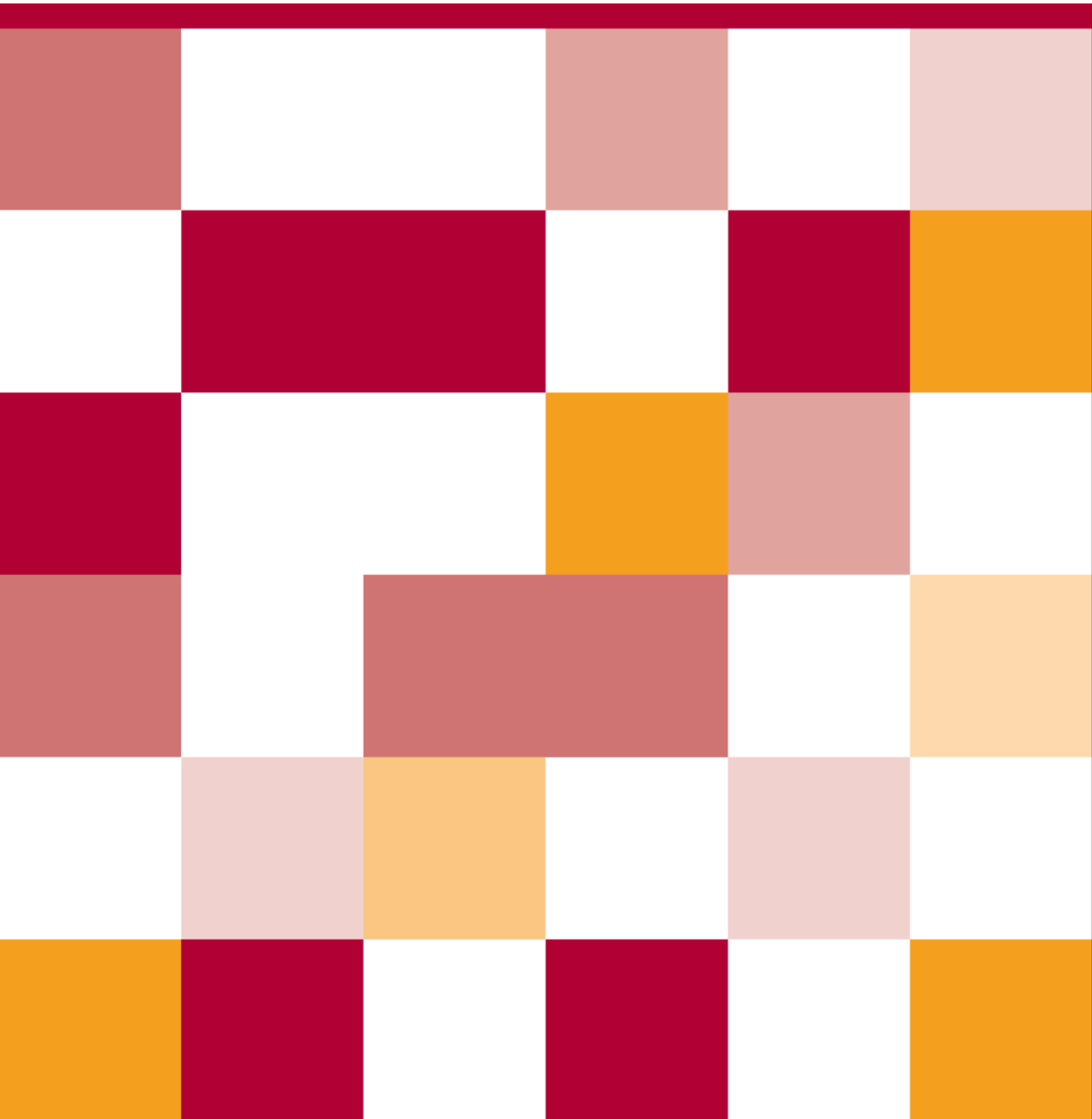




# Risk Capital Investment Fund for Social Enterprise Government Response

July 2008



# Executive Summary

## Introduction

1. In the Social Enterprise Action Plan published in November 2006, the Office of the Third Sector committed itself to working with the finance and social enterprise sectors to develop a scheme to improve the ability of social enterprises to access the finance they need when seeking to expand their businesses.
2. A consultation on a Risk Capital Fund for Social Enterprises was launched on the 10th August 2007 and closed on 2nd November 2007. The diverse range of views has been valuable in refining the proposals for a Risk Capital Fund for Social Enterprise.
3. The decision to proceed with launching the Risk Capital Fund(s) for Social Enterprise was announced by Ministers on the 27th February 2008. The evidence provided to support this decision is summarised over the following pages.

## Who responded?

4. There were 29 responses to the consultation from a diverse range of respondents, including advisors to social enterprises, fund managers, investors in social enterprises, representative bodies for social enterprises, Regional Development Agencies and social enterprises themselves.

## The equity gap

5. The vast majority of the arguments and evidence provided by the experience of those working in the market, support the Government's belief that social enterprises face a similar equity gap to mainstream small and medium sized enterprises (SMEs).
6. The Government agrees that there are also particular issues that can make it even more difficult for social enterprises to access equity finance, and that the equity gap for social enterprises may have an even lower threshold than for mainstream SMEs.
7. The Government agrees with respondents that investors encounter similar supply side constraints to those they face when investing in mainstream SMEs, but acknowledges that these constraints may impact disproportionately upon social enterprises. Furthermore, even when investors are able to overcome these supply side constraints, they may be faced by social enterprise specific

constraints, and a perceived lack of quality investment opportunities. This inhibits flow of investment capital into the sector.

#### **Pari Passu Fund(s)**

8. The Government welcomes the view of the majority of respondents that the proposed *Pari Passu* model offers a workable capital flow model. There is some evidence that informal investors and professional venture capitalists were willing to provide risk capital to social enterprises, and potential investors in the Fund(s) are willing to invest on commercial terms.
9. The Government believes it is possible to attract investment into social enterprises on these terms and that this is worth testing. The Fund(s) will combine public and independent money for onward investment into social enterprises, with the Government's capital to be invested on a side-by-side basis with independent investors.
10. The Government wants to test different ways of structuring investment and believes that this approach offers the greatest potential to demonstrate the viability of investments in social enterprise, the greatest potential for replication in the market and so the greatest potential for increasing investment in social enterprises.

#### **Fund's Objectives**

11. The Government welcomes respondents' support that the objectives of the Fund are achievable. The intention is to create a 'pathfinder fund' to address these objectives. Under the proposed structure for the scheme, the Government will invest in social enterprises through the pathfinder fund in partnership with independent investors.
12. The Government recognises, in particular, the challenge in meeting the objective of demonstrating there are a meaningful number of investors interested in making a profit-maximising investment in the area of social enterprise. The purpose behind establishing this pathfinder Fund(s) is for the Government to lead the way by example by using the Fund(s) to encourage potential investors to link up with potential investments and demonstrate that the objectives of the fund are achievable.

#### **Requisite Scale**

13. The Government acknowledges the view of the majority of respondents who favoured a fund size of £10 million. As a result, the Office of the Third Sector will make up to £10million available for investment to help address the equity gap faced by social enterprises.

#### **Legal Structure**

14. The Government supports the view of the majority of respondents who favoured a lifespan of 10 years, but wishes to retain the flexibility to curtail or extend the Fund, if appropriate.
15. The Government agrees with respondents that the limited partnership model is well established but also agrees that alternative legal structures should be considered in the competitive process to appoint a fund manager(s).

#### **Definition of Social Enterprise**

16. The Government acknowledges that the level of demand is uncertain and will be tested through the operation of this fund.
17. The Fund will be aimed exclusively at social enterprises in England. Other parts of the UK have their own approaches to assisting social enterprise access to risk capital.

#### **Performance Targets**

18. The Government believes the success of the Fund(s) in meeting its objectives can be evaluated through the investment activity of what is, by its nature, a demonstration fund. For example, through consideration of how much capital is successfully invested.
19. The Government will also, however, put in place an independent evaluation to report over the lifetime of the fund.

#### **Overhead Costs**

20. The Government accepts the points made in the consultation that the Fund manager's overhead costs should not be met from profits, but that the Government and independent investment partners should share costs, including up front if necessary, before profits are generated.

#### **Remuneration of the Fund Manager**

21. The Government believes that incentives for the fund manager by way of fund management fees should be based on financial performance and other deliverables in line with the objectives of the Fund(s).

#### **Next steps**

22. Capital for Enterprise Limited (CfEL) will be assisting the Office of the Third Sector in selecting a suitable fund manager, or managers, and will manage the ongoing relationship including monitoring and reporting on fund performance.

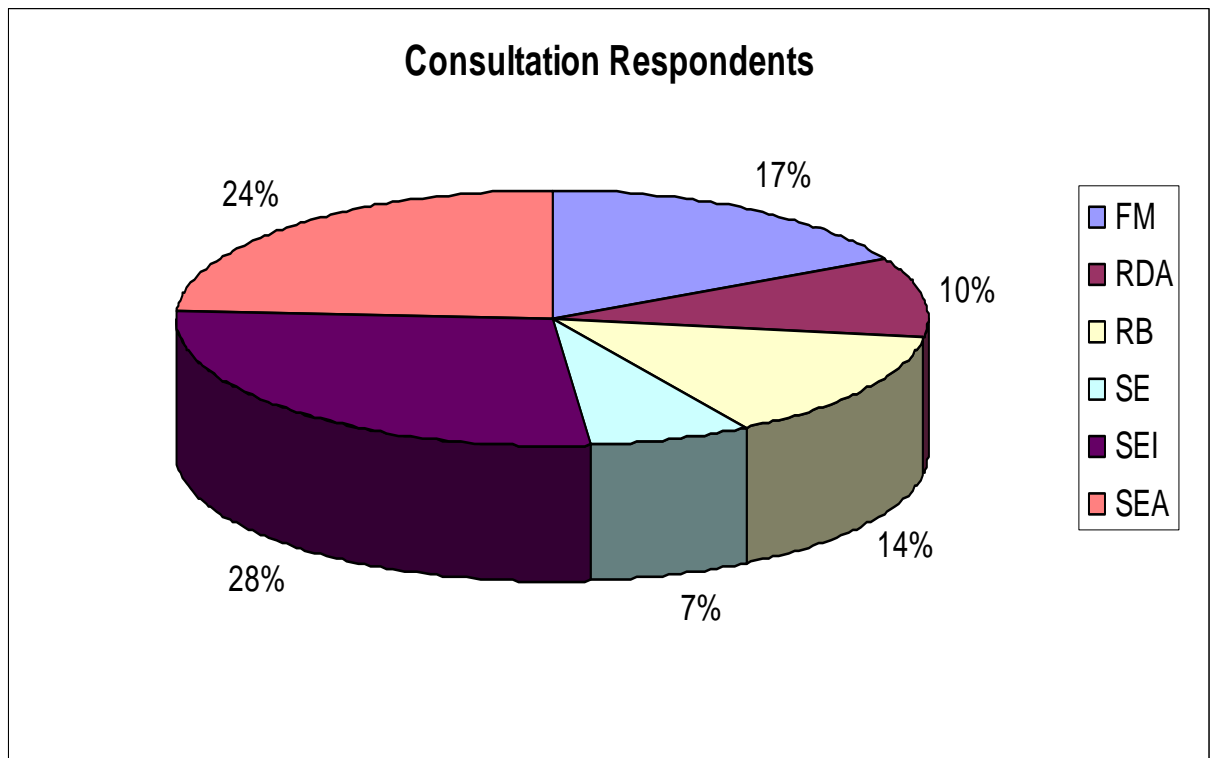
23. Capital for Enterprise Limited (CfEL) was established in April 2008 to manage investment programmes and the Small Firm Loan Guarantee on behalf of the Department for Business, Enterprise and Regulatory Reform.
24. The Government will publish a bidding document over the coming weeks, allowing a period of 12 weeks for potential bidders to respond. We hope to have a shortlist for potential fund managers in the autumn with a fund manager, or manager appointed and in a position to begin the process of making investments around the end of 2008.

## Introduction

25. In the [Social Enterprise Action Plan](#) published in November 2006, the Office of the Third Sector committed itself to working with the finance and social enterprise sectors to develop a scheme to improve the ability of social enterprises to access the finance they need when seeking to expand their businesses.
26. A consultation on a Risk Capital Fund for Social Enterprises was launched on the 10<sup>th</sup> August 2007 and closed on 2<sup>nd</sup> November 2007. This document sets out the Government's response to the consultation.
27. The consultation had two main aims:
  - First, it looked to invite comments on the existence of an equity gap faced by social enterprises, recognising that the main evidence for such a gap is derived from the experiences of mainstream small and medium sized enterprises (SMEs). The consultation looked to the market for further evidence for the case that social enterprises do encounter this equity gap when looking to expand their businesses; and
  - Second, the consultation looked for comments on the proposed structure of the Fund(s) and whether the objectives for the fund are achievable.
28. The responses to the consultation questions are summarised in the body of this Government response. An analysis of the responses and an indication of the decisions made as a result of the consultation are also included, and summarised above.
29. The Office of the Third Sector is grateful to everyone who responded to the consultation and engaged with the consultation process. The diverse range of views has been valuable in refining the proposals for a Risk Capital Fund for Social Enterprise.
30. The decision to proceed with launching the Risk Capital Fund(s) for Social Enterprise was announced by Ministers on the 27th February 2008. The evidence provided to support this decision is summarised over the following pages.

## Who responded?

31. The consultation was open to all, including practitioners and experts in the field of finance and social enterprise. There were 29 responses to the consultation from a diverse range of respondents, listed in Annex A.
32. The chart below categorises the responses by type of organisation. The organisations responding were classified into one of six categories according to their purpose. These categories are:
- i) Advisor to Social Enterprises (SEA)
  - ii) Fund Manager (FM)
  - iii) Investor in Social Enterprises (SEI)
  - iv) Representative Body for Social Enterprises (RB)
  - v) Regional Development Agency (RDA)
  - vi) Social Enterprise (SE)
33. The responses received were as follows:



## Consultation Questions

### *The Equity Gap*

#### Question 1

Do you agree that social enterprises face a similar equity gap as mainstream SMEs, i.e. that they fall into the gap between the finance available from informal investors and the failure of formal venture capital funds to invest into smaller deals?

If you agree, what evidence is there to support your belief?

34. The vast majority of respondents agreed that social enterprises do face a similar equity gap to 'mainstream' small and medium size enterprises (SMEs). These respondents pointed out additional issues that social enterprises are confronted by when addressing the equity gap and these are dealt with in the responses to question 3.
35. A minority of respondents did not agree, or had not seen any evidence, that social enterprises face a similar gap to mainstream SMEs. Instead of investing in their businesses, there was perceived to be a reliance by social enterprises on 'free money' and grants.
36. Some felt that the use of the term equity gap was unhelpful and that 'patient capital' was a more appropriate both as a term and a finance option in a social enterprise context.
37. Respondents employed a range of arguments and evidence in their responses, with much evidence of a qualitative nature.

#### Question 2

What size of social enterprise suffers from this market failure if it exists and at what point in its lifecycle is it most likely to suffer from it?

38. Most respondents felt that the equity gap had the potential to affect all sizes of social enterprises. They also felt that those at the "growth / step change" stage in their business life cycle were more likely to suffer and that this was most relevant to those social enterprises with high growth potential.
39. Some respondents felt that social enterprises could suffer at all stages of their lifecycle. Others felt it was mainly an issue with start-up capital.

40. One respondent noted that all social enterprises suffer from a lack of equity as this type of finance is inappropriate for them.

### Question 3

From your experience, do you believe there are particular issues facing social enterprises in accessing equity financing? Are these issues specific to the social enterprise sector or are they the same generic issues that face all SMEs looking to source equity finance?

41. An overwhelming majority of respondents agreed that there were particular issues facing social enterprises. Respondents pointed out that the main issues faced by social enterprises were the:
- i) need to deliver a bottom line that is wider than financial;
  - ii) difficulty in ceding control to external parties;
  - iii) lack of a suitable exit strategy to offer investors;
  - iv) unfamiliarity of equity capital and venture capital;
  - v) issuance of equity being prevented by their legal structure;
  - vi) need for capacity building;
  - vii) regulation of profit distribution; and
  - viii) lack of a developed finance market for the sector.

### Question 4

If you agree that an equity gap exists for social enterprises, do they encounter the same financial thresholds as mainstream SMEs? If not, where is the equity gap most acute for social enterprises?

42. All but one of the respondents agreed that social enterprises face an equity gap. Of those that felt there was an equity gap, the majority felt that the lower threshold was lower than mainstream SMEs, with the most common response suggesting £100,000. The upper threshold was generally considered to be the same as mainstream SMEs, the maximum being £2million.

### Question 5

From your experience, have you encountered social enterprises that have failed to achieve ECF funding or been deterred from applying for it? If so, why do you think that social enterprises have failed to benefit from existing interventions such as the ECF programme?

43. There was no evidence from the respondents that social enterprises had successfully accessed ECF funding. The vast majority of respondents had no experience of social enterprises applying.

44. Of those who had, possible reasons for this failure included an investment process which was seen to be highly involved and time consuming, the focus on technology and high growth areas, and the purely commercial drive of the ECF programme.

**Question 6**

When making a decision to invest in a social enterprise do, or will, investors encounter similar supply side constraints to those they would face when entering into an investment in a mainstream SME as described above?

45. The majority of respondents answered yes to this question. Of these, however, there was a strong view that the constraints, although similar, were more pronounced.
46. For those that answered no, this was based on the belief that social enterprise faced a greater number of constraints and that there was very little equity available in this area.

**Question 7**

Are there any other supply side constraints not mentioned above that investors might encounter when considering an investment in a social enterprise?

47. All the respondents answered yes to this question apart from one. The constraints mentioned fell into one of the below categories:
- i) lack of knowledge about finance within the social enterprise sector;
  - ii) lack of knowledge about social enterprise model amongst investors;
  - iii) consideration of social mission makes raising finance more complex;
  - iv) the social enterprise sector is conservative in nature;
  - v) lack of exit strategy for investors offered by social enterprises;
  - vi) focus by social enterprises on grant applications and fund raising rather than using loans and equity;
  - vii) lack of reliable benchmarkable data within social enterprise sector; and
  - viii) lack of capacity building funding available to social enterprises to prepare them for external investment.

**Question 8**

For those investors able to overcome their supply side constraints, are there a lack of quality investment opportunities to realise their investment intentions? If so, are you able to offer any insight as to why this may be the case?

48. The respondents, in the most part, answered yes to this question. For those that answered yes, they suggested:
- i) a need for capacity building and awareness raising of finance options available to the social enterprise sector;
  - ii) conservative values of the sector restricted the number of social enterprises willing to engage with outside investors;
  - iii) a lack of capital supply to the sector;
  - iv) a lack of competitive return offered by the investment opportunities within the sector;
  - v) a need to enhance return through tax incentives; and
  - vi) a lack of incentives for social enterprises to change how they finance their operations.
49. One respondent believed the answer depended on investor interpretation of quality investment opportunities.

#### Question 9

Do you agree that professional venture capital providers are not interested in pursuing smaller deals? If so, how does this lack of interest in pursuing smaller deals affect the social enterprise sector?

50. Of the respondents who answered this question, a strong majority agreed. Some respondents suggested that as the returns targeted by venture capitalists can be seen as unrealistic for this market, the lack of competition in the investor market led to a lack of finance for the social enterprise sector.
51. One respondent suggested that whilst smaller deals were a specialised market, it was possible to make a return.

#### Question 10

Are venture capitalists focusing their interest on relatively established businesses resulting in the financing of smaller younger businesses being left behind? Do social enterprises tend to fall into this “smaller younger business” sector and if so, how does this affect them?

52. The majority of respondents answered yes to this question with two answering no. Of those answering yes, social enterprises were seen to be smaller businesses and this was put down to the sector being nascent with insufficient capital inflows.
53. For those who said no, they suggested that venture capitalists were willing to invest in businesses at any stage in their development and that the management team and a viable business plan were more important factors. It was also felt that social enterprises tended to be older than the average SME.

**Question 11**

How does this barrier to entry for new fund managers seeking to enter the smaller end of the venture capital marketplace affect the equity finance available for social enterprises?

54. The answers to this question were varied. One major theme which came through was that the barrier to entry inhibits flow of investment capital into the sector. Other points raised included:
- i) a fund manager should be able to rely on existing resources within their institution to negate the effects of smaller deal sizes and high due diligence costs to reduce the overall transaction costs;
  - ii) if the barrier can be overcome the effect should be an increase in the capital flows to the sector; and
  - iii) the barrier to entry is not relevant as there is no marketplace for social enterprise venture capital.

**Question 12**

Are there any demand side constraints that are specifically found in the social enterprise arena or are the above mentioned deterrents found with both mainstream SMEs and social enterprises?

55. All respondents answered yes to this question except one, who felt that the demand side constraints for SMEs were largely mirrored for social enterprises.
56. For those who agreed, the main constraints pointed out were:
- i) the marketplace for equity investment is under-developed, contributing to lack of liquidity and viable exit strategies;
  - ii) that social enterprises' legal structure prevented equity investment;
  - iii) reluctance by social enterprises to cede control of business to outside investors;
  - iv) a lack of knowledge, understanding and misconception of equity investment by social enterprises; and
  - v) a need for capacity building and improved understanding of finance in the social enterprise sector.

**Government response**

57. The vast majority of the arguments and evidence provided by the experience of those working in the market, support the Government's belief that social enterprises face a similar equity gap to mainstream SMEs,

58. Although much of the evidence and arguments provided were of an anecdotal or qualitative nature, the Government agrees that this gap can affect a wide range of social enterprises.
59. The Government agrees that there are also particular issues that can make it even more difficult for social enterprises to access equity finance, and that the equity gap for social enterprises may have an even lower threshold than for mainstream SMEs. Consequently, the Government will invest through this fund no more than £2 million in any single social enterprise, but will not set a minimum threshold for investments.
60. The Government agrees with respondents that investors encounter similar supply side constraints to those they face when investing in mainstream SMEs, but acknowledges that these constraints may impact disproportionately upon social enterprises. Furthermore, even when investors are able to overcome these supply side constraints, they may be faced by social enterprise specific constraints, and a perceived lack of quality investment opportunities. This inhibits flow of investment capital into the sector.
61. The Government also agrees that there may be specific additional demand side constraints in the social enterprise sector and will look to address these issues through other interventions.

## *Pari Passu Fund(s)*

### Question 13

Are potential investors in the Fund(s) willing to invest on purely commercial terms? What other terms will investors be willing to enter into investments with the Fund(s)? What return are they likely to expect?

62. The responses to this question were broadly based, with the majority of respondents agreeing that investors of this type do exist.
63. For those who felt the investors did or could possibly exist, assumptions about the terms which would encourage investors included:
- i) the need to target specific investors;
  - ii) the need for some kind of subsidy;
  - iii) the need for a clear exit strategy;
  - iv) the need for a longer term focus;
  - v) the need to overcome weak demand amongst social enterprises;
  - vi) expected returns ranging from an IRR of 10 to 15%, with gross return ranging between 5 to 8%.
  - vii) expected returns below rates in some other sectors; or
  - viii) the need for Government to consider enhancing returns through a tax incentive, such as CITR.
64. A minority of the respondents believed that these investors could possibly exist, were unlikely to exist; or that these investors did not exist. Some suggested that:
- i) investors would not exist until social returns could be valued on a company's balance sheet;
  - ii) the actions of government may contribute to the lack of supply;
  - iii) investors were unlikely to invest without maximisation of return; and
  - iv) that investors would come to understand that they will only see a return within the constraints of the social investment market.

### Question 14

How will potential social enterprises respond to a Fund(s) that will offer investments products as described in point 40 (vii)?

[40 (vii) The investment structure will have to be equity or quasi-equity. For those that are quasi equity, they will have to be closer to equity than debt. The

fund will be prohibited from entering into investments that have the potential to be classified as debt rather than equity].

65. Most respondents suggested that conventional equity was seen to be of use to social enterprises but demand for quasi-equity was seen to be higher.

#### Question 15

Is this a workable capital flow model for the Fund(s) to operate under? If not, what are the alternative models that the Government should consider?

66. The majority of respondents felt the capital flow model could possibly work. There was also a significant number that felt it could definitely work. There were a few respondents that felt it was unlikely to, or could not work
67. For those who felt it could possibly or definitely work, assumptions included the running costs of the Fund (s) being met, and a fund which could respond speedily to investment opportunities;
68. Those who felt it was not workable suggested reasons including the absence of a track record for equity-like investment; that a pari-passu arrangement could make things difficult for investors; a need for a stronger incentive from government through tax or subordination, and the existence of a 'demand vacuum' resulting in the Fund being under utilised.

#### Question 16

What evidence is there that there are informal investors and professional venture capitalists willing to provide risk capital to social enterprises but lack the investment vehicle to do so?

69. The majority of those who answered this question cited experience of venture capitalists willing to invest in the area of social enterprises. One respondent felt they did not have enough evidence to comment.
70. Some respondents suggested that there was not a strong flow of venture capital into the sector due to the difficulty in reconciling the return requirements of investors with social enterprises being driven not by the need to maximise profit. Some warned of disillusionment amongst investors if there is no demand for social enterprise investment, and some suggested that grant dependency among social enterprises suppressed demand.

#### Government response

71. The Government welcomes the view of the majority of respondents that the proposed *Pari Passu* model offers a workable capital flow model. There is some evidence that informal investors and professional venture capitalists were willing

to provide risk capital to social enterprises, and potential investors in the Fund(s) are willing to invest on commercial terms.

72. The Government believes it is possible to attract investment into social enterprises on these terms and that this is worth testing. The Fund(s) will combine public and independent money for onward investment into social enterprises, with the Government's capital to be invested on a side-by-side basis with independent investors.
73. The Government can invest in social enterprises without infringing European State Aid rules, if it operates under the Market Economy Investor Principle (MEIP). One way of doing this is for the Government to invest on terms that are the same as, or no worse than, those of other investors, thereby demonstrating that the terms of the government investment are acceptable to an independent investor operating under normal market economy conditions.
74. The Government wants to test different ways of structuring investment and believes that this approach offers the greatest potential to demonstrate the viability of investments in social enterprise, the greatest potential for replication in the market and so the greatest potential for increasing investment in social enterprises.
75. Meanwhile, the Government continues to welcome evidence from all interested parties on how the operation of CITR and other incentives for investment in social enterprises might be improved.
76. Investment through this fund will take the form of equity or quasi-equity<sup>1</sup>; any investment that does not have the principal objective of creating capital growth and realising capital gain will not be permitted.

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<sup>1</sup> Quasi-equity can be defined as an investment which has some characteristics of equity and some of debt. In social investment terms, it can refer to an instrument which shares risks and rewards between investor and investee. It may be considered as an alternative to straightforward grants which offer no financial return, or because traditional debt or equity instruments are inappropriate. For example, returns could be based on an agreed percentage of future income.

## *Fund's Objectives*

77. The objectives of the Fund are to:
- i) demonstrate the viability of investment in social enterprise, by way of example, through encouraging an increase in the flow of independent risk capital into the equity gap;
  - ii) improve access for new and growing social enterprises that are seeking equity financing to develop their business;
  - iii) demonstrate that there are a meaningful number of investors interested in making a profit-maximising investment in the area of social enterprise and to test the terms on which they are willing to invest; and
  - iv) develop equity funding investment instruments that can be utilised by fund managers when making investments into social enterprises.

### Question 17

From your experience do you feel that these four objectives are achievable considering the proposed structure of the fund outlined above?

78. The majority of the respondents answered yes to this question. Others felt it was not possible to achieve the objectives.
79. Respondents felt that the structure of the fund would benefit the sector as a whole as it would encourage development and knowledge, on the investor and investee side, for the finance issues associated with it. Another positive outcome from meeting the objectives would be the unlocking of institutional monies.
80. One theme emerged around demand side factors. Some suggested that funding for investment readiness would need to be made available for the objectives to stand the best chance of being met. It was also pointed out that the timeframe for achieving them would be over the long term - from 5 to 7 years.
81. Some suggested that the success of the objectives would be dependent upon the ability of investors to exit their investment. One respondent pointed out that by focusing the fund on the above objectives, the fund might not penetrate the market as deeply as it otherwise could.
82. Objective (iii) was considered to be the most difficult to achieve, due to a combination of factors, including whether social enterprises would be able and willing to offer a profit maximising investment. It was suggested that the focus on profit maximisation was limited and unimaginative and that it was difficult to see how pursuing this objective would be useful to the sector as a whole.
83. One of the respondents considered that that objective iii) appeared to be at odds with the wording in the Social Enterprise Action Plan which refers to "attracting

investors that are interested in a blended financial and social return”. One suggestion was that social enterprises may be willing to deal with profit maximising investors but this engagement may undermine the “social enterprise” brand image.

#### **Government response**

84. The Government welcomes respondents’ support that the objectives of the Fund are achievable. The intention is to create a ‘pathfinder fund’ to address these objectives. Under the proposed structure for the scheme, the Government will invest in social enterprises through the pathfinder fund in partnership with independent investors.
85. The Government recognises, in particular, the challenge in meeting the objective of demonstrating there are a meaningful number of investors interested in making a profit-maximising investment in the area of social enterprise. The purpose behind establishing this pathfinder Fund(s) is for the Government to lead the way by example by using the Fund(s) to encourage potential investors to link up with potential investments and demonstrate that the objectives of the fund are achievable.
86. The Government does not believe that the proposals for a risk capital fund are at odds with the definition in the Social Enterprise Action Plan. Social enterprises represent a spectrum of investment opportunities for investors motivated by a range of financial and social risks and returns.
87. This Fund does not preclude the possibility of other investment, by government or others, addressing other gaps and market failures.
88. The Fund will be able to invest in social enterprises at different stages in their development, for example supporting capacity building where this helps meet the objectives of the fund. But the potential of the Fund for investing in successful social enterprises will be improved where the fund manager(s) has good links with providers of investment readiness programmes. Government wants to encourage fund manager(s) to work with providers of investment readiness and will therefore consider these links as a positive factor when selecting a fund manager. However, these links need not include direct involvement by the fund manager in the management of investment readiness programmes.

## *Requisite Scale*

### Question 18

What is the minimum fund size that allows the Fund(s) to operate on a commercially feasible scale and for the necessary conclusions to be drawn as to it successfully meeting its objectives?

89. The responses here varied from £2 million to £40 million. The majority of respondents favoured a fund size of £10 million.

### Question 19

What are the advantages and disadvantages of the Government appointing one fund manager to run one large fund rather than several fund managers to run several smaller funds?

90. Responses to this question varied. Suggested advantages of one fund included the increased scale and ability to make larger and follow-on investments, the potential to attract a talented team and diversify the fund, and for greater transparency.
91. Suggested disadvantages included the risk that any single fund may be based in London and could find it difficult to, or choose not to, invest in the wider regions, which could be essential for success. Some respondents suggested potential disadvantages in not testing out different models, only utilising the skills and contacts of one fund manager, and exploiting a more limited range of decision making processes, financial instruments and evaluation techniques.

### Government response

92. The Government acknowledges the view of the majority of respondents who favoured a fund size of £10 million. As a result, the Office of the Third Sector will make up to £10million available for investment to help address the equity gap faced by social enterprises.
93. This can be matched or exceeded by independent investors, making an anticipated total minimum fund size of £20million. However, if the fund manager(s) is unable to match the full £10million investment from government, then the fund(s) size will be proportionately lower.
94. The Government understands the advantages of one Fund but will consider alternatives during the process of selecting a fund manager(s) in order to ensure an approach which is most likely to meet the overall objectives.

## *Legal Structure*

### Question 20

What would be a reasonable time span for the Fund(s) to run in order for its objectives to be properly evaluated by the Government?

95. Responses varied from 5-15 years but the majority favoured a lifespan of 10 years.

### Question 21

Are there any alterations to the traditional LP structure that the Office of the Third Sector should consider when forming the legal structure for the Fund(s) or are there alternative legal structures that might create a more suitable framework for the Fund(s) to operate within?

96. The limited partnership (LP) agreement was seen to be the most appropriate model for the fund to operate under. Several respondents suggested the final model should be determined during a competition to appoint a fund manager. Other models that were suggested included:
- i) an investment trust model;
  - ii) establishing a plc that could take equity investment and for the plc to then make onward investment into the social enterprises through whichever financial instrument was most suitable for the enterprise;
  - iii) a capital partnership model; and
  - iv) an evergreen model.

### Government response

97. The Government supports the view of the majority of respondents who favoured a lifespan of 10 years, but wishes to retain the flexibility to curtail or extend the Fund, if appropriate.
98. The Government agrees with respondents that the limited partnership model is well established but also agrees that alternative legal structures should be considered in the competitive process to appoint a fund manager(s).

## *Definition of Social Enterprise*

### Question 22

What level of demand does the market anticipate from social enterprises fitting the above definition?

The definition used in the consultation was: “Business with primarily social or environmental objectives, principally reinvesting surpluses in the business or community”].

99. The range of responses to this question was broad, with the suggested level of demand variable. Those that felt the demand would be healthy outweighed those that felt it would be less so.
100. For those who felt that demand would be strong, assumptions included social enterprise investees exhibiting high growth potential, the fund taking a longer term developmental approach, the need for the fund to hold a minority stake in investees, that quasi-equity products could be offered as an alternative to conventional equity, or that social enterprises would be willing to restructure in order to take equity investment.
101. For those who felt that demand would be less strong, assumptions included the difficulty for a social enterprise to change its regulation of surplus distribution, the immaturity of the market, the need for capacity building and the existence of grant schemes.
102. Respondents expressed a range of view about the definition of social enterprises, supporting a definition which ranged from:
  - i) a very tight definition restricting enterprises to CICs and Industrial Provident Societies; and
  - ii) “businesses with primarily social or environmental objectives, principally reinvesting surpluses in the business or community rather than being driven to maximise profit for shareholders and owners”; to
  - iii) social purpose businesses, defined as having a very strong social objective as part of their core purpose, but run for profit.
103. Whilst some respondents felt that enterprises outside the Government’s definition of social enterprise should be out of scope, others suggested that wider ‘social businesses’ should be considered in order to ensure the fund did not fail because of a shortage of investment opportunities.

### Government response

104. The Government acknowledges that the level of demand is uncertain and will be tested through the operation of this fund

105. The social enterprises eligible for investment by the fund will be those fitting the definition of a social enterprise found in the Social Enterprise Action Plan: “A social enterprise is a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners”.
106. The Fund will be aimed exclusively at social enterprises in England. Other parts of the UK have their own approaches to assisting social enterprise access to risk capital.

## Performance Targets

### Question 23

What is the best way to evaluate whether the Fund(s) has increased the flow of independent risk capital into the equity gap faced by social enterprises?

107. Respondents suggested:

- i) the number of venture philanthropy funds and total volume of funds under management;
- ii) the number of social enterprises with risk capital funding and volume;
- iii) an independent study to be carried out at the start and end of the fund's life;
- iv) whether copycat funds are created; and
- v) setting and monitoring of key performance indicators.

### Question 24

How can we measure whether there has been an improvement in the ability of social enterprises to access the equity they need?

108. Respondents suggested:

- i) the change in attitude by social enterprises towards equity investment;
- ii) the total value of equity raised in the sector; and
- iii) that the fund manager look at the level of demand for fund and how much capital was successfully invested.

### Question 25

What is the best way to quantify the number of investors interested in making a profit-maximising investment in the area of social enterprise? This should involve a calculation of investors that were willing to accept the return but might not have participated in the eventual investment of the Fund(s).

109. Respondents suggested:

- i) a tracking system that establishes a range and a variety of potential and actual investors and their meaningful level of engagement;
- ii) quantifying the investors who commit to the fund, the investor type, and how diversified this is;

- iii) a study of any changes in business attitudes in the market and fund managers reporting potential investors interest; and
- iv) the fund being established, invested in and then making investments.

**Question 26**

What are the key factors that should be considered when evaluating whether there has been a successful development of equity funding instruments for investing in social enterprises?

110. Respondents suggested that key factors to be considered should include:
- i) the number of investments made;
  - ii) the value and spread of those investments;
  - iii) the results of the fund, i.e. the value of successful investments;
  - iv) the demand for investments that cannot be met due to lack of funds;
  - v) the entrance or otherwise of other investors into the market; and
  - vi) how independent and sustainable funds are without government matching investment.

**Government response**

111. The Government believes the success of the Fund(s) in meeting its objectives can be evaluated through the investment activity of what is, by its nature, a demonstration fund. For example, through consideration of how much capital was successfully invested.
112. The Government will also, however, put in place an independent evaluation to report over the lifetime of the fund.
113. The responsibility of identifying and negotiating potential investment deals will be left to the Fund manager/s. The intention is for the Government to monitor the investment portfolio but without having direct control over the fund manager's individual investment decisions.

## Overhead Costs

### Question 27

Are fund managers currently working under such terms to cover their overhead costs/management fee and if not, would fund managers be open to doing so?

114. The Government's suggestion to pay fund managers out of the profit pool was met with no positive responses. Respondents commented that the expected duration of the fund's life was too long to expect fund managers to work under this model.

### Question 28

Is there an existing model that the Government could rely on which would share the operating costs and management fee of a fund equally between the Government and the independent sector or would a new model have to be devised? If such a model exists, what are its characteristics?

115. Respondents suggested that the model proposed in the consultation was the standard model under which the market operates. One respondent felt that any surpluses generated should be reinvested back into the fund and not awarded to the fund manager.

### Government response

116. The Government accepts the points made in the consultation that the Fund manager's overhead costs should not be met from profits, but that the Government and independent investment partners should share costs, including up front if necessary, before profits are generated.

## *Remuneration of the Fund Manager*

### Question 29

How is this remuneration best structured so as to create a strong incentive for the fund manager to maximise the financial performance of the Fund(s)?

117. Responses to this question were varied, particularly around the proposed management fee, with suggestions ranging from 2 to 5%. Responses also included the suggestion that:
- i) the management fee should be higher than regular Venture Capital funds as social enterprises are less investment ready than regular SMEs;
  - ii) remuneration should be generated if all performance criteria are met;
  - iii) social objectives should be considered where possible given the state of the market;
  - iv) the management fee reduced over time; and
  - v) the fund manager should not share in further profits – so as not to encourage the pursuit of the most lucrative deals.

### Question 30

The Office of the Third Sector would like opinion on features in current models being used in the market that although viable would be a deterrent for fund managers to bid.

118. There were two main themes emerging from the responses to this question. First, that the Government should not restrict the amount and timing of investments and second, that the structure of the management fee should be given careful consideration so not to act as a deterrent to fund managers.

### Question 31

Looking outside the financial performance of the Fund(s) is it possible to compensate the fund manager for meeting the other objectives of the Fund(s) outlined in point 25 and if it is, how is this best achieved?

119. Respondents included suggestions that:
- i) a range of objectives as well as financial return should be considered and rewarded;
  - ii) the fund manager should be incentivised to achieve policy goals;

- iii) the fund manager should share learning over the life of the fund; and
- iv) a mechanism should be established to measure social and environmental outputs, such as an independent panel.

**Government response**

120. The Government believes that incentives for the fund manager by way of fund management fees should be based on financial performance and other deliverables in line with the objectives of the Fund(s).

## *Next steps*

121. Capital for Enterprise Limited (CfEL) will be assisting the Office of the Third Sector in selecting a suitable fund manager, or managers, and will manage the ongoing relationship including monitoring and reporting on fund performance.
122. Capital for Enterprise Limited (CfEL) was established in April 2008 to manage investment programmes and the Small Firm Loan Guarantee on behalf of the Department for Business, Enterprise and Regulatory Reform. The new body combines private sector expertise and the experience of developing public investment programmes, which it is able to offer as a service to other organisations. CfEL is regulated and authorised by the Financial Services Authority.
123. The selection of a suitable fund manager, or managers, will take into account the issues considered during the consultation and summarised in the Government's response.
124. The Government will publish a bidding document over the coming weeks, allowing a period of 12 weeks for potential bidders to respond. We hope to have a shortlist for potential fund managers in the autumn, and a fund manager, or managers, appointed and in a position to begin the process of making investments around the end of 2008.

## Annex A – Consultation responses

1. Adventure Capital Fund
2. Alliance Fund Managers
3. Baker Brown Associates
4. Big Life Company
5. Buildings for Life
6. Bridges Ventures
7. Can-Online
8. CDFA
9. Community Innovations (Equity Plus)
10. Co-operative UK Limited
11. Employee Ownership Association
12. Futurebuilders England
13. Impetus Trust
14. Investing for Good
15. London Development Association
16. London Rebuilding Society
17. Moveable Feast
18. NWES
19. Nordic Enterprise Trust
20. Rathbone Greenbank investments
21. SCA Group
22. SEEDA
23. Social Enterprise Coalition
24. South West England RDA
25. SEE Potential
26. Triodos Bank
27. UCIT Ltd
28. Unltd
29. YFM