THE LESSONS

we have learned

LESSON #1

HOW CAN SOCIAL INVESTMENT FUND INNOVATION?

Most people who are involved in social investment would agree that it should be funding innovations that will improve the lives of disadvantaged people and communities. But what do they mean by the word "innovation"? At one end of the spectrum "innovation" might mean doing something that is tried and tested, but making small changes to improve results. At the other end, it might mean creating something that is completely new. This could be a new intervention or a new organisation. Sometimes it involves both at the same time.

Projects that are completely new are often the most exciting. The social entrepreneurs who champion them are typically inspiring. They and their projects hold the promise of making the greatest change to the world and therefore having the biggest social impact. Since that is the reason why most organisations (the people and the money) are in social investment in the first place, it is easy to see why such projects are tempting for social investors.

But something else also applies to projects that are completely new. Not only do they offer the potential for the highest impact, they also involve the highest degree of financial risk. Innovative social investment projects that aren't successful may result in a total financial loss for investors. Good social intentions may not always lead to good financial outcomes. If this is not well understood, there is a risk that a few bad experiences could poison the well.

The conventional world of for-profit investing has a simple way to fund risky innovation. Investors know they will back some losers. They often expect a higher proportion to fail than to succeed. But big wins on a few investments more than offset a larger number of losers. If investors put their eggs in more than one basket by buying shares in several for-profit companies, they can end up with a rate of return on their investments as a whole that reflects the risk they have taken. This means making a profit that is many times the initial sum invested.

SASC believes it is dangerous to assume that this model transfers easily to social investment. For one thing, most organisations in the social investment arena (for example charities and companies limited by guarantee) have no mechanism to generate private gain through joint ownership with investors. They have non-profit legal structures and cannot issue shares. Creative ways can be found for such organisations to pay a financial high return despite these restrictions. The term "quasi-equity" is sometimes used to denote these instruments. But SASC believes this approach misses an important point.

SASC's view is that social investment exists to back organisations that are driven by impact so that they can become financially sustainable. It is unlikely that an approach to running a business that is focussed on impact will be compatible with generating the kind of very high financial returns that make the for-profit model of investing in innovation work.

This issue runs into a bigger question that hangs over the whole field of "impact" and "social" investment. The bigger question is: Do you believe there is a trade-off between impact and financial returns? SASC's view is that at the "more social" end of the spectrum, there both is and should be a trade-off. Truly social organisations that really want to maximise their impact are both likely to, and should be helped by social investors to, favour impact over maximising financial returns.

Such an approach has important consequences. It means that social investors who want to fund risky innovations by non-profit organisations face some harsh but simple arithmetic. With no prospect of any big financial wins to offset the inevitable financial losers, social investors have a choice.

Either they believe they can avoid all the financial losers. That means defying the laws of financial gravity. Or they can decide to accept the laws of financial gravity. In that case, they must accept that across a basket of riskier investments they will likely not get back all the capital they invested.

Funding true social innovation requires a specific kind of social investor – one that feels that the potential for impact, or social return, offsets the prospect of weaker financial returns or losses.

At SASC we see our fair share of the sort of risky start-up social investment opportunities being described here. In a few cases we have been able to convince ourselves that we can pick a winner, and we have invested, believing that we can generate a financial return that is commensurate with the level of risk. What we have found is that the laws of financial gravity apply to us as well. Backing innovation creates the need for a lot of extra inputs, both financial and human. We have been building up a network of partners who we can work with in these situations where appropriate. Lesson 2 in this report goes into more detail on this topic.

FUNDING TRUE SOCIAL INNOVATION REQUIRES A SPECIFIC KIND OF SOCIAL INVESTOR – ONE THAT FEELS THAT THE POTENTIAL FOR IMPACT, OR SOCIAL RETURN, OFFSETS THE PROSPECT OF WEAKER FINANCIAL RETURNS, OR LOSSES

Our experiences to date have reinforced our view that investing in early stage, innovative ideas is an activity that likely does not fit with the current return expectations of social investment. As a result, most risky innovations targeting impact are, and will go on being, set up in a format where investors can look for the possibility of a big financial winner. In other words, the opportunities will be companies limited by shares that may describe themselves, for example, as "profit with purpose". Conventional venture capital and similar "impact investors" will continue to fund these opportunities because a few big winners will offset the losers to generate a commercial investment return overall for investors.

But we believe this raises a question for donors, asset owners with an interest in impact, and policy makers. Do these groups want to ensure funding can be provided to risky innovations that have high impact, but without the prospect of any big financial winners – for example, because it is charities that are creating the innovations? Currently there is a funding gap. The financial risk/return profile in this area will not satisfy conventional or "profit with purpose" impact investors. Nor does it fit with the current mandate of the social investment market which is, at a minimum, focussed on the preservation of capital.

The article on pages 10-12 explains how we developed our new housing fund as a response to one gap we see in the market. SASC would also be interested in trying to address the different gap described here – the one for funding innovation. As with Social and Sustainable Housing, though, this would only work if it was set up with funding and resources that match the kind of opportunities involved.

LESSON #2

POST INVESTMENT SUPPORT

Grant funded "investment readiness" has been a significant feature of the social investment market over the last six years. Our experience has been that the work done to help an organisation secure investment can create a false sense of security for both the lender and the borrower. Recipients of social investment often find themselves requiring additional skills and resources to work effectively with a new set of external stakeholders, and meet the inevitable challenges of change or growth.

The Social Investment Business published a report last year (*"Strength in numbers"*) looking back over six years of investment and contract readiness programmes. Its authors conclude by proposing a shift of focus away from "investment readiness" and towards "improving resilience". As an investor focussed on lending to small to medium sized organisations, we wholeheartedly endorse this shift to improving resilience and have been testing various ways to make this work. Although still early in our journey, we see some useful lessons emerging.

At SASC we have found that the road towards improving resilience needs to continue long after an investment is made. Investment readiness programmes typically fund an organisation to hire external consultants. Often, the consultant's key task is helping to develop the business plan and build a financial model the organisation can present to potential funders.

But a business plan and financial model only go so far: they are just the start, not the end of the story. They describe what is expected to happen, based on a set of assumptions. But things rarely go to plan. Organisations need the human capacity, knowledge and skill to deal with unexpected events. Social sector organisations are no more able to predict the future than those in the private sector, but they generally have less internal resource. Their management teams are often built around the skills that go into delivering the organisation's core mission. Typically, this leaves little to spare for dealing with the various unexpected challenges or opportunities that might come up. These might arise from funding shocks, restructurings, changes to market dynamics, succession planning, or growth opportunities.

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When these inevitable events occur, we work in partnership with our investees to help them navigate challenges and explore opportunities. As well as providing direct support, we work with a network of partners. These offer services such as pro-bono legal support (via a partnership with Weil, Gotshal & Manges LLP and the TrustLaw platform) or peer-to-peer networking (such as the Social Club).

During the last year, alongside Key Fund, we took part in a pilot programme of post-investment support. Funding for the programme came from Power to Change and the Connect Fund (through the Barrow Cadbury Foundation). Eastside Primetimers worked with six of our investees to deliver support that ranged from financial modelling and support on fundraising to advice on strategic options and planning.

So, what have we learned so far? Feedback from the pilot has been extremely positive and it prompted investees to think about other areas where they could use this type of support. Even so, we can see areas for improvement:

- Avoid "too little, too late". It is better to plug in operational planning or financial management support early on, rather than see an organisation burn through its reserves.
- Ensure there is senior buy-in to the support. If the Board or CEO has not bought into the exercise, then even if the advice is timely, it is unlikely to be heeded.
- Build in frequent feedback loops. In a situation that is often dynamic, creating shorter feedback loops helps ensure that the work continues to meet the needs and capacity of the organisation.

Our experience so far highlights the importance of finding ways of making post-investment support more widely available to our investees. Ideally, this should be part of a multi-year programme. But let's also be open about the challenges this raises for SASC itself. Whether we expand our network of external advisers or build an in-house team, making this work will require new funding. Ironically, social investors often have similar resourcing problems as the organisations they fund and this poses a significant challenge. But as Craig Dearden-Phillips correctly points out in his article on page 17, we must keep in mind how important post-investment support is in helping our investees deliver successful outcomes. Becoming an "invested social investor" is a challenge we accept.