SOCIAL ENTERPRISES ACCESS TO FINANCE

An exploration into the constraints around social businesses access to finance in Portugal

EXECUTIVE SUMMARY

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Quaternaire Portugal

LABORATÓRIO DE INVESTIMENTO SOCIAL

ACRONYMS

B2B – Business to business

B2C – Business to consumer

B2G – Business to Government

EIB– European Investment Bank

EMPIS – Portugal's Social Innovation Mission Structure

FEEI – Structural and Investment European Funds

IIES – Social Innovation and Entrepreneurship Initiatives

LIS – Laboratory for Social Investment

OES – Social Economy Organisations

QP – Quaternaire Portugal

1. Agreeing on concepts and definitions: social enterprises

This report aims to identify the main constraints around social enterprise access to finance in Portugal. The conclusions of the report aim at supporting potential initiatives and products promoted by the EIB group that can tackle the constraints identified by the report and improve the access to finance by social enterprises in Portugal.

According to the framework of this report, social enterprises are all entities (regardless of their legal status, stage of development or approach) whose (1) goods and services are targeted to vulnerable segments of the population and/or (2) integrate vulnerable people in their value chain. The activity of social enterprises is based on the creation of a measurable impact. In English, these organizations are called *social enterprises*. **Annex 1** summarizes the scope of social enterprises analyzed in this report.[12].

2. The challenge: social enterprises lack access to capital

QP and LIS work from the assumption that the majority of social service provision is undertaken by circa 5.000 social enterprises with IPSS status (Social Solidarity Private Institutions). The IPSS status allows these organizations to benefit from Cooperation Agreements, which entails the provision of social services on behalf of and contracted by the State. The total amount of these Agreements is near 1.4 billion of euros per year[3]. As a result, approximately 40% of IPSS' revenues come from these Cooperation Agreements with the Social Security Institute[4].

Notwithstanding the dimensions of State transfers through Cooperation Agreements, a large part of which consists of services delivered to State itself, social enterprises are undercapitalized. The more recent Social Economy data (2013), although with several reporting limitations, reports a need of 412 million of euros for the whole social economy sector in Portugal[5]. Even if not directly comparable with past years' data, these figures demonstrate the financing gap that exists for social enterprises and corroborate the need to mobilize additional sources of financing – banking institutions and other traditional investors (business angels, venture capital funds, among others).

This financing gap leads to a vicious circle: on the one hand, social enterprises do not succeed in finding solutions to mitigate their constraints in accessing capital; on the other hand, banks do not see a market potential among the segment of social enterprises and therefore do not devise financial products that meet their needs. As a result, social enterprises are in a situation of

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[1] Regarding the access to capital, three main types of capital have been considered: donations, debt and investment. In general terms, donations are capital flows without a reimbursement expectation; debt consists of loans in which there is an expectation of reimbursement of capital plus interest; investment consists of acquisition of capital shares of an organization with an expectation of reimbursement plus dividends.

[2] The conclusions of this report only reflect the view and ideas of Quaternaire Portugal and Laboratory for Social Investment, not compromising the EIB Institute.

[3] Social Security Budget (2017), available in https://www.oe2017.gov.pt/wp-content/uploads/2016/10/20161017-mtsss-oe.pdf

[4] John Hopkins Centre for Civil Society Studies (2012), Portugal's Nonprofit Sector in Comparative Context

5 Social Economy Accounts (2016). Lisbon: National Institute of Statistics.

financial vulnerability whilst there is a pressure on the State's budget induced by the increasing prevalence and incidence of societal challenges.

Social entrepreneurship emerges as a movement that brings market-based solutions to solve societal issues in a more efficient and innovative manner. These business models are often called social businesses which entail simultaneously a financial return and creation of impact with the aim of building sustainable business models for the medium and long run.

The majority of social businesses have emerged within already established social enterprises. By coexisting – social business and traditional grant-making / fully subsidized models – they have brought many internal and external challenges. These include gap of management capacity and legal ambiguity, which aggravate the constraints in accessing capital. To mitigate some of these issues, recent trends indicate that social businesses are taking more and more a private company status with a locked social mission.

3. Methodology: an approach based on the specificities of social enterprises' business model

The conclusions of this study are based on a vast set of information sources, including interviews, online surveys and discussion panels (please see **Annexes 4, 5 e 6**).

According to an evidence-based analysis, the conclusions have been interpreted through the lens of the previous experience of QP and LIS in working with social enterprises[6] and investors in Portugal and internationally.

The most important variable influencing the access to capital by social enterprises is their business model, which is only viable when revenues are higher than costs involved in the delivery of services. Looking deeper, even though social enterprises have no specificity regarding their cost structure, there are some particularities concerning the revenue generation model. The main reason for that is the fact that most times, the user of services is not the payer.

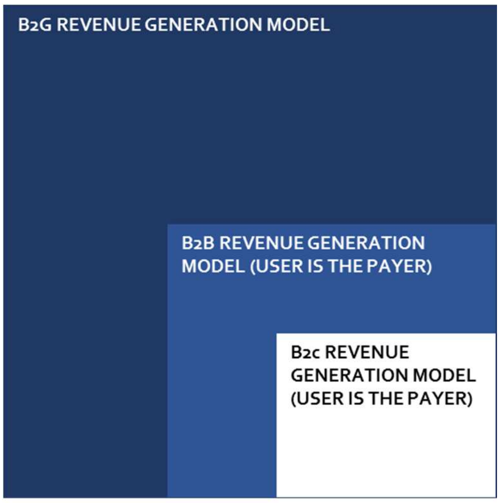
Figure 1 – ***The main elements of a social enterprise business model***

[6] Please note that the variable "business model" as a main factor influencing the access to finance is not exclusive of social enterprises and it is also relevant in other ventures.

Given the importance of the revenue-generating model for social enterprises, QP and LIS have segmented three models: (i) B-to-G, in which the entity sells goods or services to the State; (ii) B-to-B, in which users are usually the payers (see some exceptions in **Annex 3**); (iii) B-to-C, in which the user always pays for the service.

In Portugal, the vast majority of social enterprises work under B2G[7] and B2B models, in which the user does not pay for the service.

Figure 2 – Illustrative distribution of revenue-generating models in Portuguese social enterprises



This figure is illustrative. The size of segments does not reflect quantitative values.

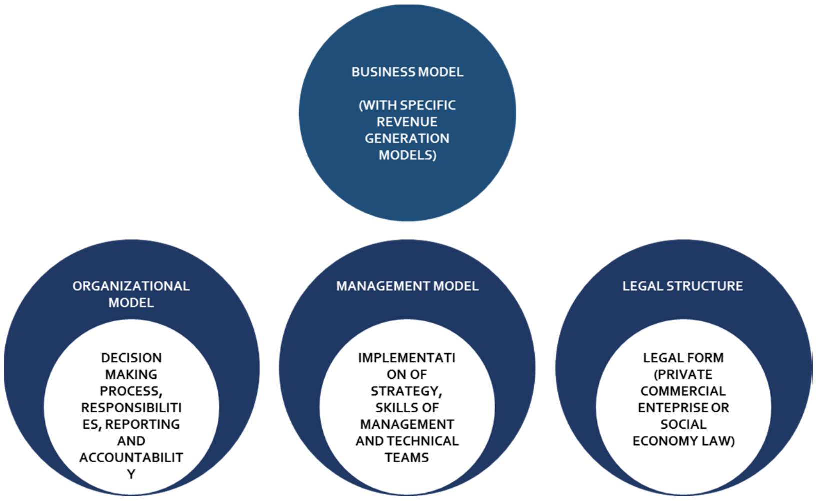
A robust business model (revenues exceed costs) requires efficiency in articulating several dimensions: organizational model, management model and legal status. The work research has concluded that the main constraints faced by social enterprises in accessing capital reflect exactly these dimensions.

7 See annex 2 showing that 40% of IPPS revenues come from Cooperation Agreements with the Portuguese State.

4. Understanding the constraints faced by social enterprises in accessing capital and their implications

The diagram below summarizes the constraints faced by social enterprises when accessing capital.

Figure 3 – *Summary of social enterprise constraints in accessing capital*



4.1 The organizational (governance) model as a constraint in accessing capital

To whom does it apply? This constraint applies mainly to social enterprises with no revenue-generating model (e.g. charities and non-profit associations)[8].

What does it entail? Social Economy Organizations (as defined in the Portuguese Law) are required to have the following statutory bodies: General Assembly, Board of Directors, and Fiscal Council (or a single accountant).

Even though the statutes vary across social enterprises, generally speaking, responsibilities are split as following: the General Assembly is usually responsible for deliberating on material issues, such as approving annual budgets and key strategic goals; the Board of Directors is responsible for ensuring that strategic goals are reflected in daily activities; the Fiscal Council is responsible for financial auditing and ensuring the good financial management of the organization.

When does it become a constraint? It is common for the Board of Directors to be made of non-executive, non-paid members – people who are not involved in daily activities and do not perform executive tasks. A decision of accessing credit will always pass through the Board of Directors. In the majority cases when the Board of Directors is non-executive, it will become

[8] Which is not to say that it applies to all social enterprises or cannot also apply to companies with a social mission.

even harder to make this kind of decision. The social enterprises consulted by QP and LIS pointed this as one the main reasons for not accessing debt instruments.

On the other hand, the organizational model of social enterprises which take a legal status of charity/non-profit association do not foresee the existence of property/ownership of the organization by any of its members. This is directly related to the constraints regarding the legal structure of social enterprises, explained further in this report.

The lack of property rights by the members of the managing board is one of the biggest challenges in the access to credit because banking institutions end up demanding personal guarantees from one or more members of the board. In the many cases where this board is non-executive, and even in cases where it is executive, personal guarantees represent unbearable risks for the managing teams of social enterprises.

4.2. The management model as a constraint in accessing capital.

To whom does it apply? This constraint applies to all social enterprises.

What does it entail? A robust and efficient management model is one that can articulate all the necessary resources for implementing a series of activities of goods and services that generate revenue and impact. A successful implementation and execution depends on the managing and technical teams involved.

When does it become a constraint? Throughout this study, the lack of managing competences in social enterprises was pointed out as one of the main constraints in accessing capital. This view was shared by the social enterprises themselves (demand side) as well as by investors and banking institutions (supply side).

On one hand, social enterprises endure in an environment of great financial vulnerability, thus, the fact that they can still manage themselves, despite their lack of financial health, already indicates some management skills. On the other hand, without adequate access to capital, it becomes difficult for these organizations to invest in improving the competencies of their management and technical teams.

In this context, QP and LIS have concluded that the key management competency in the context of accessing capital is the internal capacity of social enterprises to receive repayable forms of capital, that is, debt or investment. It would be ill-considered to assume that the responsibility of improving these competencies lies solely on social enterprises:

- Social enterprises should organize their teams so that there is a balance between the competencies and skills of the human resources and the activities developed in the context of producing goods and services. They should also work to improve the efficiency of their structures, looking at their beneficiaries as clients to whom they should deliver the best possible service.

- Investors should consider supporting the structure of social enterprises in the moment of deciding which support to give them. Much of the capital flowing into social enterprises comes with restrictions to its use. Namely, it is often intended exclusively for the work with the final beneficiaries, an imposition that leads to vulnerabilities on the structure of social enterprises[9].

In the context of social enterprises, the issue around overheads is particularly relevant, namely due to their need of becoming more and more efficient in service delivery. It is thus fundamental that investors allow and encourage their contracts with social enterprises to include, in an adequate proportion, the financing of structural improvements. Such investment would improve the efficiency, innovation and sustainability of social enterprises. Simultaneously, channelling of public funds towards the modernization, efficiency gains and capacity-building of social enterprises is a way of ensuring that overheads will be included, in the rightful proportion, in the pricing of services.

This point supports one of the main learnings resulting from the interviews and surveys: the need to work alongside investors in educating them towards the needs of social enterprises. In the same way that the use of repayable capital by social enterprises is a novelty for them, it is also something novel for investors. Public and supranational entities have a key role to play in the education of both sides and in mobilizing catalytic market-building investors[10].

4.3. Legal structure as a constraint in accessing capital.

To whom does it apply? This constraint applies to Social Economy Organizations (as defined in the Portuguese Law, i.e., social enterprises with legal status of NGO, non-profit association, cooperatives and mutuality).

What does it entail? In this context, the legal structure of social enterprises refers to its juridical form. These include non-profit association, cooperative, NGO, private company limited by shares, among others. Social enterprises can exercise their activities assuming one of the forms described in Lei de Bases da Economia Social, the main law regulating the social economy in Portugal. Alternatively, they can take up one of the forms regulated by Código das Sociedades Comerciais. The Portuguese law does not envision the existence of hybrid models (such as Community Interest Companies in the UK), which would combine elements of social enterprises and elements of traditional commercial enterprises.

[9] At an international level, this constraint is known as the overhead myth.
[10] This point is developed further in the recommendations section.

When does it become a constraint? The limitation around property rights on some social enterprises (as defined in the Portuguese law) often constrain the access to capital.

Furthermore, the law has not yet caught up with the development and proliferation of social businesses, which have some specific characteristics:

- They focus simultaneously on creating impact and generating revenue;
- The most prevalent revenue models are those where the users are the payers;
- Because it is a recent movement, most social businesses are in the start-up stage.

The results of this study were in line with the widespread idea that, in the universe of social enterprises, debt instruments are not the most adequate: on one hand, during start-up phase, revenues are not steady, which makes meeting the usual credit periodical payments very difficult; on another hand, at an initial stage these enterprises look for investors that are willing to share with them the risk and the return linked to the success, or lack thereof, of the project. For these reasons, they typically have the need to access a different type of capital: equity investment.

Paradoxically, following the current legislation, it is not possible to make an equity investment in any social enterprise that has one of the legal forms predicted in Lei de Bases da Economia Social, as these have no capital or shares that they can issue to investors (because they are not the property of their members). The fact that these social enterprises cannot access equity investments means that there are no investors available to share the risk and the return with them.

This risk-sharing would be key in creating incentives for investors and social enterprises to work together towards the viability of the business model, as it happens in the technological start-up ecosystem. As a positive externality, this incentive structure would also push, with investor support, the capacity-building and professionalization of the management teams in these organizations[11].

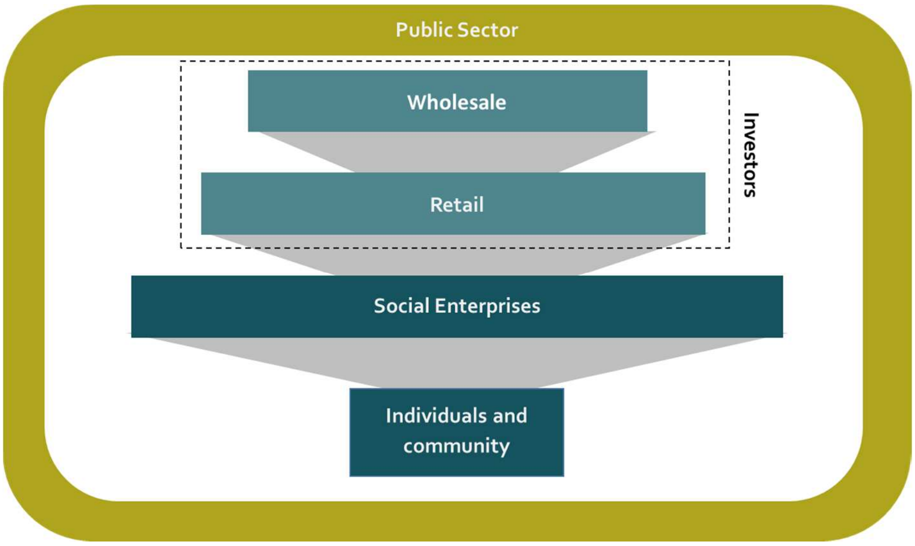
5. Recommendations: action points to tackle the constraints of social enterprises in accessing capital

The recommendations are based on the analysis of qualitative and quantitative data collected from investors, social enterprises, and the public sector throughout this study. Some of the recommendations were made directly by the people inquired, whilst others were formulated based on QP and LIS' interpretation of the information collected.

[11] This incentive for investors and organizations to work together towards capacitation, contributes to the mitigation of the constraints identified in the section "The management model as a constraint in accessing capital".

So as to make the recommendations as objective as possible, we segmented them by stakeholder as depicted in the diagram below.

Figure 4 – Stakeholder-based approach for recommendations



5.1. Recommendations for wholesale investors

In the group of wholesale investors acting (or with the potential to do so) in Portugal, we include Portugal Inovação Social (EMPIS) (see further details in **Annex 7**) and the EIB Group.

Within this category of stakeholders, it is relevant to point out that there are a number of initiatives in Portugal that are still in their development stage and that will potentially improve the access to capital by social enterprises. An example of this is EMPIS' Fund of Funds for social innovation. Even though there is still no public information about this fund of funds, it is expected that it will alleviate many of the constraint identified in the access to credit, namely the constraints related to guarantees.

Regardless of the initiatives under development, the main recommendations for wholesale investors are:

(i) Finance risk, so that is becomes easier to mobilize private investors. In the case of credit instruments this could be done by reallocating funds, currently provided by the State and other social investors donations, to a guarantee instrument for loans provided by the private sector. In the case of equity investments, wholesale investors can finance risk by "withstanding" risk-return asymmetries. The role of wholesale investors such as EMPIS and the EIB Group should focus on mitigating market insufficiencies. As long as private investors see social enterprises as high risk, the access to capital will only improve if this risk is mitigated by a stakeholder that can assume that risk.

(ii) Articulating EIB Group's activities in Portugal and those of EMPIS. The existence of similar initiatives at a national level (Portugal) and at a European level, should strive for complementarity, not duplication. An example of such situation is the similarities between the Fund of Funds from EMPIS and the Fund of Funds for Social Innovation promoted at a European level by the European Investment Fund (Social Impact Accelerator, SIA). So that options are clear for private investor in Portugal, there should be complementarity between the two initiatives.

Ideally, the initiatives of these two bodies (EMPIS and the EIB Group) should work symbiotically. For example, ensuring that SIA can invest in Portuguese social innovation retail funds that have EMPIS' fund of funds as a shareholder. This would lead to a more effective mobilization of private investors.

These recommendations aside, entities like those in the EIB Group and EMPIS play a key role in educating private investors through the dissemination of information and promotion of case studies that show the viability of investing in social enterprises.

5.2. Recommendations for retail investors

This type of stakeholder mainly includes, among others, banking institutions and private investors such as business angels, venture capital funds, and companies.

The recommendations for retail investors can be split by products and approach:

(i) Development of new products adapted to the needs of social enterprises. Throughout the interaction with social enterprises, two types of financial products were repeatedly mentioned as strongly necessary: factoring and flexible cash-flow solutions. The development of customized products for social enterprises could lead the banking sector to look at the social economy as a specific client segment.

Factoring products are relevant for social enterprises because they allow them to sell its account receivables (i.e. invoices) to banking institutions at a discount, to meet its immediate cash needs. This type of products would provide a much-needed liquidity to social enterprises for whom that is a key constraint.

Flexible cash-flow solutions would allow for more flexible payments to banking institutions, aligning them with the timings in which they receive the payments for their projects. This is particularly relevant for social enterprises whose activities are financed by the State or supra-national organizations, where they often have to advance much of the financing upfront and where delays in payment are relatively common.

If these solutions would allow for instalments to be paid to banking institutions on the timings of the projects, rather than on the timings usually defined by the banks, social enterprises would access credit much more comfortably, arguably with little increased risk for the banking institutions.

(ii) The adoption of a new approach towards financing the structure of organizations with a social mission. QP and LIS recommend that retail investors become more open to the idea of financing the structure of these social enterprises, particularly regarding risk evaluation. This recommendation applies to banking institutions, companies, business angels and venture capital funds.

As pointed out in the "Management Model as a constraint" section, the reluctance in financing the structure of social enterprises that many investors display is one of the main barriers to ensuring efficiency and readiness to receive repayable forms of capital. As happens in the private sector, social enterprises need to invest in their structure and team, especially in process improvement, human resource development and attracting talent. Without these investments it becomes difficult to ensure the quality and improvement of goods and services. Thus, investors should accommodate in their contracts the progressive financing of structural improvements in the organization, oriented towards a greater impact.

5.3. Recommendations for social enterprises

In order to improve their access to capital, social enterprises should focus on the following:

(i) Accessing capacity-building and acceleration programmes. Social enterprises that are looking to maximize their impact on their beneficiaries must be efficient, innovative and well managed. Furthermore, the organizations whose goal is to access repayable capital must have internal control systems that will guarantee their ability to repay the capital received. Both cases require appropriate management competencies. QP and LIS suggest that social enterprises explore EMPIS's instruments: "Capacitação para o Investimento Social" (capacitation for social investment) and "Parcerias para o Impacto" (partnerships for impact), as a way of addressing their internal needs.

Furthermore, we recommend the development and launch of capacity-building programs focused on internal organization, management, efficiency, value creation, and ability to measure and report impact. The goal is to increase the autonomy of the social enterprises in relation to the State, either regarding capacity-building on an initial phase, either through acceleration processes that will foster growth and access to new financing mechanisms.

(ii) Improved understanding of the available financial mechanisms. The majority of social enterprises surveyed and interviewed by QP and LIS have mentioned some reluctance to access debt instruments and would only do it in extreme necessity. However, there are several financial products that can support social enterprises in making relevant investments in their activities with a moderate risk. Such products include equity crowdfunding (e.g. Seedrs) and peer to peer lending (e.g. Raize). In both cases, the capital raising processes are quick, flexible and less bureaucratic. As a result, they are cheaper (lowering the cost of accessing capital). Given that these instruments are also crowd-based, they entail a positive externality through the validation from the crowd on the goods and services of social enterprises.

5.4. Recommendations for public sector entities

The public sector is the main source of funding of social enterprises in Portugal. The actions that public sector entities can undertake to improve the efficiency of social enterprises does not necessarily demand an increase in funding but rather a different approach. As a result, the main recommendations are rather systemic:

(i) Outcome-oriented Cooperation Agreements. Public sector entities can test new contracting models with social enterprises which are based on outcomes and there is a clear link between the financial flow and the outcome (not the output) achieved. A first step would be through pilot projects that demonstrate the benefits of such contracting methods. Based on an initial track record, more social public services can be subject to outcome-based contracts with the aim of improving efficiency, savings and, ultimately, promote innovation. There is already a pilot project of an outcome-based contract in Portugal by the Municipality of Lisbon, whose payment is subject to an improvement in educational attainment compared to a live control group. The project is Code Academy Jr and delivers computer programming classes to primary school students with the aim of improving their educational attainment in math and reading.

(ii) Create a specific legal status for social enterprises. QP and LIS consider that tapping into equity investors is fundamental to amplify the impact and improve the efficiency of social enterprises. Therefore, a legal status that allows social enterprises to issue shares and therefore raise equity investment is the main condition for it to happen. International experiences in the UK, Italy, France and USA have shown that it is possible to have legal structures that are a hybrid between social enterprises and private commercial enterprises.