

INQUIRY INTO FINANCE FOR THE NOT FOR PROFIT SECTOR

Submission to The Senate Economics References Committee

Mechanisms and options for the development of a capital market for social economy organisations:

Social Traders welcomes the opportunity to make this brief submission to the Senate Economics References Committee's current inquiry into financing the not-for-profit sector.

Social Traders is a non-profit company established in 2008 to support and encourage the establishment of commercially viable social enterprises throughout Australia.

A social enterprise is an organisation led by an economic, social, cultural or environmental mission with demonstrable public or community benefit. It trades to fulfil its mission, derives a substantial portion of its income from trade, and reinvests the majority of its profits to fulfil its mission.

Social Traders makes this submission in its capacity as an independent and specialist social enterprise development organisation that works with government, community, business and research partners to:

1. Open up markets for social enterprise;
2. Increase the trading capacity of social enterprises; and
3. Increase finance available to develop social enterprise.

Social Traders regards this inquiry as timely for several reasons:

- There are many individual entrepreneurs, community organisations, and consortia with excellent ideas for market-oriented solutions to social problems, but who lack access to capital as well as the business development support required to make their access to capital a sound investment proposition.
- There are potential funds available in corporate and private philanthropy to invest in social, environmental and cultural impact, but at this point in Australia there is insufficient experience of social investment other than existing practices of corporate social responsibility and grant-making.
- Social innovation and in particular social enterprise needs new forms of resources beyond those directly grant-funded by Government and philanthropy.
- Evidence of a shifting culture in grant-making towards social investment; increased recognition by philanthropic funds of convergence between investment and grant-making strategies and choices.
- The Government's investment in social enterprises through the DEEWR Innovation Fund and the Community Jobs Fund in recent years indicates the need for a different structure and decision-making process to determine the feasibility and investment-worthiness of social enterprise proposals.
- There is growing expertise and momentum towards establishing ways of measuring social impact in order to establish return on investment. Though these are far from being widely understood, broadly agreed or readily accessible, the emergence of more social investment opportunities will accelerate the need to develop and apply measures that link finance to demonstrated social impact.

Social Traders' response to the questions presented in the terms of reference for this Inquiry is derived from our experience of:

- Direct investment in social enterprises through Social Traders' Social Enterprise Development Fund and associated development and support initiative 'The Crunch, which invested around \$950,000 in ten start-up social enterprises in its 2010 pilot year.

- Assisting social enterprises to become financially sustainable and/or investment-ready.
- Research on the social enterprise sector (Finding Australia's Social Enterprise Sector project) and on the development needs of social enterprises.
- Research and policy development on social impact measurement.
- General information, social enterprise development and networking support provided to social enterprises from around Australia.

Finance and credit options available to not-for-profit organisations, social enterprises and social businesses, the needs of the sector and international approaches

Development and growth of the social enterprise and social innovation sectors in Australia is constrained by a lack of available capital. Moreover, the majority of capital available to the not-for-profit and social enterprise sectors is grant based funding from government and philanthropy. In many instances these grant-based funds employ mechanisms of assessment and disbursement that are grounded in traditional 'charitable' models and not structured to support the establishment of viable and sustainable social initiatives.

The Federal Government's commitment to establish the Social Enterprise Development and Investment Funds (SEDIF) is a significant and positive development in the Australian social finance landscape. However, it will not exist as the sole vehicle seeking to attract sources of finance for social investment. Organisations such as Social Ventures Australia, Foresters Community Finance and Social Traders (see below), along with individual social enterprises such as GoodStart, Hepburn Wind and the Mt Buffalo Community Enterprise are all looking to raise capital.

In the social enterprise sector, the lack of financing options is felt at all stages of the business cycle. There is a lack of financing available for establishment, working capital, development and asset acquisition, sustainability and consolidation and growth.

Social Traders view is that the biggest gap relates to finance available for start-up and the early-stage development of social enterprises. Social Traders has actively chosen to address this gap through the establishment of its Social Enterprise Development Fund (SEDF). The SEDF is Social Traders investment vehicle for 'The Crunch' initiative that provides an integrated model of mentoring and business planning prior to financial investment. In its pilot year in 2010, nine social enterprise ideas were selected for 'The Crunch' to participate in a five month program of mentoring and support to develop a rigorous and detailed business plan. Of the nine participants, Social Traders made investment offers from its SEDF to five totalling \$702,000, of which \$410,000 is repayable as patient capital at sub-commercial rates of interest.

The design of 'The Crunch' and the investments made through the SEDF serve to highlight the needs of the social enterprise sector:

- The high-risk nature of a start up venture is exacerbated by the typical lack of business experience and knowledge of 'social entrepreneurs' and those in the community and not-for-profit sectors more generally wishing to establish a social enterprise. It is important that any financing mechanism controls for this risk and provides capacity building support.
- Most social enterprises will not yield high profit margins, due to the additional commercial pressures imposed by their social objectives. Therefore, financing often needs to be tailored to allow for longer repayment cycles and a longer time to achieve a cash-positive position.
- In Australia, the lack of a not-for-profit legal structure that allows equity capital to be generated severely constrains the development and growth potential of these organisations, and forces debt financing in those instances where equity would be a more suitable form of capital.
- The frequent lack of business experience and knowledge of those in community-benefit organisations leads to a reluctance to take on debt to achieve sustainability and growth. This is

particularly the case in smaller organisations, even if it were available. This tendency to avoid debt financing, constrains the potential for the community sector to innovate and address Australia's social issues independent of ongoing grant based financial support from government and other sources.

An unintended outcome of providing finance could be a reduction in the social impact due to the high costs of initial capital investments needed. It is important that finance available to the not-for-profit and social enterprise sectors should not significantly dilute the social impact due to the costs of raising the capital, especially where social ventures of the kind cited here are regarded as a way to bring private investment into addressing previously government-financed services.

Strengthening diversity in social business models

The development of a diversity of models that achieve social impact through business is contingent on there being customers for the goods and services produced. Government has a major role to play at the local, state and federal levels to mitigate some of the perceived revenue risks of providing capital to social enterprise. Government can play an important role as a purchaser of both standard good and social outcomes through 'social procurement' and a key influencer in the development of social procurement practices in Australia.

The Victorian State Government is a leader in this area through its 'Expert Support Panel' project, which is supporting the development of social procurement practices for local government. This work is aimed at unlocking the strategic value for government in their procurement budgets – through purchasing goods and services that deliver broader public benefit and social outcomes from social enterprises and the not-for-profit sector more broadly, government is able to purchase social outcomes in addition to the products in question.

Similarly, government has a key role in investing in the development of "purchasing directories" and promotion of these resources. Directories, such as those produced by the Australian Indigenous Minorities Supply Council, the Industry Capability Network, Australian Disability Enterprises and "Ecobuy" in Victoria, play an important role in stimulating demand for the products of social businesses. Social Traders is in the process of developing 'The Social Enterprise Finder', an online directory of social enterprises across Australia. 'The Finder' will enable government, corporate and community organisations and individuals to purchase and procure from Social Enterprise.

Incentives to support investment in the sector

Investment in social enterprise and other forms of social innovation is constrained by the lack of an effective legal structure and associated tax incentives for investors. Many social enterprises, despite achieving significant and long-term social impacts and having a legal structure that does not allow the distribution of profits or surpluses for personal gain, are not eligible for Deductible Gift Recipient status; rendering them unable to attract significant funds from philanthropy, unable to raise capital from equity and unlikely to be able to access commercial finance due to a perception of high-risk by commercial lenders and low profit margins that hamper their ability to service traditional financial products.

Other social enterprises, such as many community enterprises, community banks and co-operatives have a for-profit legal structure *and* achieve significant social impact. While there is an opportunity to raise capital from equity or in the case of co-operatives from members, there is not the opportunity to access tax-deductible philanthropic capital and many have profit margins that preclude commercial lending.

The establishment of a hybrid legal structure that would enable access to equity capital and tax-deductible finance (both debt and gift) would serve to stimulate investment in the social capital market. It would facilitate and promote the social enterprise and not-for-profit sectors to adopt a more commercially robust and viable way of operating based more on social investment rather than grant dependency.

Thought should also be given to the role of organisations that work to increase the capital available to social enterprise and the community sector more broadly. Organisations such as Social Traders,

Foresters Community Finance and Social Ventures Australia devote considerable resources to raising the broader community's awareness of the important place that social investment and philanthropy has in addressing social issues in Australia. Social Traders' work increases the 'investment readiness' and viability of social enterprises by providing capacity building support and generating market opportunities. We also endeavour to attract social investment from private and corporate philanthropic sources - work that is impeded without an appropriate tax structure that acknowledges philanthropic contributions to social enterprise as important in addressing some of Australia's most intractable social issues.

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