since Macmillan (1931). Primarily, there are problems of accessing early stage business finance and the financial needs and options of small firms change as they become 'less informationally opaque' to potential finance providers (Berger and Udell, 1998). A central tenet is that the inter-connectedness and substitutability between different sources of finance is crucial to financing the continuous development of businesses. It is most difficult for early stage and marginal businesses to obtain finance, because they lack track record and collateral and face informational asymmetries and moral hazard issues in presenting their case for external finance (Hughes, 2009). Moreover, the use of standard credit scoring techniques by banks tends to favour established trading businesses with collateral rather than higher risk enterprises with intangible assets (Stiglitz and Weiss 1981; Bank of England 1996 and 2001; Cressy 2002).

During recessionary times the supply of finance to SMEs has been further exacerbated by 'cyclical' credit rationing activities of the banks, resulting in more expensive, and more stringent terms of lending (Cowling et al., 2012). This means that even for more established SMEs, the availability of working capital overdraft, and short term loan asset finance has been limited, severely hampering further business development and the availability of less expensive longer term loan finance for business growth projects.

A final observation is that whatever the supply of finance, demand-side business applications have to be up to standard. Mason and Kwok (2010) and Mason and Harrison (2001) note that SME owners managers often have little experience in applying for finance, with various studies (e.g. North et al., 2013) demonstrating that more experienced entrepreneurs have greater success in accessing all types of external finance. It is argued that there is a continuing need for SME investment readiness programmes. This paper will explore the extent to which these issues affect social enterprises

- Social investment

There has been growing interest in the issue of finance for social enterprises, with studies looking at the sources in banks and conventional sources (Bryson and Buttle, 2005) as well as the a focus on finance that has a particular social value orientation combining both financial and social returns (Nicholls, 2010). This latter form of 'social investment' provides finance at preferable rates and combines loans with elements of philanthropy (Scarlatta and Alemany, 2010; Lumpkin et al., 2013), or longer term patient capital (Van Sandt et al., 2009).

The hybrid nature of social enterprise allows them to approach both philanthropic and commercial capital providers (Chertok et al. 2008).The actual demand for loan finance by social enterprises is not clear. Although it has been reported that SEs increasingly seek support from banks and venture capitalists (Bryson and Buttle 2005), research by Sunley and Pinch (2012) found that the majority of SEs with asset locks restricting individual benefit, continued to rely on public sector grants and were cautious about taking on debt.

- Social enterprise and social investment in the UK

There is a growing interest in lending for a social purpose amongst philanthropic funds, the government, and growth oriented social enterprises. There are new sources of 'social investment' with the arrival of Big Society Capital acting as a wholesale bank for social investors developing innovative sources of finance. There has been further interest in social investment at a European level with the Social Business Initiative.

With the change government in 2010 there has been a growing interest in social investment with the publication by the Cabinet Office (2011) of Growing the Social Investment Market: a vision and strategy. While the social investment policy agenda is a continuation from the last government's policies across the disruptive period of government change, the actual outcomes can be seen to meet a number of diverse wider policy objectives, some of which are radically different. For example, social investment continues to be seen as a way of encouraging social enterprises to scale-up, but it also has an explicit objective of supporting social ventures to "open up and decentralise our public services" (Cabinet Office, 2011.7). The capital funding can also be used to finance the more radical areas of the coalition policies such as the involvement of social enterprise in driving competition in health services, free schools and academies, and the delivery of Payment by Results contracts (where social enterprises may be paid months after delivery of the service based on getting people back to work or reducing reoffending) (Cabinet Office, 2011: 14).

Further policy developments have seen a range of programmes looking to promote social investment such as the 'Contract and Investment Readiness Fund' that supports social ventures looking to build capacity to take on repayable finance.

These policies and investment funds have been operating in an environment of multiple uncertainty. Firstly there is a lack of evidence on the size of the social enterprise population. Estimates that only include organisations with legal forms that restrict distribution of profit and assets to individuals puts an estimate at approximately 20,000, while estimates with a looser definition (and including organisations with private ownership legal forms)give estimates at closer to 72,000 (Teasdale et al., 2012). Recent estimates that have an even looser definition and greater private ownership involvement have quoted figures of 180,000 social enterprises (BMG Research, 2013). Secondly there is a lack of evidence of demand for loan finance from social enterprises, and thirdly there is a lack of knowledge about the existing supply of mainstream finance that might be operating in competition with social investment. It is the latter two issues that are the focus of this paper.

## 3. Methodology

This paper draws on an analysis of the Social Enterprise UK survey, which surveyed 878 social enterprises (SEUK, 2013). The sample frame of 9,024 organisations was built from members of social enterprise umbrella bodies representing UK regions and social enterprise sectors. The survey questionnaire confirmed if organisations conformed to the standard UK government definition of social enterprise with at least 26% of annual income from trade as opposed to grants and donations and with respondents defining themselves as social enterprises complying with the following statement:

> Social enterprises are defined as “businesses with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or community, rather than being driven by the need to maximise profit for shareholders and owners”. The social enterprise movement is inclusive and extremely diverse, encompassing organisations such as development trusts, community enterprises, co-operatives, housing associations, 'social firms' and leisure trusts, among others. Would you say that does describe what your organisation does?

This results in a large sample of organisations self-defining as social enterprises and having links to regional support infrastructure bodies. The sample may exclude those organisations that are not linked into these support networks. The majority of organisations (51%) were Companies Limited by Guarantee, usually with charitable status, with a further 19% being Industrial and Provident Societies, and 17% being Community Interest Companies. A further 12% were Companies Limited by Share. Forms of social enterprise such as cooperatives, social firms or development trusts can take on any of these legal forms. There is no population survey of social enterprise but comparisons of the sample frame to other large samples shows that this survey is broadly representative. A comparison to the National Survey of Third Sector Organisations (renamed National Survey of Charities and Social Enterprises) shows no statistically significant differences according to the sectoral balance, legal ownership status and the size of organisations, once the private sector entities have been taken out of the State of Social Enterprise sample.

The analysis presented here is based on access to finance questions in which senior managers or owners of social enterprises were asked via a telephone survey in February 2013 whether they had applied for new sources of external finance during the previous 12 months (effectively 2012). This definition of seeking external finance is potentially slightly problematic, firstly because the emphasis on application focuses on access to formal finance and, secondly, because the SBS 2012 (BIS, 2013) asked if the business had tried to obtain finance in the past 12 months, not only potentially collecting data on informal finance, but also being more likely to pick up on refinancing activity[1]. However, as can be seen, this line of questioning is broadly in-line with the SBS approach allowing the comparisons presented in this paper between the social enterprise findings from the recent SEUK (2013) survey and the mainstream UK SME findings form the SBS 2012. This latter survey has a sample of 52,723 SMEs drawn from Dun and Bradstreet and stratified according to size (BIS, 2013).

A binary logistic regression model was run in order to find out: (i) the likelihood for seeking debt finance in the last 12 months (dependent variable, 'sought finance'); and (ii) secondly, the likelihood for success in receiving finance (dependent variable, 'received at least some finance'). The dependent variables were tested against a series of independent variables relating to social enterprise characteristics, including: establishment age; size by annual income; legal status; main trading customer market; future growth aim orientation. Additionally, consideration is given to the type of debt finance sought and the of type lender approached.

Using a sifting process, it was quickly possible to identify many of the business characteristics as insignificant and those which are presented in the model are those which appeared to have greatest significance in the likelihood of social enterprises seeking and receiving formal external debt finance in the previous 12 months.

## 4. Findings

In this section we explore the demand for debt finance exhibited amongst social enterprises in 2012. Surveyed social enterprises were asked whether they had sought external finance during the previous 12 months and, if so, what types of finance they had sought.

### 4.1 Types of finance being sought by social enterprise

Half the social enterprises surveyed were found to be seeking some external finance in the form of grants ore repayable finance. The focus of this paper is on repayable debt finance which was sought by 14.8% of social enterprises, relating mainly to loans (9.8%) and overdrafts (6.2%). Unsurprisingly, social enterprises exhibit a high proportion seeking grant finance (43.1%) during the previous 12 months, far higher than was typically found in the UK SME population during a similar period (3.9% for all SMEs in the SBS 2012). Demand for equity finance is in line with national SME trends, which typically see less than 2% of all SMEs seeking this type of finance annually (North et al., 2013).

[1] The SBS 2012 found only 0.3% of all UK SMEs sought informal family finance and 3.4% undertook refinancing.

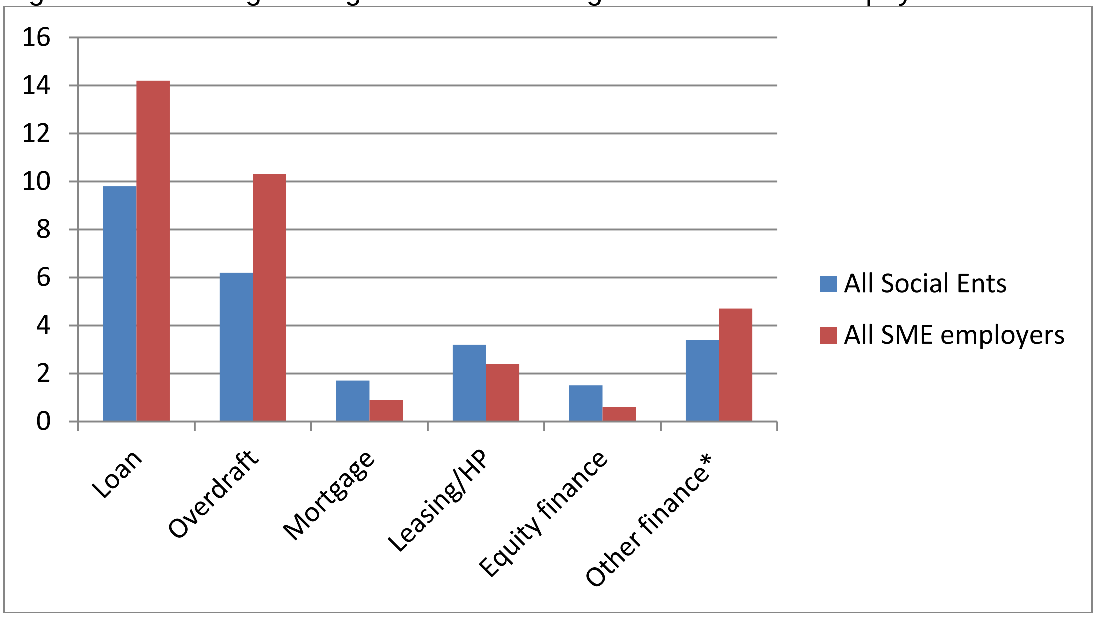
**Table 1: Types of finance sought**

| | | % of all SEs | All SMEs** |
|---|---|---|---|
| Grant finance | 378 | 43.1 | 2.1 |
| Loan | 86 | 9.8 | 14.2 |
| Overdraft | 54 | 6.2 | 10.3 |
| Leasing/HP | 28 | 3.2 | 2.4 |
| Mortgage | 15 | 1.7 | 0.9 |
| Equity finance | 13 | 1.5 | 0.6 |
| Other finance* | 30 | 3.4 | 4.7 |
| | | | |
| All Debt finance | 130 | 14.8 | |

Note: * Includes 12 cases of government support such as employment and training subsidies **(BIS 2013). Note we only selected the 130 cases seeking debt finance, whilst almost half of surveyed SEs (47.6%) sought finance in the period, the vast majority seeking grants, as detailed above.

Seven out of eight (86.8%; 59/68) of those debt finance seekers looking for development finance were also seeking grant finance. For our analysis we will be focusing on the repayable finance, and the figure below shows the balance of different types of repayable finance for social enterprises, in comparison with conventional enterprises

Figure 1: Percentage of organisations seeking different forms of repayable finance




Source: SEUK data on social enterprise and BIS (2013) data on SMEs

Banks remain the main source of finance, with 64% of respondents having this as their main source. One in five of those looking for debt finance were found to be approaching social investors.

**Table 2: Main source of debt finance**

| | % of each category that are seeking | Number of Seekers | % All SEs |
|---|---|---|---|
| Bank | 63.8 | 83 | 9.5 |
| All Social Funders (SB, SI, CDFI) | 24.6 | 32 | 3.6 |
| Other (not social investors) | 34.6 | 45 | 5.1 |

Note: Seven out of eight (87.7%) debt finance seekers sought more than one type of finance. Data presented represents where it was the main source in a funding round (n=130 debt finance seekers). 'Other' comprises building societies, credit unions, government/local authority loans, peer to peer lenders and informal friends and family lenders.

Overall the level of debt finance sought during the 12 months prior to they survey in 2012 ranges from £500 to £30m, with a mean of £1.04m and a median of £85,000. The differential between the mean and median demonstrates how the extent to which the data is skewed by exceptionally high levels of debt financing required by the larger social enterprise surveyed. A comparison with the SBS 2012 demonstrates this significant difference in the size of social enterprise and their scale of demand for debt finance with the UK SMEs seeking on average £171,000 in a similar period and four out of five seeking less than £100,000. Avoiding very large outliers of social enterprises, we would suggest taking the median figure, or the overall trimmed mean (excluding the outlying 5% largest and smallest loans). This average trimmed mean was found to be £380,643. This is still much larger than the SME mean even though the social enterprises that would be larger than the SME definitional boundaries (250 employees) would have been excluded in the trimmed mean.

**Table 3: Amount of debt finance sought by size of social enterprise**

| | N= | Min (£) | Max (£) | Med (£) | Mean (£) | Trimmed mean |
|---|---|---|---|---|---|---|
| <£100k | 30 | 500 | 750,000 | 50,000 | 126,543 | £100,733 |
| £100k to £1m | 47 | 2,750 | 13,000,000 | 70,000 | 720,803 | £330,148 |
| £1m+ | 30 | 30,000 | 30,000,000 | 300,000 | 2,570,666 | £1,465,000 |
| All debt seekers | 107 | 500 | 30,000,000 | 85,000 | 1,048,122 | £380,643 |

Note: Trimmed mean excludes outlying highest and lowest 5% of responses

The size of 'average size of lending' differs according to the type of the provider. There are some large outliers, so a trimmed mean, excluding the 5% largest and smallest debt finance shows that social investors are being approached for loans that are slightly smaller than banks.

**Table 4: Amount of debt finance sought from different providers of debt finance**

| | N= | Min (£) | Max (£) | Median (£) | Mean (£) | Trimmed mean |
|---|---|---|---|---|---|---|
| Bank | 74* | 2,000 | 30,000,000 | 80,000 | 1,352,064 | 505,164 |
| All Social investors | 29** | 15,000 | 7,000,000 | 250,000 | 705,414 | 437,174 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Other (not social investors) | 38*** | 6,000 | 5,500,000 | 100,000 | 620,547 | 386,140 |
| All debt seekers | 107 | 500 | 30,000,000 | 85,000 | 1,048,122 | £380,643 |

Note: Includes examples of multiple finance seeking from different sources; Trimmed mean excludes outlying highest and lowest 5% of responses *9 missing cases; **3 missing cases; ***7 missing cases

The survey shows a predominance of unsecured lending by those seeking finance, with 58.8% seeking debt finance without collateral in the form of business or personal assets. Just under half of those seeking finance from banks are reporting that they have unsecured lending, while this rise to 61% having unsecured funding from social investors. This is in sharp contrast to reported reliance on secured lending by social investment financial intermediaries reported elsewhere (GHK, 2013).

**Table 5: Use of assets as security for lending when applying to different sources**

| | N= | Secured on business assets | Secured on personal assets | Unsecured |
|---|---|---|---|---|
| Bank | 48 | 45.9 | 6 | 48.1 |
| All Social Funders (SB, SI, CDFI) | 28 | 35.7 | 3.6 | 60.7 |
| Other (not social investors) | 32 | 25 | 3.1 | 71.9 |
| All debt seekers | 77 | 37.6 | 3.6 | 58.8 |

Note: Data based on loan applications, with multiple responses

## 4.2 Segmenting the demand: the types of seekers of repayable finance

Further analysis is focused on the types of seekers of debt finance (excluding grants, equity and other). Demand for debt finance is significantly (<.001 level) greater amongst the largest social enterprises with annual income of over £1m (28.1%), with least demand exhibited amongst the smallest social enterprises with less than £100,000 annual income (9.8%). This significant trend is in line with national studies such as SBS 2012 and Cowling et al.'s (2012) findings from the UK SME Finance Monitor.

**Table 6: Sales turnover size for debt finance seekers**

| | % of seekers in each category | Number of Seekers | % All SEs |
|---|---|---|---|
| <£100k | 9.8*** | 31 | 3.5 |
| £100k to £1m | 15.9 | 52 | 5.9 |
| £1m+ | 28.1*** | 38 | 4.3 |

As would be expected, there is a greater likelihood of seeking debt finance from those expecting growth, although there is still 11% of those decreasing seeking finance, suggesting that they are looking for ways to grow out of trouble, or are taking on debt to survive. Although less significant, the higher proportion of growth oriented social enterprises seeking finance (16.4%) corresponds with findings for UK SMEs in the SBS 2010 and 2007 (RT&P, 2010) and also the SBS 2012.

**Table 7: Sales growth prediction for next 2-3 years for debt finance seekers**

| | % of seekers in each category | Number of Seekers | % All SEs |
|---|---|---|---|
| Increase | 16.4 | 90 | 10.3 |
| Same | 13.3 | 28 | 3.2 |
| Decrease | 11.4 | 9 | 1 |

There is a significantly (<.01 level) high proportion of social enterprises aged between 6-10 years seeking debt finance. This is in contrast to SMEs in general which exhibit a significant increase in demand by younger UK SMEs trading less than five years (BIS 2013).

**Table 8: Age of debt finance seeking social enterprises**

| | % of seekers in each category | Number of Seekers | % All SEs |
|---|---|---|---|
| | | N=130 | N=878 |
| Up to 2 years | 14 | 27 | 3.1 |
| 3-5 years | 12.5 | 17 | 1.9 |
| 6-10 years | 22.3** | 40 | 4.6 |
| 11-20 years | 15.9 | 25 | 2.8 |
| 21+ years | 10.1 | 21 | 2.4 |
| All | 14.8 | 130 | 14.8 |

For all SEs (n=878) growth aim is significantly at >.05 level associated with younger SEs, with a decline in growth aim in each ascending age category, from 85% seeking future sales growth trading under 2 years to 48% of those trading more than 20 years. The 6-10 year category (55% seeking future growth) is therefore less likely to be growth oriented than the younger age categories. Therefore the high proportion of debt finance sought by those trading 6-10 years relates to this group being more suited and able to seek debt finance rather than having a growth aim (62.5% of the SE aged 6-10 years and seeking debt finance had a growth aim compared to 72.2% having a growth aim in all other age categories).

Although not significant findings, it is evident that Companies Limited by Guarantee (CLG) (16.9%) and Community Investment Companies (CICs) (15.4%) exhibit above average proportions of social enterprises seeking debt finance in the previous 12 months. It is also evident that social enterprises whose main trade is with the public sector have a higher proportion seeking debt finance (19.7%), followed by those mainly trading with the private sector (15.5%).

**Table 9: Main source of income for debt finance seekers**

| | % of seekers in each category | Number of Seekers | % All SEs |
|---|---|---|---|
| Public sector | 19.7 | 39 | 4.4 |
| Private sector | 15.5 | 18 | 2.1 |
| Third sector | 11.8 | 10 | 1.1 |
| General Public | 11.8 | 33 | 3.8 |

A closer examination by sector activities demonstrates that social services and childcare (22.9%), culture and leisure (22%) and employment and training (21%) are all significantly (<.05 level) more likely to seek debt finance that their other social enterprise counterparts in the other sectors categorised. However, it should be noted that most social enterprises delivered services across a number of sectors.

**Table 10: Main sector of social enterprises seeking debt finance**

| | % of seekers in each category | Number of Seekers | % All SEs |
|---|---|---|---|
| Housing | 17.0 | 19 | 2.2 |
| Workspace | 14.9 | 11 | 1.3 |
| Business support | 12.5 | 18 | 2.1 |
| Culture & leisure | 22* | 22 | 2.5 |
| Healthcare | 21.4 | 15 | 1.7 |
| Employment & training | 21* | 25 | 2.8 |
| Education | 17.4 | 25 | 2.8 |
| Financial services | 9.9 | 8 | 0.9 |
| Creative industries | 22.4 | 13 | 1.5 |
| Environmental services | 14.7 | 10 | 1.1 |
| Retail, hospitality, transport | 19.0 | 28 | 3.2 |
| Social services & childcare | 22.9* | 25 | 2.8 |
| Other services | 13.8 | 13 | 1.5 |

## 4.3 Success rates in seeking debt finance

This section focuses on the success rates of those 130 social enterprises that had sought formal external debt finance during the past year. Surveyed social enterprises were asked whether they had received the funding that they had sought during the 12 months prior to the survey and, if so, whether this was all or some, or if not, why this was the case. As is typical with SME finance in general, the majority of those seeking external debt finance were able to obtain at least some of the finance that they required, with more than two thirds (69.2%) receiving at least some debt finance and 63.1% receiving all of the debt finance that they required. Recent UK Small Business Survey 2012 (BIS, 2013[2]) findings indicate that around half of all UK SMEs (50.9%, including self employed) experienced some problems in obtaining external finance in the previous 12 months, with nearly three fifths (58.5%) obtaining all of their required finance, a further 3.5% receiving at least some and 38% not receiving any. In this context the social enterprises surveyed appear to be more successful. Reasons behind this are not clear but could be attributed to higher quality propositions, the role of the social investment finance intermediaries, or more marginal applications being deterred.

**Table 11: Success rates in obtaining debt finance in the previous year**

| | No | % Seekers (n=130) | % of All SMEs |
|---|---|---|---|
| Received all funding | 82 | 63.1 | 58.5 |
| Received some funding | 8 | 6.1 | |
| Received no funding | 31 | 23.8 | |
| Pending decision/unclear yet | 9 | 6.9 | |

Success rates in obtaining debt finance were significantly higher for leasing and hire purchase finance for vehicles and equipment, with almost nine out of ten (89.3%, significant at <.01 level) seeking this type of finance obtaining all of the finance required. Four out of five applicants (significant at <.05 level) seeking mortgage finance, mainly for building purchase or development, were successful in gaining all of the finance required.

Applications for overdraft finance were slightly more successful than those for loans, with around two thirds obtaining all of the overdraft (66.7%) and loan (65.1%) finance required, but with a higher proportion of those seeking overdraft finance receiving at least some (75.9%, significant at <.05 level) when compared with loan applications (69.8%). Analysis of the 23.8% who were unsuccessful in obtaining finance shows that just under half of them were able to source some or all of the finance from a secondary source. In all cases this secondary source was in the form of grants, although the amount received is not known.

**Table 12: Secondary sources by those not obtaining debt finance**

| | No | % Seekers (n=130 |
|---|---|---|
| Received no funding | 17 | 13.1 |
| Received some from secondary source | 7 | 5.4 |
| Received all from second source | 7 | 5.4 |
| Received no finance from formal debt finance source | 31 | 23.8 |

[2] BIS (2013) Report only contains data fro SME employers, but the survey also includes self employed.

When examining the success rates for secured and unsecured loans, there appears to be little difference, with 75.9% of those with security and 73.3% of those without security receiving all or some of what they requested.

**Table 13: Secured lending for loan applications in the previous year**

| | Number of debt Seekers | Received all | Received all or some | Received none |
|---|---|---|---|---|
| Secured lending for Loans | N=77 | N=52 | N=56 | N=21 |
| Secured on business assets | 29 | 69.0 | 75.9 | 24.1 |
| Secured on personal assets | 3 | 33.3 | 33.3 | 66.7 |
| Unsecured | 45 | 68.9 | 73.3 | 26.7 |

Note: n=77 cases where secured lending for debt finance is known

Those social enterprises with a lower proportion of trading income and a greater proportion of grants and donations were found to be more successful in receiving all or some of their finance, with only 16.7% receiving no funding and almost three quarters (72.2%) receiving all of the funding that they required. The middle group with between 51-75% trading income appear least successful with only half receiving all of the funding that they required and one third receiving none of the debt finance they sought at all.

**Table 14: Social enterprise proportion of trading income by success rate**

| | All | At least Some | None | Seekers |
|---|---|---|---|---|
| **% Trading Income** | Row % | Row % | Row % | N= |
| 26-50 | 72.2 | 72.2 | 16.7 | 18 |
| 51-75 | 50 | 61.1 | 33.3 | 18 |
| 76-100 | 63.8 | 70.2 | 23.4 | 94 |

Note: Row % do not always add up to 100% because of pending/unknown decisions

Larger social enterprises, with annual income of over £1m, were significantly more likely (at <.05 level) to receive at least some of the finance required (84.2%). Indeed, only three in five (61.3%) applicants in smaller firms with under £100,000 annual income received all of the funding tat they required compared with more than four out of five (81.6%) of those with annual income of over £1m.

**Table 15: Success rates according to sales turnover size**

| | Received All | All or Some | None | Seekers |
|---|---|---|---|---|
| <£100k | 61.3 | 67.7 | 29 | 31 |
| £100k to £1m | 61.5 | 69.2 | 23.1 | 52 |
| £1m+ | 81.6 | 84.2* | 18.4 | 38 |

Debt finance seekers in the £1m annual income category were more likely to be trading with the public sector than their smaller counterparts (71.1% compared with 61.4%). Larger social enterprises are also, significantly (>.01) less likely to be trading with the private sector (42.1%

compared to 68.7% for smaller enterprises), with SEs (>.05 level) (39.5% to 59%), with the general public (63.2% to 67.5%) and with the third sector (50% to 63.9%).

In terms of their principal activity £m+ organisations were significantly more likely to be leisure trusts (>.01) (15.8% compared with 1.2%) and public sector spin outs (>.01) (7.9% to 0%), but less likely to be social firms (>.05) (5.3% to 22.9%). They were also less likely to be co-ops (7.9% to 20.5%) and development trusts (13.2% to 18.1%), but more likely to be housing associations (13.2% to 3.6%) and charities (39.5% to 27.7%).

Whilst enterprise age was not a significant factor in success rates, it is evident that the older established enterprises, trading more than six years, with longer financial track records were more successful in receiving either all or at least some of their required debt finance. It is notable that those enterprises trading between 3-5 years were least successful in obtaining finance, with more than one third of these debt finance seekers (35.3%) receiving no formal debt finance.

**Table 16: Success according to age of enterprise**

| | Received All | All or Some | None | Seekers |
|---|---|---|---|---|
| | Row % | Row % | Row % | N= |
| Up to 2 years | 55.6 | 66.7 | 25.9 | 27 |
| 3-5 years | 52.9 | 58.8 | 35.3 | 17 |
| 6-10 years | 67.5 | 70 | 22.5 | 40 |
| 11-20 years | 64 | 68 | 24 | 25 |
| 21+ years | 71.4 | 81 | 14.3 | 21 |
| Total | 63.1 | 69.2 | 23.8 | 130 |

Although not statistically significant, it is evident that a higher proportion of businesses trading mainly with the public sector were able to receive all (74.4%) or at least some (79.5%) of their required formal debt finance. This may be indicating that public sector clients are perceived by debt financers as more reliable sources of income (despite recent public sector cutbacks) or those with weaker business cases are more likely to be dissuaded in applying in the first place.

**Table 17: Success according to main source of income**

| | Received All | All or Some | None | Seekers |
|---|---|---|---|---|
| Public sector | 74.4 | 79.5 | 20.5 | 39 |
| Private sector | 50 | 55.6 | 22.2 | 18 |
| Third sector | 60 | 60 | 40 | 10 |
| General Public | 60.6 | 69.7 | 18.2 | 33 |

When examining specific sectors, the only sector exhibiting a slightly significant trend is the lower proportion of enterprises in employment and training receiving at least some finance

(56%; significant at <.1 level). The creative enterprise sector also exhibited proportionally lower success rates.

**Table 18: Success according to sector**

| | Received All | All or Some | None | Seekers |
|---|---|---|---|---|
| Housing | 63.2 | 63.2 | 15.8 | 19 |
| Workspace | 63.6 | 63.6 | 18.2 | 11 |
| Business support | 55.6 | 61.1 | 27.8 | 18 |
| Culture & leisure | 72.7 | 72.7 | 13.6 | 22 |
| Healthcare | 73.3 | 86.7 | 20 | 15 |
| Employment & training | 52 | 56 | 36 | 25 |
| Education | 60 | 68 | 32 | 25 |
| Financial services | 50 | 62.5 | 25 | 8 |
| Creative industries | 46.2 | 53.8 | 23.1 | 13 |
| Environmental services | 90 | 100* | 0 | 10 |
| Retail, hospitality, transport | 60.7 | 67.9 | 21.4 | 28 |
| Social services & childcare | 72 | 72 | 24 | 25 |
| Other services | 92.3* | 92.3* | 7.7 | 13 |

For those expecting to grow, 71.1% were receiving all or some of what they sought. For those looking to remain the same size there was a slight reduction in success with 64.3% receiving all or some of what was requested. There are nine cases of SEs that expected to decrease in size but still sought funding. Of these enterprises, eight were successful in receiving all finance.

**Table 19: Success according to sales growth prediction for next 2-3 years**

| | Received All | All or Some | None | Number of Seekers |
|---|---|---|---|---|
| Increase | 65.6 | 71.1 | 23.3 | 90 |
| Same | 53.6 | 64.3 | 28.6 | 28 |
| Decrease | 77.8 | 77.8 | 11.1 | 9 |

Examining the type of lender, whilst there are no statistically significant results, it is evident that social enterprises were more likely to obtain all of the funding that they required from a social lender (75%), or source other than mainstream banks (65.1%). However, the highest proportion of social enterprises failing to obtain any finance was exhibited by social lenders (25%).

**Table 20: Success rates from different providers of finance**

| | Received All | All or Some | None | Seekers |
|---|---|---|---|---|
| All Social Funders (SB, SI, CDFI) | 75 | 75 | 25 | 32 |
| Bank | 65.1 | 73.5 | 17 | 83 |
| Other (no social funders) | 73.3 | 77.8 | 22.2 | 45 |

The 31 social enterprises that failed to obtain any of the debt finance that they applied for were asked why this had happened. In the majority of cases the applicant social enterprise was rejected because the application was unsuitable, either due to lack of collateral or trading record (17 cases). Eight applicants rejected the terms and conditions offered (six in relation to loans), and six were not offered an appropriate explanation.

### 4.4 Discouraged borrowers

One in five social enterprises (21%) had not sought external debt finance during the previous 12 months, but indicated that they may have sought finance if circumstances had been different. This is considerably higher than the 11.7% of UK SMEs indicating latent demand for external finance during the previous 12 months in the SBS 2012 (BIS, 2013) and evidence of Fraser's (2009) 'discouraged borrowers'. Discouraged borrowers were significantly more likely (<.01 level) to be smaller social enterprises with less than £100,000 annual income, and also more likely to be younger enterprises trading for five years or less (11.2%) and Community Interest Companies (12.8%).

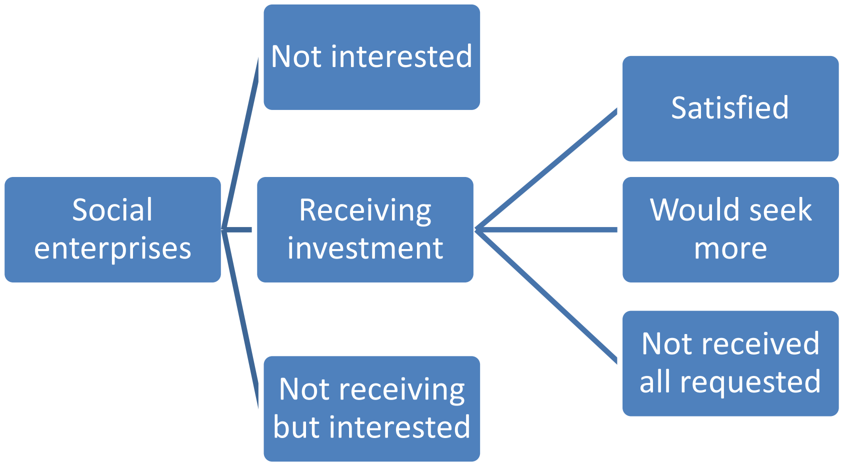
However, these organisations may not have viable business propositions that are needed to pay back loans. The survey found that 8.8% of social enterprises were being deterred from seeking finance due to a combination of perceived high costs of interest and fees, stringent requirements for collateral and trading record, lack of previous success and lack of belief or knowledge that appropriate finance currently exists. In further detail: 2.8% stated that the cost of finance was too high; 2.5% did not know where to find appropriate finance; 1.4% lacked confidence to apply; 1.3% did not believe that they have sufficient security; 1.5% expecting rejection; 0.8% stated that there was no suitable form of finance available; 0.8% felt that it would take too much time to find a suitable source of finance; 0.5% indicated potential 'cultural' barriers for social enterprises to borrow from mainstream lenders; and 0.3% were put off by previous application rejections.

## 5. Discussion

This study has examined the types of finance and shows the importance of bank finance as well as the provision of specific social investment finance. 15% of the social enterprises were seeking some form of repayable finance, with two thirds of those approaching commercial banks. While a large proportion of the finance was secured against assets (42% of the cases), the majority of organisations borrowing finance were using unsecured lending. Social investment is found to play a small but important role with 3.6% of social enterprises using these sources. These are more likely to be larger organisations with those with a turn over of over £1m being almost three times more likely to seek repayable finance. As expected, those predicting growth are more likely to seek finance but 11% of social enterprise with decreasing income also sought repayable finance. In terms of age, those in the five to ten year age group were more likely to seek finance. This differs from other SMEs where there is greater likelihood of seeking finance in the first five years (BIS, 2013). It is also interesting to note that those with the public sector as their main income are more likely to seek finance, suggesting there is growth in these sectors. However, this correlation may be explained by the larger organisations being more likely to win public sector contracts.

This data allows a segmentation model to be developed related to the use of finance by social enterprises. The figure below shows the three core segments of the social enterprise sector.

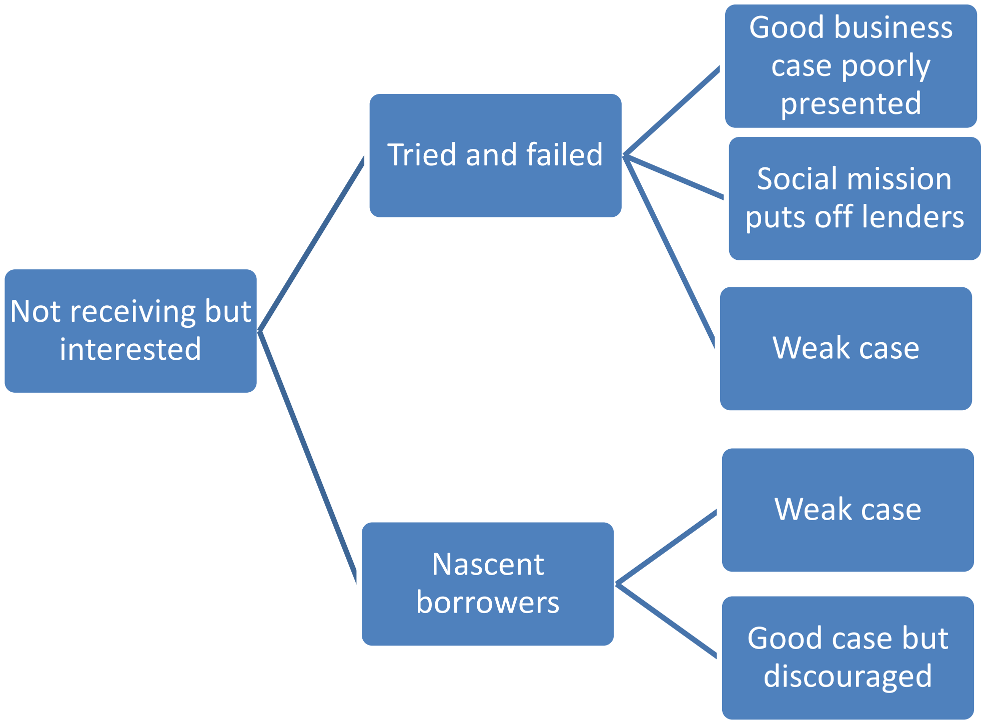
Figure 2: Segmentation model for social enterprises seeking finance




Analysis of the data shows that the largest segment is those that are not interested, making up 65% of the sample. These may be organisations that are not looking to grow, do not have an income generation business model that allows them to have a surplus for paying off loans, or are able to identify other non loan forms of finance such as grants. The second segment relates to those receiving investment and can be subdivided into those who have received what they requested (10% of the sample), but within this category there are those that would seek more. There are also a small number who did not receive all that they requested (just less than 1%).

The final segment covers those not receiving any finance but are interested, which makes up one in four of the social enterprise sample. It is this final segment that covers the social enterprises, not currently satisfied with the provision of finance and so may be the focus of attention for social investors. We will therefore look at these in more detail.

Figure 3: Segmentation model for social enterprises seeking but not receiving repayable finance




Firstly there are the 3.5% of social enterprises (24% of those seeking) that have tried but failed to get repayable finance from banks, social investors and other sources. This may be due to the poor presentation of their proposition (lack of investor readiness) or a supply side issue in terms of lenders being concerned about their form of ownership and assets. Further analysis of this data explored the relationship of secured lending to rejection. This showed that an insignificant different with 27% of unsecured applications being rejected compared to 24% of secured loans being rejected.  It may also be the case that rejection is due to the organisation having a poor business proposition, in which case they should not be applying for repayable finance in the first place and be advised to seek other ways of meeting their social purpose.  These organisations may also be a focus for business support to build their capacity to develop a sustainable business. A comparison to SME borrowing shows that social enterprises have lower rejection rates than SMEs as whole, with 32% of them not receiving any finance.

Of particular interest to the social investment sector are the 21% of organisations that we can call nascent borrowers as they report that they would consider borrowing if circumstances were different. These can be subdivided into those with a weak business case who should be dissuaded from seeking repayable finance (or supported in building more sustainable business propositions), and those with a good case but are discouraged borrowers. Further research is needed to understand the needs of this particular segment of potential demand.

## 6. Conclusion

This research shows that there is interest in repayable finance amongst a proportion of the third sector. It has focussed on those organisations that define themselves as social enterprises and meet key criteria related to trading income and social aims. In looking at these organisations acting as hybrids with both social missions and commercial objectives, this paper shows how a sizable minority are seeking loan finance, although slightly lower than the rate for small businesses as a whole. The paper shows the particularly important role of banks in providing both secured and unsecured debt finance.

The success rate in receiving all or some of the debt finance requested was very similar between these sources. Just under half of applicants (48%) to banks were for unsecured lending, compared to 61% of applicants to social investors being for unsecured lending. There was no difference between the success rate for secured and unsecured lending applicants. The success rates for social enterprises appear to be higher than the success rates reported by SMEs. This may be due to the quality of the applications and the extent to which organisations with weaker business cases are not making applications.

This research raises particular questions for the social investment community. There are two real challenges for social investment: identifying the funding gaps and not simply taking business from commercial banks. There is still a lack of understanding of the relationship between lending from banks and lending from social investors. There is evidence of social investment leveraging in other finance as well as examples where social enterprises are offered loans from banks and prefer to borrow from social investors. There is also a lack of understanding of the extent to which social investors will invest in businesses considered risky by banks. Investing in risk requires social investors to accept that a sizable proportion of investees may not repay and may have to close. When there is public accountability (such as in Government supported funds, or even with Big Society Capital) coping with such ‘failures’ is a challenge. Will investors be criticised for investing in organisations that close? There is evidence that social investors are more likely to offer unsecured debt, with 61% of social enterprises borrowing from social investors not using security, compared to 48% of social enterprises borrowing from banks.

Taking business from commercial banks (which already dwarf current levels of social investment), might help organisations to reduce finance costs and demonstrate the long term potential of the social investment sector, but in the short term displacing bank finance is not a way to maximise the social impact of social investment funds. There is still a degree of unmet demand for loan finance amongst social enterprises but it cannot be assumed that loan finance can replace other forms of support for the large proportion of charities and social enterprises who cannot, or do not want to borrow. This paper therefore adds to the growing understanding of the current financial needs of the social enterprise sector. The research also shows the large gaps in our understanding about the demand for social investment. As much of the rest of the world looks to the UK experience of social investment, there is a need to show how the demand for social investment is based on clear evidence.

## Appendix: Binary logit regression model

**Model 1: Social enterprise likelihood of seeking debt finance in the previous 12 months (n=878)**

**Variables in the Equation**

| | | B | S.E. | Wald | df | Sig. | Exp(B) |
|---|---|---|---|---|---|---|---|
| Step 1[a] | Age_mid (6-10 yrs) | .631 | .232 | 7.383 | 1 | **.007** | 1.879 |
| | T_public trade | .213 | .256 | .691 | 1 | .406 | 1.238 |
| | T_TS/SE | .498 | .316 | 2.477 | 1 | .115 | 1.645 |
| | Sales_low <100k | -.583 | .256 | 5.169 | 1 | **.023** | .558 |
| | Sales_upper 1m+ | .785 | .261 | 9.088 | 1 | **.003** | 2.193 |
| | Grow future aim | .461 | .248 | 3.444 | 1 | .063 | 1.585 |
| | Decline | -.492 | .448 | 1.204 | 1 | .273 | .611 |
| | Q3A CLG | .250 | .225 | 1.238 | 1 | .266 | 1.284 |
| | Q3D CIC | .207 | .292 | .501 | 1 | .479 | 1.230 |
| | Q7F_cultleisure | .478 | .301 | 2.530 | 1 | .112 | 1.613 |
| | Q7H_emptrain | .271 | .285 | .905 | 1 | .341 | 1.311 |
| | Social_child | .629 | .284 | 4.902 | 1 | **.027** | 1.875 |
| | Retail_hostran | .602 | .269 | 5.002 | 1 | **.025** | 1.826 |
| | Q7K_creative | .461 | .379 | 1.475 | 1 | .224 | 1.586 |
| | Constant | -2.733 | .318 | 74.023 | 1 | .000 | .065 |

a. Variable(s) entered on step 1: Age_mid, T_public, T_TSSE, Sales_low, Sales_upper, Grow, Decline, Q3A, Q3D, Q7F_cultleisure, Q7H_emptrain, Social_child, Retail_hostran, Q7K_creative.

**Model Summary**

| Step | -2 Log likelihood | Cox & Snell R Square | Nagelkerke R Square |
|---|---|---|---|
| 1 | 615.109[a] | .071 | .122 |

a. Estimation terminated at iteration number 5 because parameter estimates changed by less than .001.

The above findings which are extremely robust (R sq .122), indicate that the following business characteristics were all significantly (<.05 level) more likely to be associated with social enterprise debt finance seekers during the previous 12 months: most significantly the largest SEs with annual income of £1m or more (<.01 level), SEs aged between 6-10 years (<.01 level), with the social services and childcare and retail, hospitality and transport sectors all significant (<.05 level). Future growth aim was fairly significant (at <.1 level), whilst the smallest social enterprises with annual income of under £100k were significantly (<.05 level) less likely to seek finance.

**Model 2: Where at least some debt finance received by SE seekers in the last 12 months (n=130)**

**Variables in the Equation**

| | | B | S.E. | Wald | df | Sig. | Exp(B) |
|---|---|---|---|---|---|---|---|
| Step 1[a] | Age_mid | -.040 | .490 | .007 | 1 | .935 | .961 |
| | T_public | 1.066 | .594 | 3.221 | 1 | .073 | 2.904 |
| | T_TSSE | -.025 | .633 | .002 | 1 | .968 | .975 |
| | Sales_low | -.242 | .598 | .164 | 1 | .685 | .785 |
| | Sales_upper | .794 | .610 | 1.694 | 1 | .193 | 2.211 |
| | Grow | .009 | .551 | .000 | 1 | .988 | 1.009 |
| | Decline | 1.382 | 1.330 | 1.081 | 1 | .299 | 3.983 |
| | Q3A | -.940 | .584 | 2.587 | 1 | .108 | .391 |
| | Q3D | -.457 | .668 | .467 | 1 | .494 | .633 |
| | Q7F_cultleisure | .471 | .645 | .534 | 1 | .465 | 1.602 |
| | Q7H_emptrain | -1.484 | .611 | 5.903 | 1 | .015 | .227 |
| | Social_child | -.070 | .587 | .014 | 1 | .905 | .932 |
| | Retail_hostran | .844 | .626 | 1.818 | 1 | .178 | 2.326 |
| | Q7K_creative | -.398 | .741 | .288 | 1 | .591 | .672 |
| | Constant | 1.342 | .761 | 3.111 | 1 | .078 | 3.825 |

a. Variable(s) entered on step 1: Age_mid, T_public, T_TSSE, Sales_low, Sales_upper, Grow, Decline, Q3A, Q3D, Q7F_cultleisure, Q7H_emptrain, Social_child, Retail_hostran, Q7K_creative.

**Model Summary**

| Step | -2 Log likelihood | Cox & Snell R Square | Nagelkerke R Square |
|---|---|---|---|
| 1 | 123.745[a] | .124 | .181 |

a. Estimation terminated at iteration number 5 because parameter estimates changed by less than .001.

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## About the Centre

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## Social Enterprise

What role can social enterprise play within the third sector? This work stream cuts across all other research programmes, aiming to identify the particular characteristics and contribution of social enterprise. Our research includes theoretical and policy analysis which problematises the concept of social enterprise, examining the extent to which it can be identified as a distinct sub-sector. Quantitative analysis will map and measure the social enterprise sub-sector, and our qualitative case studies will contain a distinct sub-sample of social enterprises.

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