INFORMATION SHEET 4

RAISING FINANCE

Social Enterprise Legal Toolkit

SOCIAL IMPACT HUB

sfl Centre for Social Finance Law

RAISING FINANCE FOR SOCIAL ENTERPRISES

Once you have a clear idea of your mission and business opportunity, you will likely need access to finance to get started. Traditionally, not-for-profits have been supported with government grants and philanthropy – but how can social enterprises attract the right funding to help them scale?

Beyond initial help from friends and family, government grants and philanthropic efforts, there are many financing options for social enterprises. From debt to equity and impact investment; the types of finance you can utilise will depend on your legal structure.

Tax deductible donations can only be made to charities registered with the ACNC with deductible gift recipient status, which are typically companies limited by guarantee or incorporated associations. Grants and donations can be made to for-profit for-purpose companies, but they will not be tax deductible.

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Equity finance is not available for charities and not-for-profit structures because they do not have shareholders or owners. **Debt finance** is available for all of these structures but there must be sufficient financial capacity to repay. Later on in this information sheet, there is further detail about both of these options.

It is important to recognise that the need for finance and your ability to raise finance depend on the stage of your growth journey. At the beginning, personal resources, loans from family and friends and sweat equity may be all that is available. As an enterprise grows, it may be possible to access some grants and possibly debt finance if the business model is sufficiently robust. If the enterprise is capital intensive or has significant development costs, such as a tech related business, the most likely option will be equity finance.

See our case studies for examples of how this has worked in practice. Chuffed is a good example of a tech related business that needed to change its structure to access equity capital.

Some financiers have remarked that a social enterprise needs to be open to accepting whatever finance it is able to access.

WHO CAN INVEST?

Angel Investors

- An angel investor is usually a high net worth individual who provides financial backing for small social enterprises and often can be found among an entrepreneur's family and friends. The angel investors could provide a one-time investment or potentially an ongoing injection of funds.
- They tend to provide more favourable terms compared to other lenders since they usually invest in the entrepreneur starting the business, rather than the viability of the business. Angel investors are generally more focused on helping social enterprises take their first step, rather than the possible profit they may receive from the business. In this way, they can be distinguished from venture capitalists.
- Investing in early stage enterprises is considered risky and usually does not represent more than 10% of an investor's total portfolio.

Family and friends

- This is a common source of early-stage financing for businesses, as it can help them meet their initial capital needs. The funding usually comes from the founder's networks of friends and family. Typically, these investors are individuals willing to invest anywhere between $10,000 and $150,000 because they feel loyalty and affection for the founders or are motivated by their business idea.
- Given the close personal connection, entrepreneurs may be tempted to accept these investments without following the corporate formalities that institutional investors require.
- Even when you receive funds from those closest to you, you should make it a practice to carefully document each investment. This will help avoid future conflicts, while ensuring there is a proper foundation for future investment.
- This round of funding could come in two forms: debt or equity. Financing with debt is a great option if you can afford making repayments but this is not the case for most businesses starting up. In the early stage, sustainable cash flows are often difficult to achieve, making equity raising a more attractive option.

Venture capital

- Venture capital is financing that investors provide to businesses to facilitate long-term growth. Venture capital funds are usually capitalised by high net worth individuals, family offices, investment banks, and other financial institutions. Venture capital does not always take a monetary form, and can also be provided in the form of technical or managerial expertise.
- The main downside for this source is that investors usually receive a substantial amount of equity in the company and, thus, have a say in company decisions. Most venture capitalists are profit-driven, and so their actions could potentially conflict with the overall social purpose of a social enterprise.

IMPACT INVESTMENT

Impact investments are investments made into companies, organisations, and funds with the intention to generate measurable social and environmental impact alongside financial return (Global Impact Investment Network GIIN).

Impact investments:

- Are intended to generate measurable social or environmental impact
- Exist across all asset classes and sectors
- Are expected to be repaid

The International Finance Corporation's latest estimate of the market size for impact investments shows that $2.3 trillion was invested for impact in 2020. The market is growing rapidly and there are an increasing number of investors motivated by impact.

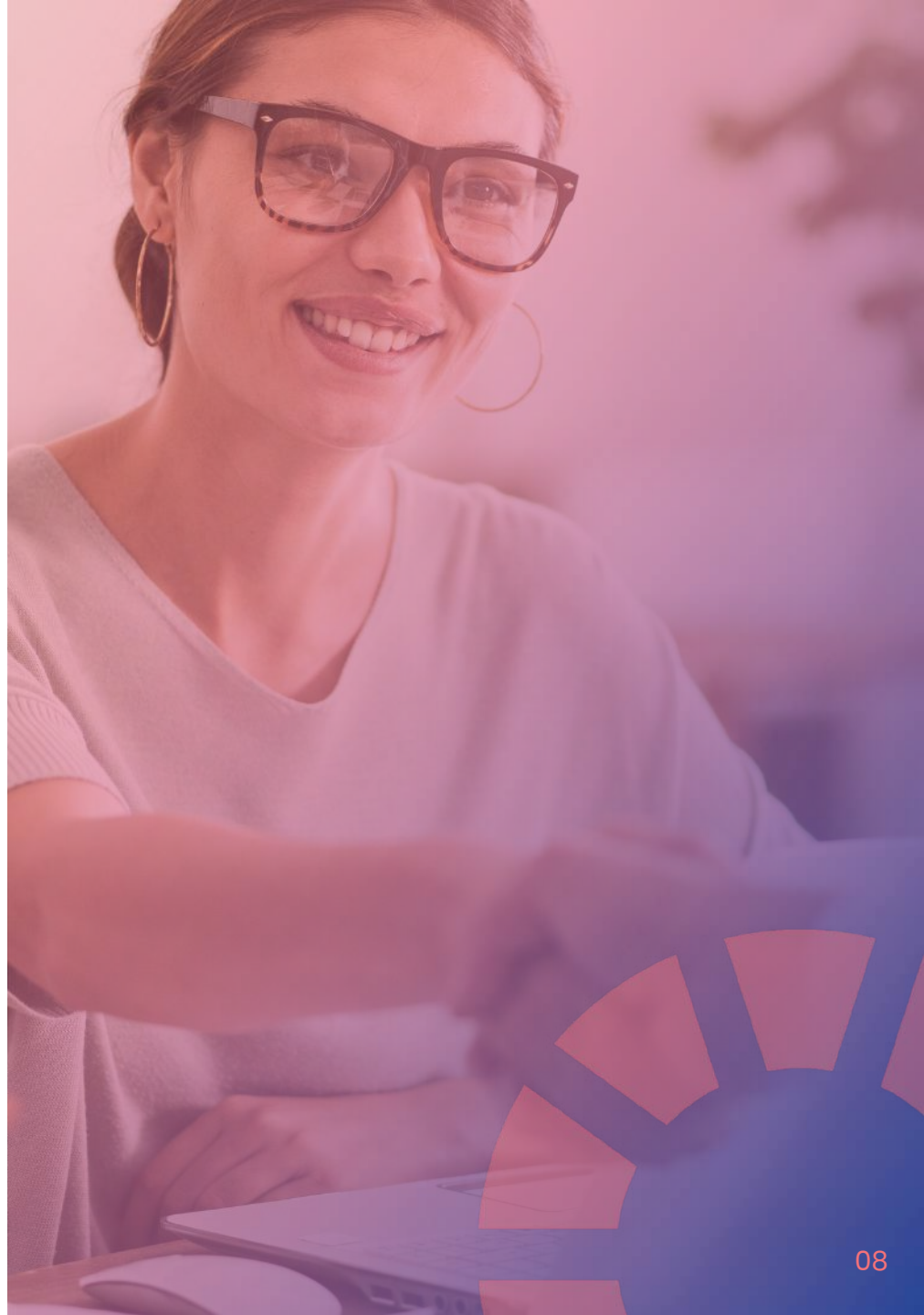
There are many other terms that are used, sometimes interchangeably, to describe various investment approaches. **Responsible investment** is defined by UNPRI (a group of the world's largest institutional investors) as a strategy and practice to incorporate environmental, social and governance factors in investment decisions and active ownership. **Ethical investment** typically refers to investing in mainstream companies but avoiding those causing social harm, such as tobacco and gambling. Within impact investing, financial returns vary from market-rate to below market (also known as concessionary impact investments or impact first impact investments). This is closer on the spectrum to philanthropy.

Impact investment can take many forms and the market is growing quickly, as more people are seeking an ethical and purposeful home for their money. Social Impact Hub has many useful resources about impact investing. We also suggest you have a look at https://www.impactinvestinghub.com.au/.

EQUITY FINANCE IN MORE DETAIL

Capital raising

- Equity capital raising is the process of raising capital through the sale of shares in the company. A social enterprise that grows into a successful company will likely have several rounds of equity financing as it evolves with potential investors. These investors could include angel investors, venture capitalists, private equity firms, and corporate investors; each with different motives for investing and varying levels of involvement with the social enterprise.
- To achieve a successful round of equity capital raising, it is important for the social enterprise to develop a comprehensive business plan, outlining its purpose, clarify the market gap and analyse current competitors in the field, amongst other things. Social Impact Hub has developed other resources to assist with investment readiness.

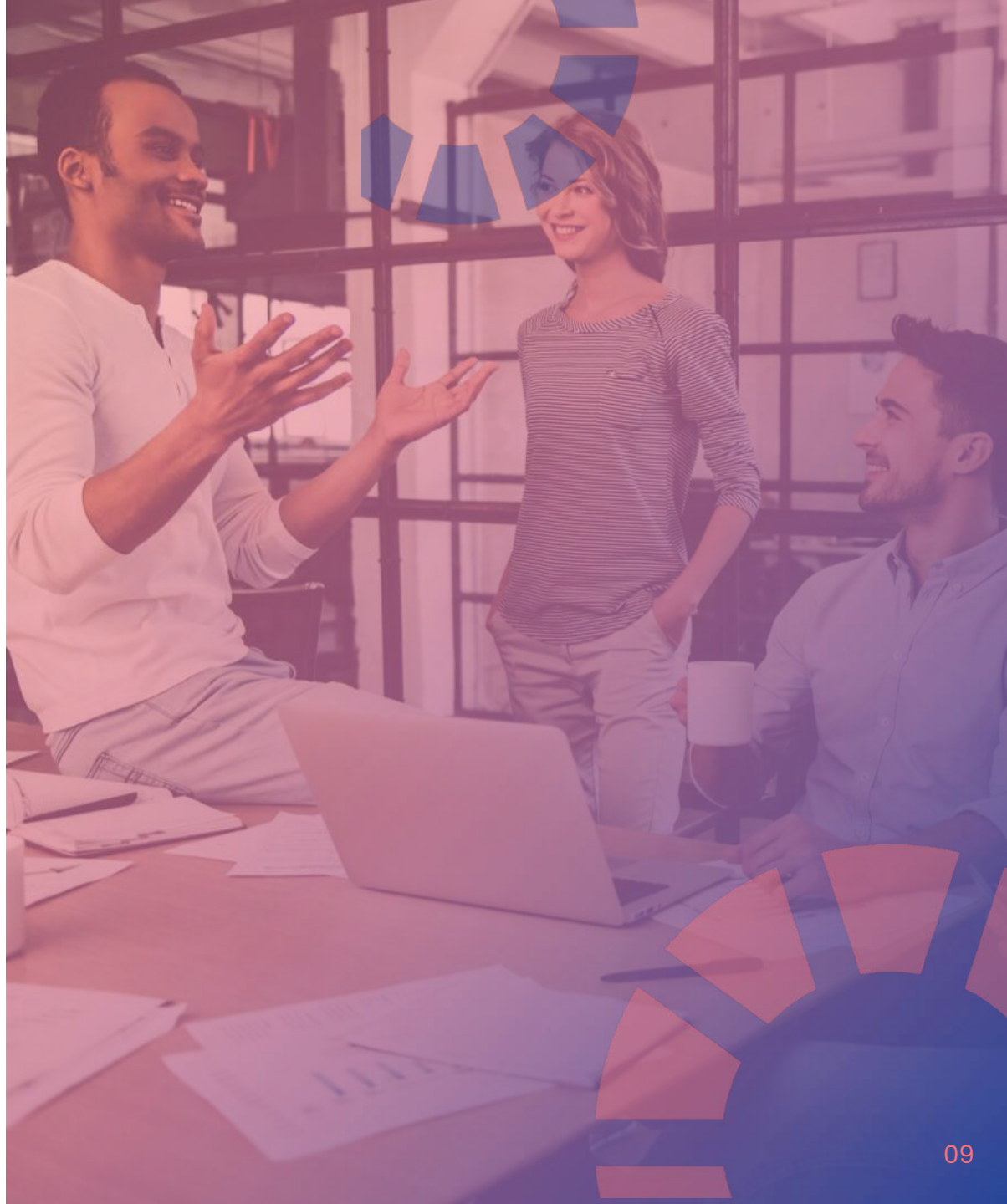


Crowd-sourced equity funding

Equity crowdfunding is the use of small quantities of capital from a large number of people to finance a new business venture, in exchange for shares and a percentage ownership in the company.

New rules for crowd-sourced equity funding came into force in 2018 ASIC Crowd-sourced funding. A company can raise up to $5m per year and individual investors can invest up to $10,000 each for shares in the company.

For example, Food Connect is an ethical food social enterprise that aims to create a fairer supply chain for distributing food by connecting local farmers with local buyers. It was able to raise over $2m in 2018 for the purchase of the building which it had rented for a number of years.



DEBT FINANCE IN MORE DETAIL

Loans

Debt finance is the simplest form of finance and can be used at any time in the growth cycle of a social enterprise, providing that adequate security or cashflow is available.

There are specialist financial intermediaries who provide debt finance to social enterprises such as Social Ventures Australia, SEFA and Foresters Community Finance.

When providing loans to social enterprises, a lender will generally focus on your ability to make social impact and ability to repay.

Some of the specialist lenders have specific funds set up to lend to social enterprises, therefore they will look closely at the social purpose of your enterprise. A mission lock in your constitution or an independent director to advocate for the mission are often useful to demonstrate that your purpose is embedded in your social enterprise.

Impact should be measurable and an integral part of the business activities. Many financiers have commented that it is challenging enough to run a successful business, let alone do good as well. In making an impact, it is worth considering focussing on doing one thing really well, rather than trying to have impact in every possible way.

For a social enterprise just starting, it may be difficult to access debt funding because lenders often require a 2 year track record. Having access to property that can be mortgaged or assets that can be given as security (such as plant and equipment), or personal guarantees from founders will assist.

If no security is available, a lender will require greater confidence in cashflows. Financiers will look at all aspects of your business to ascertain the robustness of your cashflow, for example customer base, margins and ability to change prices. There may also be implications for the rate of interest that is charged – a higher rate being needed to compensate for extra risk.

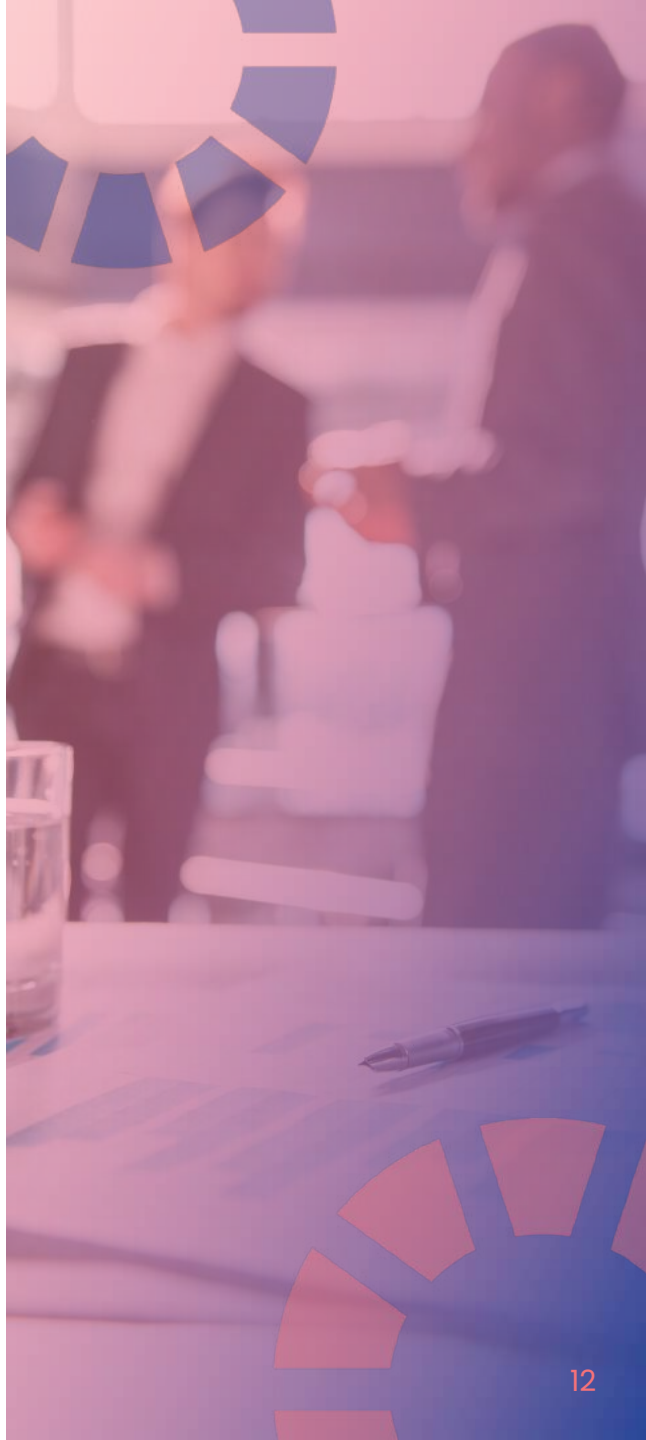
Lenders will carefully consider your governance structures. The board structure (do you have a small number of directors, or an advisory board?), board composition (does your board have people with all of the skills needed?) and the relationship with and calibre of the management team will likely all be considered.

There are a range of financial intermediaries – the big four banks, regional banks, supply chain finance specialists and the social enterprise focused intermediaries mentioned above. Traditional banks are increasingly providing finance for social enterprises. The specialist social enterprise lenders often provide a bespoke service and also focus on capacity building. They may lend for longer terms with a higher loan to value ratio. Traditional lenders might have a more standard product, but their rates could be cheaper since they usually have a lower cost of funds.

The conditions and structure of the loan will be impacted by the availability of security, security of cashflow and borrowing amount. Lenders also tend to look favourably on a founder who has contributed their own funds or “sweat equity”.

Blended finance can be attractive to social enterprises – part debt, part equity, part grants. Some interesting blended finance transactions have been arranged, but they can be time consuming and complicated to document, particularly if there are a range of investors involved – for example, government, philanthropy and venture capital. Different stakeholders such as these will have very different motivations and requirements, so fairly sharing risk and return can be challenging.

In an ideal world, many social enterprises would obtain “patient” capital – finance from someone who believes in your cause and is willing to wait for a long term pay-off, even perhaps providing top-up funds along the way. Having third party investors also gives credibility to your business and is attractive to financiers.



Supply chain and payment finance

Particularly for social enterprises involving manufacturing overseas and sales into Australia or elsewhere, there are a range of financial institutions who specialise in trade finance, debtor finance and payment solutions. These are traditional forms of debt finance, but since they are tailored to supply chains, they operate differently to a bank loan and the security requirements may be different.

GOVERNMENT FUNDING

Government grants are financial awards paid by government authorities. It is a “gift” in the sense that the amount offered does not have to be repaid, and it is typically rewarded for ideas that facilitate the provision of public services and stimulate the economy. Receiving a government grant is a prestigious achievement which often helps social enterprises gain recognition within both the for-profit and not-for-profit space.

Stringent compliance and reporting obligations will generally need to be adhered to. Grants can be available for any organisation, but many require Deductible Gift Recipient (DGR) status (which is only available to charities registered with the ACNC who meet specific criteria).

Grants are becoming harder to find and many social enterprises are increasingly focused on creating a sustainable business without reliance on grants.

It is generally best to look at the State government grants programs for more information, for example the Queensland Social Enterprise Grants Program.

OTHER

If you are looking for other avenues of funding, Australia has an ecosystem of other platforms that offer monetary incentives, ranging from cash prizes to grants and equity capital. There are also many crowdfunding platforms which raise funds from everyday people who are passionate about social causes. Some of these are listed below:

Accelerator programs

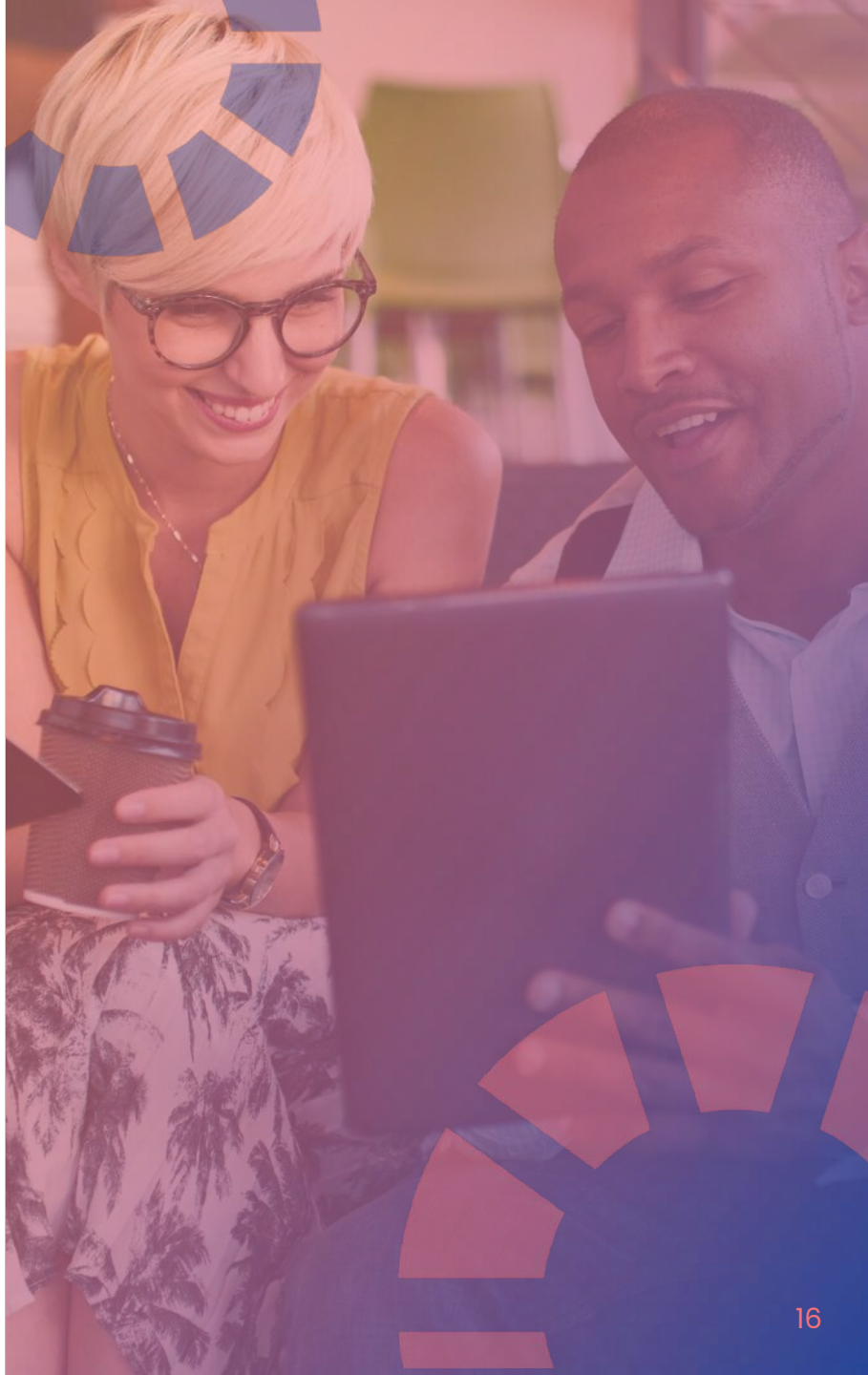
Programs specifically designed to help social entrepreneurs create and grow sustainable social enterprises. These programs offer access to experienced mentors, and the opportunity to pitch to potential investors. Social Impact Hub's Scaling Impact accelerator program is focused on impact investment readiness. See Social Change Central for more information on other programs.

Competitions

Competition winners often receive cash awards, which may help them scale their businesses without sacrificing equity or taking on debt. They can also be a great way for your business to gain recognition and attention.

Reward based crowdfunding

Reward-based crowdfunding offers rewards (e.g. social media shout-outs, thank you notes or pre-orders of the promised products) in exchange for funding. This method of crowdfunding has the benefit that social entrepreneurs do not have to sacrifice any company equity in exchange for funding. Meanwhile, for the crowdfunders, it is essentially an opportunity for them to gain early access to the products they believe in, but are not yet available for sale to the general public. This type of crowdfunding has been used for artists to raise money for one-off projects and in many other circumstances. Three of the websites operating in Australia are StartSomeGood, Pozible and Kickstarter.

Resources

Since most social enterprises start as small businesses, you can refer to government websites designed to assist small businesses with finance, for example Business Victoria – Sources of Finance, as well as the websites of the big banks, regional banks and the specialist impact intermediaries such as SVA, SEFA and Foresters.