Financing Options for Social Enterprises

-by Mark Cheng – Ashoka & Clifford Lee - DBS

Ashoka Director and experienced social investor Mark Cheng talks about how to raise social finance for your social enterprise; how to explain your social impact, how do pitch to social investors and what key information social investors are looking for.

The following are brief notes taken during the class. For more information on social financing, refer the Social investment toolkit (www.socialinvestmenttoolkit.com) for financial models, legal documents and due process.

Definitions

- What is a social enterprise? An organisation that uses a for-profit business model to achieve a social mission. A charity is not the same as a social enterprise
- What is social finance?
  - Finance that looks at two aspects: for profit and social mission
  - For profit = selling goods and services to someone
  - Revenue made goes into trying to help solve a social mission
- What is a social business?
  - Social businesses seek to be profitable but not necessarily profit-maximising (you can't ignore profit because you must survive and be sustainable, but the organisation does not have a duty to make as much money as possible)
  - Social businesses are impact maximisers subject to being profitable (covering costs)

Why is it hard for social entrepreneurs to raise money?

- Main challenge of SEs is to be able to do both models below, equally well
  - Impact model = do activities to help a cause/certain group of people
  - Business Model = commercial operation selling goods to customers and making money
- They're encountering challenges that come with dual bottom-line models and objectives

- A social investor has two different motivations – they want to see impact, but they also want financial return (this could be anything from 0% to full commercial return)
    - For Social impact: Grants
    - For Financial return: Commercial finance
    - Social investors want both above

<u>Financing options to choose from:</u>

a. Philanthropy (grants, donations) *The grant maker doesn't care about getting the money back
b. Equity
c. Debt
   *Need to have business model that helps you pay back. This business model cannot be reliant on donations. A donor will not allow their money to pay someone else's investment off.

<u>Which option is right for you and can they be blended for the right solution?</u>

Most people go for grants because it's "easier". But once your business grows to a certain level, it's likely that you need to raise more investment. Usually there aren't enough grants for that, so you must raise investment. And investments can only be repaid with a commercial model. Equity and philanthropy can't be mixed in the same vehicle. Only way is a structural separation (a business and a charity sitting side by side doing different things)

<u>How do you pick the right financing option for your organisation?</u>

Two questions you should ask:

a. What kind of cash flow do you generate?
b. Which stage is your business at?

For any organisation, your revenue curve should go up over time. Assume that your costs remain flat over time. Your costs will be more than your revenue when you first start out at which time you need more capital. You'll break even after and then start making profit (revenue > cost). Eventually your profit should be more than funding needs.

- Breakeven period: Before company breaks even
- Repayment period: After breaking even when company starts making profit
- The shape of your cashflow forecast determines the kind of financing that you should be seeking
- If your costs are high and perpetually exceeds revenue, company should immediately seek philanthropy options. Don't waste time looking for investments cause it's near impossible to get in that stage. Raising investments can become a distraction and when you should be focusing on something else. Or it may require a radical change in business model then they won't be doing the same thing anymore.
- If your potential market is huge and your product is in demand, you may potentially have a revenue model that starts off low but has the potential to increase in revenue substantially and quickly.

You should go for: Equity funded model – you can offer investors significant upside (high risk but high growth potential)
Why not debt? Equity has no insolvency risk. You're giving up control of your company, but you have no bankruptcy risk.

- Another common profile would be a model that has no profit in the early years, and this can go on for quite a while, and they'll only become profitable after many years. Can they raise equity? May take too long
  They should go for - Hybrid finance: blending different options together at different times/stages

Case study: Fair Finance

- Started funding itself through grants
- Social impact: Started giving debt advice to clients who have debt and help them restructure debt to pay them off
- Micro loans: Gives people loans with a much more manageable interest rate
- One activity is a business activity (micro loans) and one is a social activity (debt advice)
- Fair Finance then splits organisation up into two subsidiaries
  - Debt advice stays a charity
  - Micro loaning becomes a commercial business
  - Original organisation becomes parent organisation (one brand) that manages both subsidiaries
- Fair Finance looks for equity investors for the micro loans subsidiary (investors only have to take risk on the business sides of things)
- Micro loans portion gets funding from banks (can go to bank for a loan/credit cause of restructure and donors underwriting risk)
- Debt advice gets grants from donors

<u>Which type of investors should you approach?</u>

- Depends on the stage of the business / life-cycle of business you are in.
- (Prototype --> Standardize --> Scale) - these stages are not prescribed by time but by activity and milestones achieved by your business.
  - The type of funding you're looking for at each stage is radically different
  - One of the main mistakes is that investors pitch for the wrong funder.

  - **Prototype stage of business**
    - Find a business model
    - Demonstrate social impact
    - Create a minimum viable product (a stripped-down version of the product you're trying to sell. What's it at its core) what's the one essential feature of this business
    - Find a customer who gives genuine feedback and whose problems are solved by your business / product.
    - Funding options: grants, donations, bootstrap (you fund your own business), 'friends and family' (depends on the size of your networks)
    - There aren't that many funding options at this stage cause of limited pool of donors/investors

- Size of funding: Up to USD 250,000 (depending on personal networks)

- **Standardize stage of business**
  - Create 'Core Product(s)': Something that has been perfected to the point where you can describe it very well
  - Develop a 'standard' product(s)
  - Establish price point (not negotiating with every customer anymore)
  - Establish customer base
  - Positive gross margin (need to cover fixed costs and cost of product. Can you sell enough products to cover your cost?)
  - Very easy to replicate
  - Opportunity for Social enterprises: Angel Investors who really believe in your cause/product may give you very good rates for funding. This gives you more opportunities as compared to a normal commercial entity.
  - Rapidly growing space: More foundations are going into this space instead of just giving grants

- **Scale-up stage of business**
  - Scale to net profit
  - Raise investment
  - Roll out product at scale
  - Get to break-even and net profit
  - Funding options: Institutional investors (i.e. funds), angels
  - Size of funding: EUR 0.5mn – 5mn

<u>How to make your perfect pitch: (If you only had 1 minute to pitch, what would you say?)</u>

- Pick the right 5 things to say and get them in the right order, and pick 2 statistics that make the most sense
- You're telling a story to an audience, and stories have narratives
- You're answering a series of questions in their minds and you should do it in an order that these questions come up:

1. The social problem
2. Size of problem, who suffers, what is cost to society? You must help them visualize and understand the problem and the person who is actually suffering.
3. Cost to society (look for that one number that encapsulates what is the cost to society/the seriousness)
4. What is your solution?
5. How does it solve the problem? (Contextualise it against the statistic that was shared earlier)
6. Impact statement (something to close your argument and bring it together). "$1mn invested in us will enable us to reach XX people and create YY impact"

Part 2: Discussion with Mark Cheng (MC) & Clifford Lee (CL)

<u>What are some developments and trends in the social financing space?</u>

CL: A common misconception is that if you have a sustainability/green bond, you have more investors to bring down the price. The reality is that there aren't enough of those investors to bring down the price, especially in Asia.

Issues to be considered:

1. Borrow on own merits
2. Proceeds don't go into cost savings
3. Playing in an investor field that is quite cold

In Asia, there are funds to be willingly deployed. But investors need to know what you're asking for. Bonds and loans require repayment within a certain period, so you must be able to display that you can do it.

MC: Social finance is a new asset class, but it's more complicated than that. All the problems you have with a start-up market multiply with the fact that social issues don't fall within a specific bracket."

CL: Professional investors are starting to carve out pockets of their portfolio that they want to put in impact investments. The eternal struggle is whether these investments pass the credit test.

Another way is to work through intermediaries. Instead of pitching to 50 individuals, pitch to 1 who understands the model and wraps it with a guarantee.

MC: There's a lot of innovation coming in from social financing. The IIX Women's Livelihood bond is an example of that. There's going to be a lot of change in this space.

<u>Will DBS be a bank that is willing to think creatively about structuring credit?</u>

CL: Our intent is to do what we can to help. If the IIX bond model works, we can get the market to participate in a bigger way. I'm encouraged by a few things. I believe there are ample funds in the market to be deployed. I daresay even more monies to be deployed than social enterprises need. Liquidity isn't a problem. The challenge is to package needs in a way that they can invest. DBS has identified championing social enterprises as our cause and have a Foundation to take this further. We mentor SEs, fund them and are also exploring funding them in the form of guarantees. Because Asia continues to be growing, when they see a need that is urgent and big, the investors will start putting aside funds to help. The key is that the effort must be big enough for investors to do that.

Similarly, social enterprises should also clearly articulate why DBS should partner them.

<u>On Crowd funding:</u>

MC: There's a lot of interest in crowd funding so the potential is there. It only works if you have a substantial "fan base" out there. People need to know about your work. The best campaigns usually have a couple of early investors that agree to put in the first 10%. People invest in projects that already have momentum.

Does “social cause” matter:

MC: Organisations that boast bigger number of people reached will have benefits. If you’re going for depth of impact, make that your selling point. There’s nothing stopping you from going out looking for investors. Many of them are looking to invest where their heart is.

CL: What type of funding is needed must be very clear, whatever your cause. If you want funds to grow your business, but you can’t show the repayment profile clearly, then you’re going more for equity financing rather than debt.

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ASHOKA

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Agenda

1. **What is social finance?**
2. **What are your financing options?**
3. **How to pitch**

Definitions

What is social enterprise?

Social enterprise

an organisation which uses

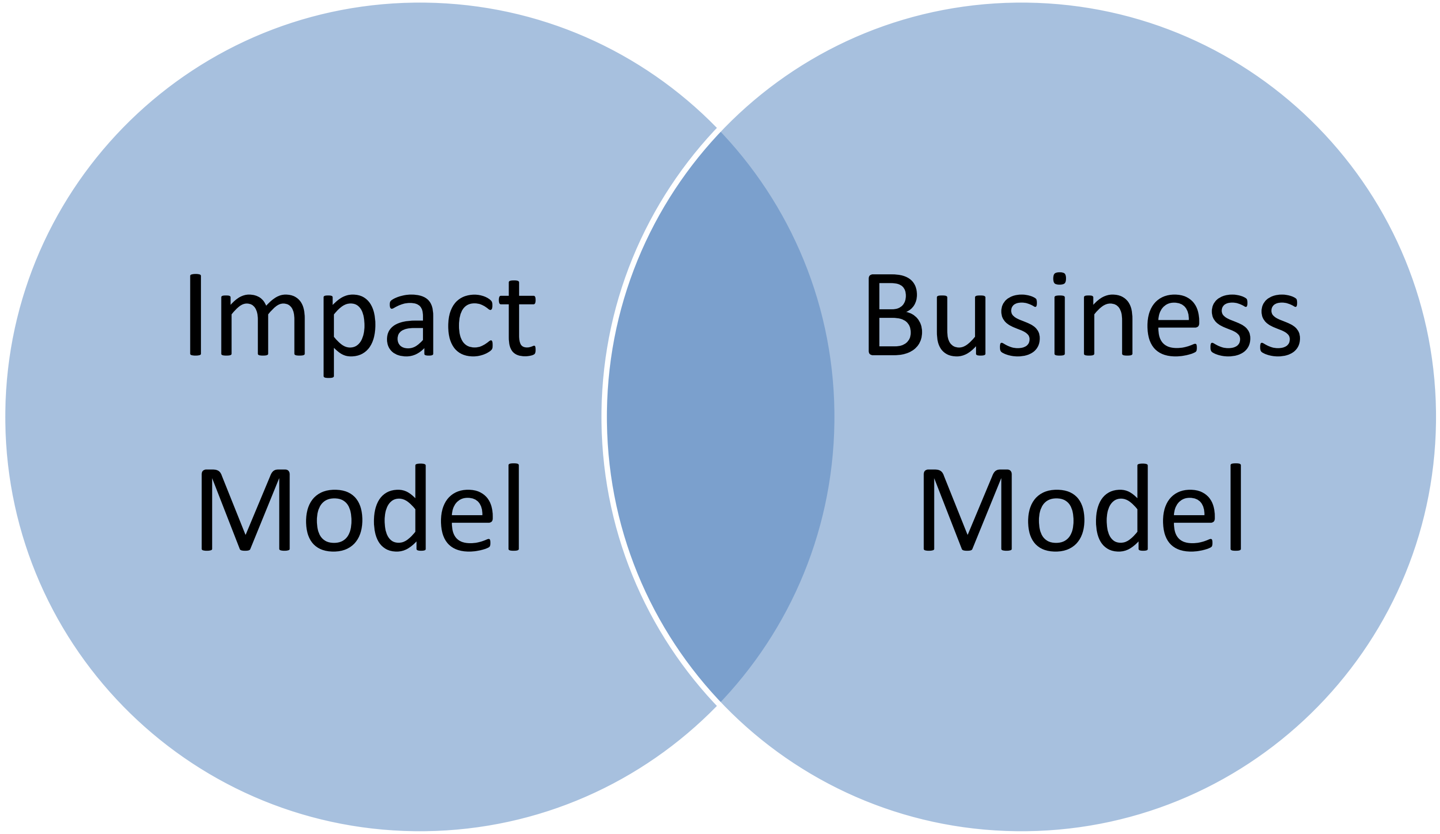
a for-profit business model

to achieve a social mission

Social Businesses seek to be profitable but not necessarily profit-maximizing

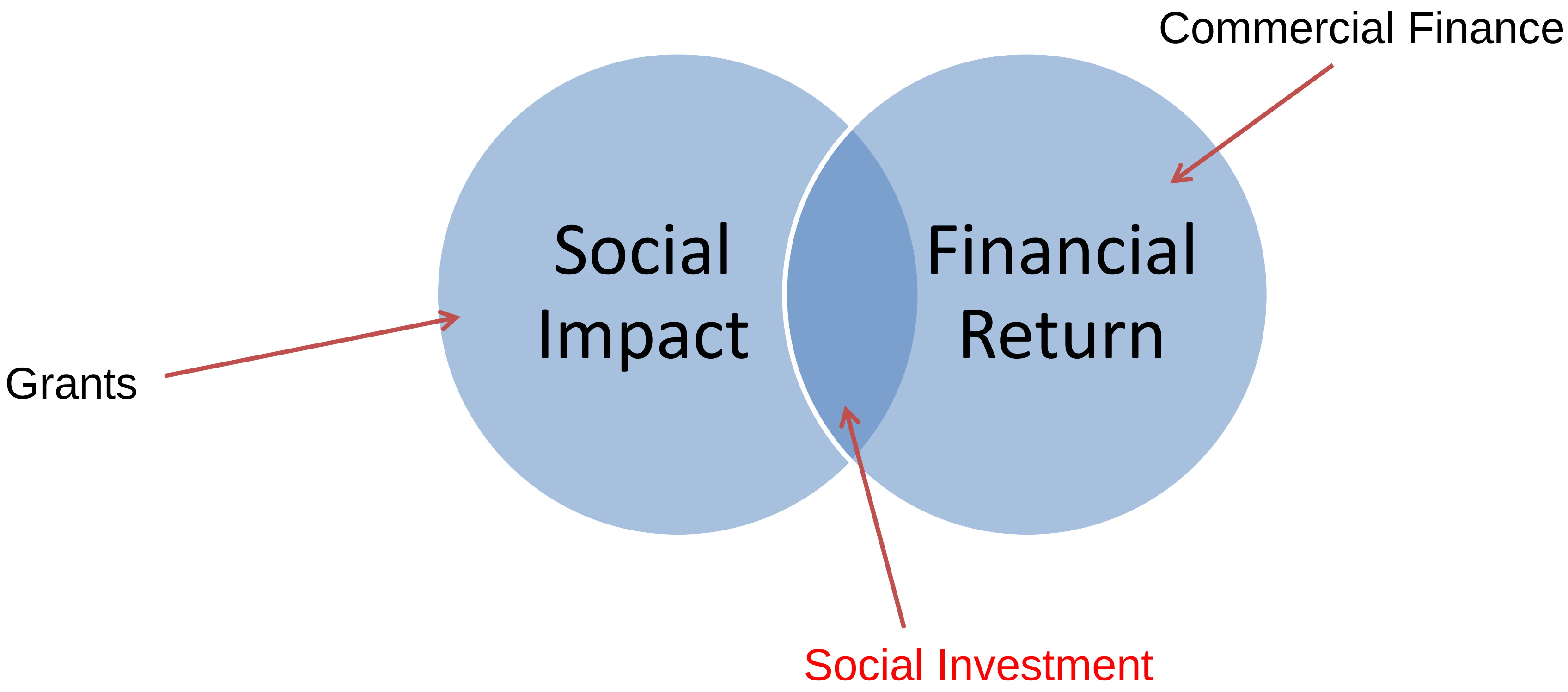
Social Businesses are *impact* maximizers

Social enterprise = Impact + Business



What is social finance?

Social Finance or ‘Impact Investing’



3 financing options

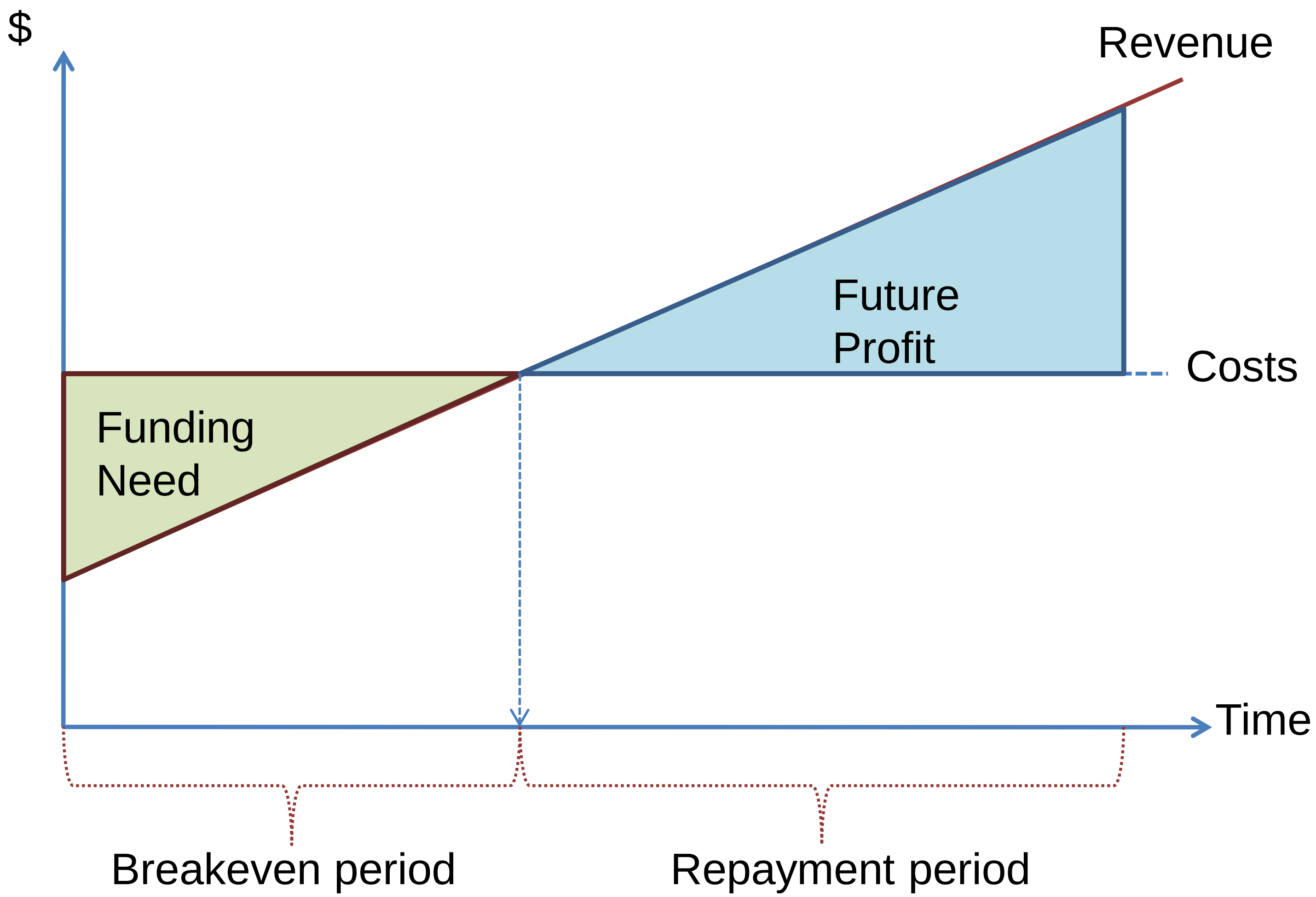
1. **Philanthropy (grants, donations)**
2. **Equity**
3. **Debt**

Which financing option should you choose?

Meet three entrepreneurs...

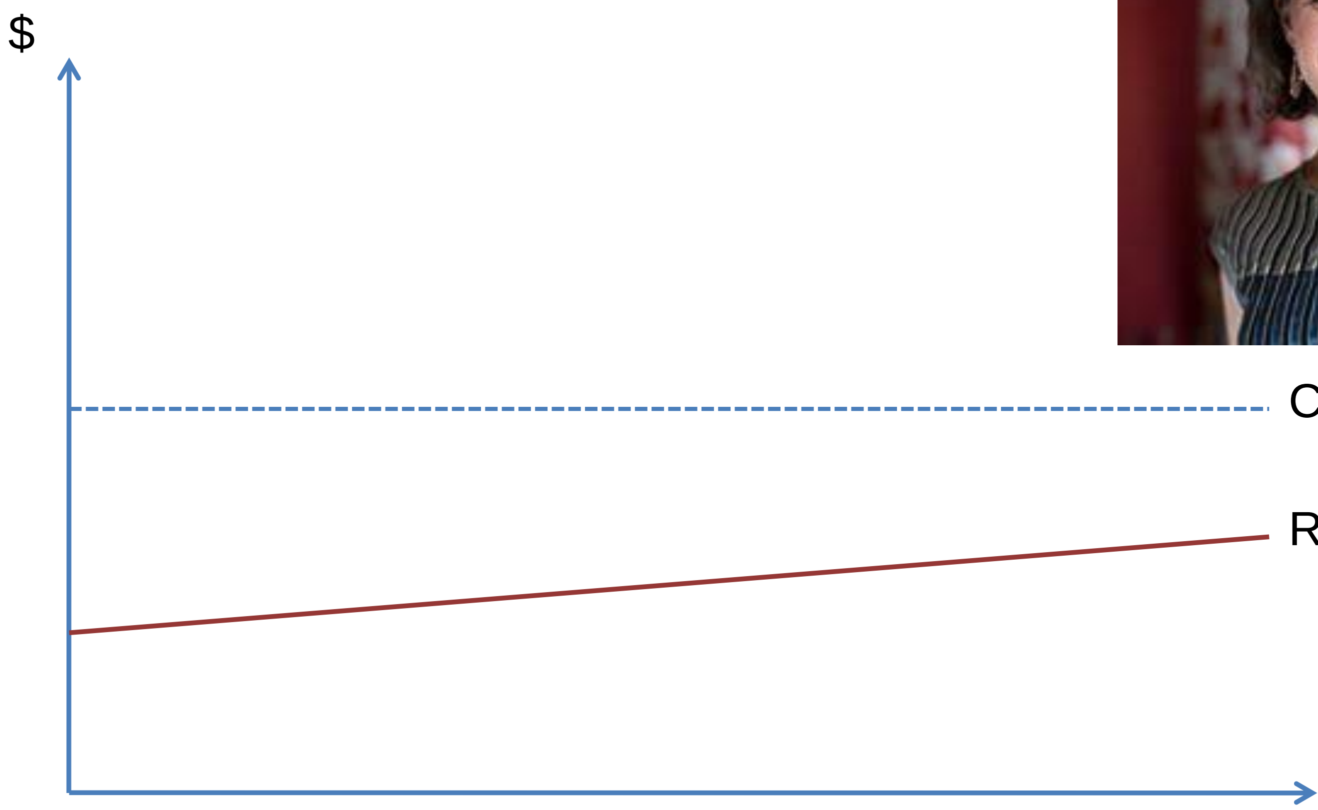


Profit = Revenue - Costs



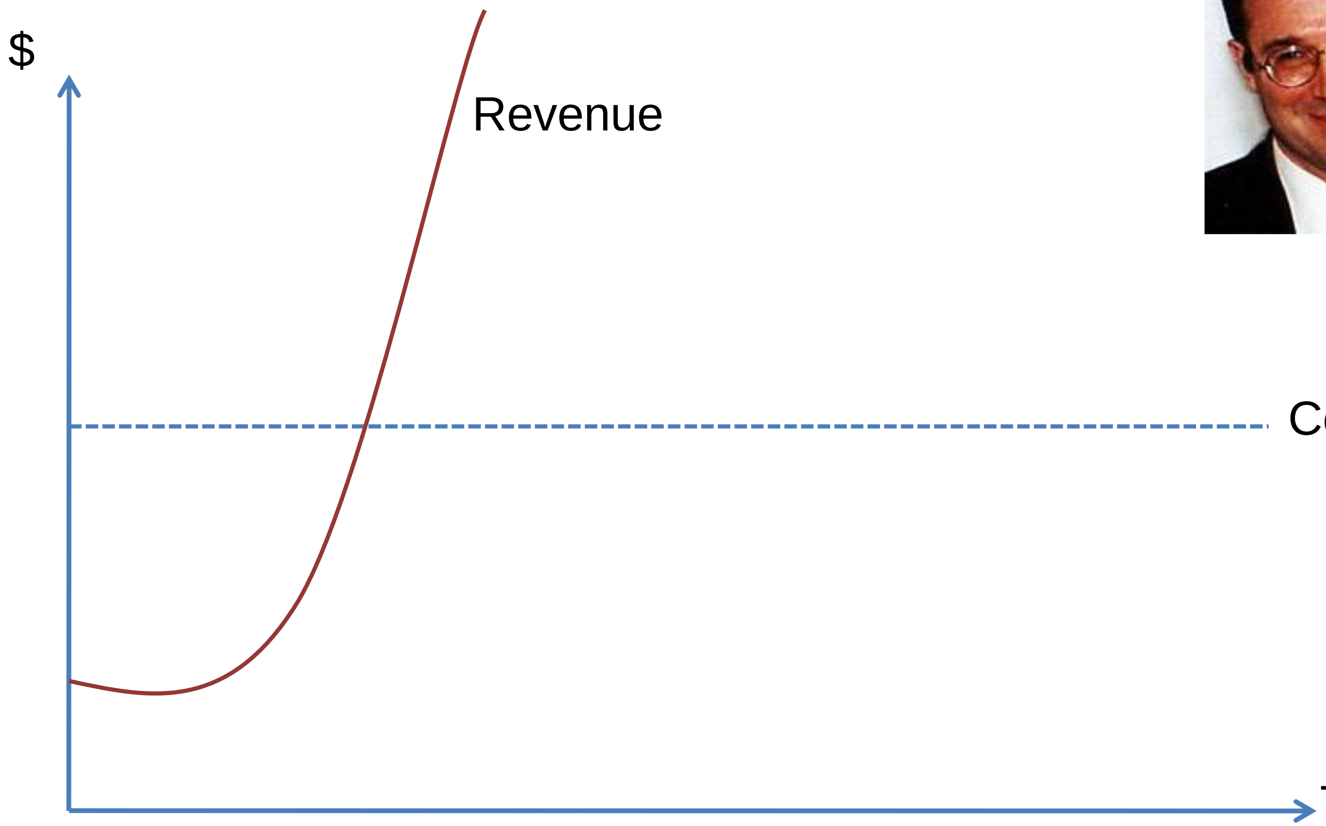
The shape of your cashflow forecast determines the kind of financing that you should be seeking

Gina



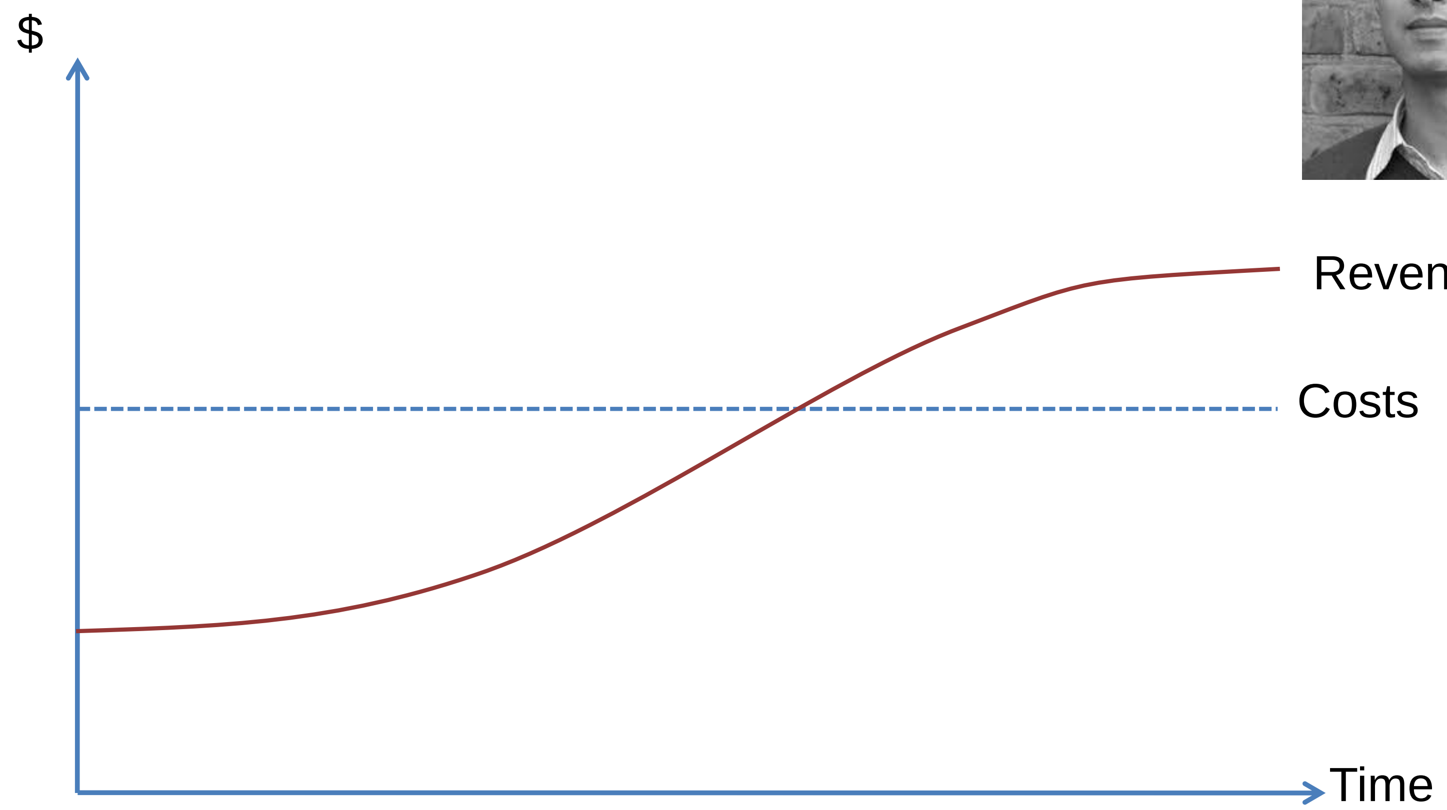
Philanthropy

David



Equity

Faisel



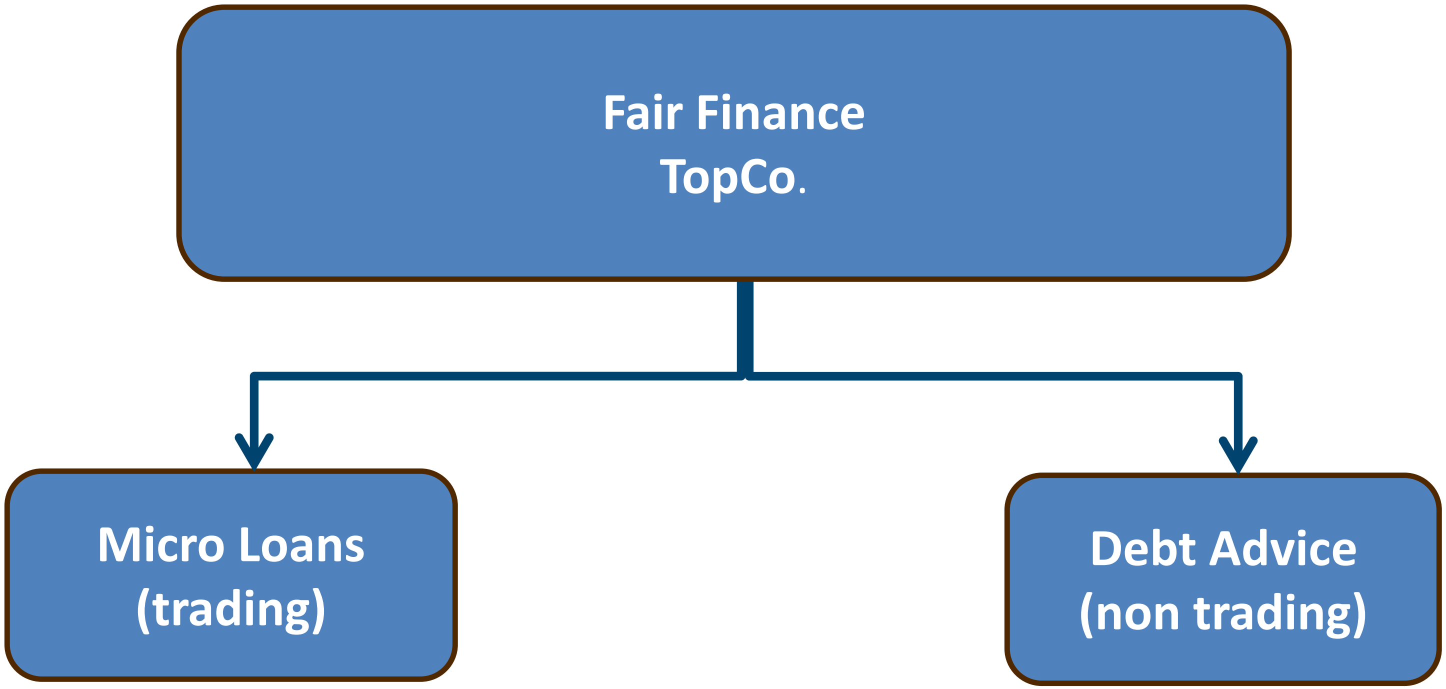
Hybrid finance

Faisel Rahman

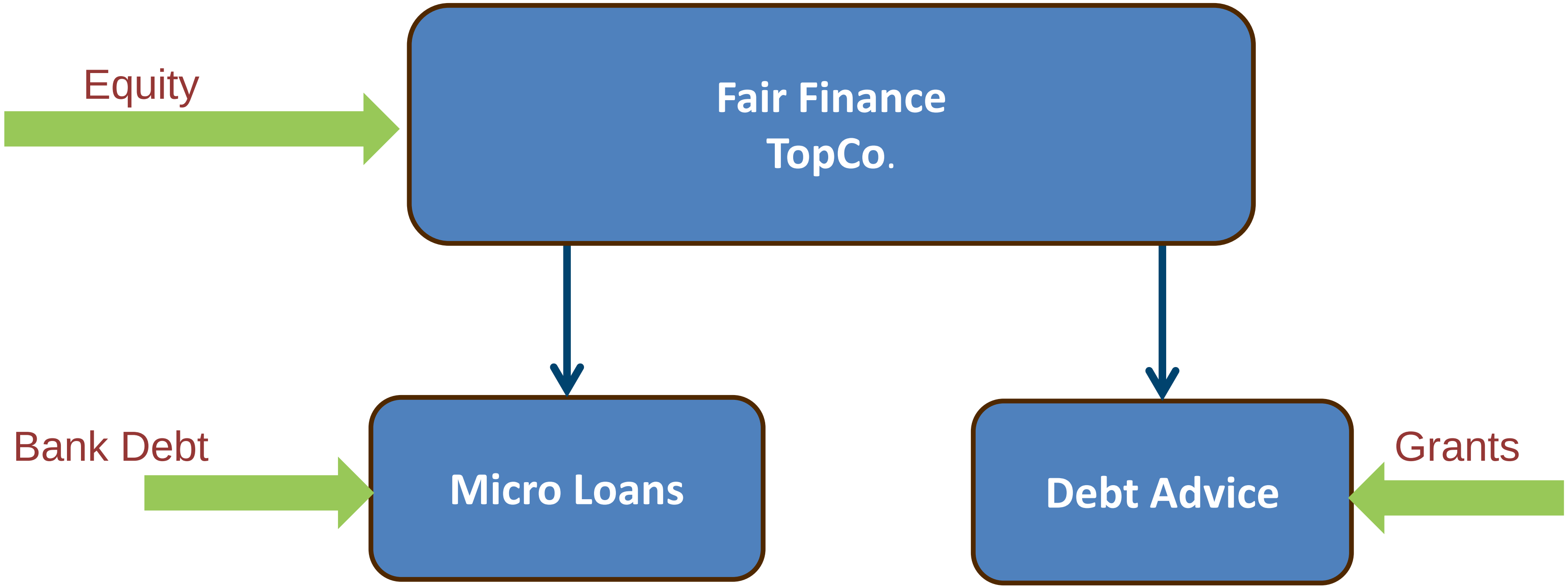
Example: Fair Finance

Micro-Lender / UK Fellow Faisel Rahman

Separate business from non-business activities…



…to raise the right kind of finance for each part



Which stage of the business life-cycle are you in?

3 Stages in the Lifecycle of a Business Model

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Goal: **Find a business model**

Prototype

- Demonstrate social impact
- Create a **Minimum Viable Product**
- Find a customer

Funding options: Grants, Donations, Bootstrap (i.e. you), 'friends and family'
Size of funding: Up to USD 250,000 (depending on personal networks)

3 Stages in the Lifecycle of a Business Model

Goal: Create 'Core Product(s)'

Standardize

- Develop a 'standard' product(s)
- Establish Price point
- Establish customer base
- Positive gross margin
- Very easy to replicate

3 Stages in the Lifecycle of a Business Model

Goal: Scale to Net Profit

Scale

- Raise investment
- Roll out product at scale
- Get to break-even and net profit

Funding options: Institutional Investors (i.e. funds), angels
Size of funding: EUR 0.5mn – 5mn

3 Stages in the Lifecycle of a Business Model

Prototype → **Standardize** → **Scale**

How to make the Perfect Pitch

If you only had 1 minute to pitch…

what would you say?

The social *problem*

Who are the Beneficiaries?

Our Solution

Our team

Growth plan
Marketing
Social IMPACT
CVs
The amazing board

Where we work
Our founder's story

Our Cool logo!

$$ Financials

Our tech

Debt or equity?

Massive Financial Return

What are exit options?

Customer testimonial

The Social Problem

Size of problem
Who suffers?
What is cost to society?

Your Solution

What is your solution?
How does it solve the problem?

Impact Statement

"$1mn invested in us will enable us to reach XX people and create YY impact" www.SocialInvestmentToolkit.com

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