Finance For The Not For Profit (NFP) Sector

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Introduction

Christian Super, as a fund with a strict mandate to make investments that uphold high Environmental, Social and Governance (ESG) standards, we are keen to expand our investment options and we consider the social economy sector as a good complement to our current investment portfolio. Although we seek investments with high social value, we also have a fiduciary duty to our members to maximise their financial returns and minimise the risk. It is in our interest therefore, that a robust capital market for social economy organisations be developed so that we can mitigate some of the risks currently existing in the sector.

It is with this background that we would like to participate in the ongoing dialogue on mechanisms and options for the development of robust capital market for social economy sector in Australia. As an investor who is currently considering investing in the sector, with particular focus on Community Sector Organisations (CSOs), we believe we can bring some useful insights based on our experience so far and our vision for the sector.

Areas of improvement for the social economy sector

As an ethical investor, we are concerned about both the ethical and financial value of any investment we make. Although there is still a need to develop robust tools to measure the Social Return of Investment (SROI) of the work that CSOs do, we would be comfortable with well-defined and articulated, albeit hard to measure, goals. However, the greater challenge is making a financial assessment of the investment. With that in mind, we thought it might be useful to outline below some commercial focus areas that would be helpful for the social economy sector to adopt if they are going to be an attractive option for the general investment community:

- Valuation – For commercial businesses there are already well developed tools to measure the value of a business based on, for example, expected future cash flows or the price that the market is willing to pay for a similar business. Additionally, these tools can be used to value the collateral in case that the business wants to secure future borrowing. However, current tools are mostly not applicable to CSOs because of lack of predictable cash flows. However, as outlined below, the security of recurrent government funding provides some increased cash flow certainty. Similarly, it is hard to value social sector's assets capital growth potential as there are no mechanisms or markets to realise capital gains.
- Transparency – CSOs that raise money from the public have detailed disclosure regime due to regulatory requirements and more importantly due to the fact that donors and investors require high level of disclosure for them to fund the organisation. The CSO's track record plays a crucial role in the funding decision. From an investor's perspective, transparency is essential in proving comfort. Furthermore, the social economy sector should consider how it might establish some long term disclosure standards so that investors can feel comfortable that they have appropriate disclosure before making an investment.

- Funding Sources and Flows – As contrasted with commercial businesses that have multiple sources of funding and types of financial products available to them, the funding sources and flows for the social economy sector is vastly different. The funding sources are characterised by a combination of high risk tolerant individuals (donors), risk ambivalent organisations (government) and altruistic institutions (not-for-profit organisations e.g. churches and foundations). Understandably, these fund flows within the social economy sector are both complex and transactionally costly.

Lessons Learnt

At Christian Super, we are targeting the social economy sector as possible area of growth. As our approach to investment is not completely dissimilar to other investors without an ethical mandate, this inquiry may benefit from some of the lessons we have learnt from reviewing and considering such investments. In particular, we will outline lessons drawn from our latest consideration to invest in one of the funds established by Foresters Community Finance (Foresters). Foresters is a Community Development Finance Institution (CDFI) committed to community finance activities which focus on providing excluded markets with access to finance and investment.

Lesson # 1: Viable Social Investment Concept

Foresters has been involved in social impact investing for over 150 years. Recently, they have been setting up social investment funds that aimed at "providing investors with a diversified income producing finance portfolio exclusively serving the social economy sector, whilst providing regular income and capital stability for investors." From an investor perspective, channelling funds to the sector through a fund set up by a CDFI like Foresters is viable and provides some comfort due to a number of reasons, namely:

1. Sector Expertise: Given Foresters' long history of investing in the sector; it is probably very well positioned to determine the social and financial value of CSOs. Instead of investors developing new skill-sets to evaluate CSOs, Foresters will be able to use already existing resources and tools to assess the CSOs for potential investments. Foresters have done numerous research on the subject of funding the social economy and what can be done to reduce the risk and maximise both social and financial value. Additionally, Foresters has developed cost effective tools to assess CSOs which include:
    a. Investment Ready Appraisal: This appraisal focuses on business development and/or asset development for the organisation including due diligence to establish strengths and weaknesses of the organisation's activities. Additionally, Foresters helps the organisations to be investment ready which may include capacity building and providing access to a range of specialist business consultants to support the development of the organisations.
    b. Community Asset Building Strategy: This strategy provides the CSOs with detailed analysis of their financial position in relation to securing funds to purchase assets, helps with the assets acquisition process (negotiation and due diligence) and helps secure funding for purchasing the assets.

    As an investor, such detailed analysis and due diligence provides comfort in the areas of valuation and transparency.

2. Alternative Investment Product: The investment through a social investment managed fund provides the wider investment community with an alternative way to obtain exposure to the

social economy sector. Investing through a fund allows different funds with different risk profiles to be established to suit varying risk appetites among investors. Additionally, within each fund, different unit classes can be created to cover the whole spectrum of investors such as capital warranty units, subordinate units, senior units, etc. Under the right structure, the units can be bought and sold in the wider market, increasing the liquidity for investors. This will open up the investor universe for the social economy sector and increase the funding sources and flows mentioned above. As the social economy investment products deepen and mature, diversification benefits might be established.

3. Return on Investment (ROI) Expectation: Due to the amount of time and analysis that goes into an investment decision within the fund and the structure of the fund, the ROI expectation is likely to be less variable and closer to actual. The provision of greater certainty of returns can be largely attributed to the pre-investment analysis done by the fund manager like Foresters.

4. Accountability: There are already very strict and well documented reporting and auditing requirement for funds that raise capital from the public. Social investment funds will have to adhere to the same principles if they are to operate legally and if they want to attract investors. Fund managers will in turn demand from CSOs the same high level of disclosure and scrutiny as a condition of investment. Within the social economy sector, standardised accountability mechanisms for investors have not been established and the work of Foresters provides some objectivity for the investment community as they are able to utilise government accountability mechanisms to understand investment propositions.

Lesson # 2: Crucial Role of the Government

It is clear from lesson # 1, that CDFIs like Foresters have a crucial role to play in developing a sustainable capital market for the social economy sector. Our experience assessing CDFIs has reviewed that their financial health on a stand-alone basis is not sufficient to carry out all the work they need to do to help CSOs have access to funding. Our experience further informs us that the existence of some level of government support is necessary to attract and retain investors and ensure that more of CDFIs exist to help the sector in the same way with Foresters. In Christian Super's view, there are a number of ways the government may consider to help create and sustain a robust capital market for the social economy sector:

1. Long Term Funding: We have found it to be necessary for the CDFIs to have reliable sources of funding in order to invest in long term assets as well as meet short term operating costs to ensure overall business viability. One of the most crucial assets of the CDFIs is their skilled employees who need to be adequately remunerated to be retained even though the initial staff attraction is likely to be on the basis of altruistic motives. Government funding to cover such expenses would ensure that CDFIs concentrate on providing the services to the CSOs. Additionally, if the government assist with the capital raising costs for CDFIs, solvency concerns in the initial period will be alleviated. The funding can be channelled in form of grants, performance based payments or loan guarantees. Most of the CSOs that are helped by CDFIs need more long term funding than short term funding hence the need for a government

commitment to funding CDFIs (and their investors) for the long term to give confidence that the CDFIs will be able to carry out their duties throughout the duration of the investment.

2. Funding Guarantee: We have learnt that a government guarantee in any CSO's funding drastically improves the risk profile of both the CDFI and CSO. The subordination of government funding has resulted in the government changing the overall risk profile of the investment. From an investor's perspective, this has the potential to deepen the liquidity of the sector.

3. Implied AAA Credit Rating: According to the Rating Agencies models, the rating of an issuance of bonds or loans is as high as the rating of the institution that guarantees the scheduled principal and interest payments on that issuance. If the government guarantees issuance of Social Impact Bonds, for example, then that issuance should have an implied rating of the government i.e. AAA. This will lower the cost of funds, increase liquidity and diversify funding sources as institutions with a lot of funds but low risk appetite like insurance companies and superannuation funds add Social Impact Bonds into their portfolio. Naturally this is dependent on the details of the each underlying investment.

4. Education: The government may play the crucial role of educating both the investor community and social economy sector on available funding options and various mitigation strategies applied. Our experience has been that investment advisors are less cautious of the purchase of social investment funds units once they learn that the government is absorbing the significant portion of the risk in the investment. Additionally, the government would be the only entity with big enough resources to provide such training to the social economy sector on acceptable reporting and disclosure standards, performance measurement (both SROI and ROI) and the recording of such measurements. Indeed, they might have access to useful information and history through their existing accountability requirements under government departments such as DEEWR and FaHCSIA. The government agencies are positioned well to set those metrics and how they are measured. The education can be channelled through CDFIs who have already developed the relationship with organisations and have already existing tools of measurement and evaluation of performance. Alternatively, education can be done through institutional investor organisations like the Australian Council of Super Investors.

5. Encourage Cooperation: There are a large number of CSOs in Australia which will most certainly benefit from a robust capital market for the sector. However, a lot of them are too small to engage in capital raising on their own and fund the financing costs and ongoing costs involved. There is a need therefore for such organisations to find a platform on which they can do combined capital raising based on social issues targeted or geographic location, etc. This will lower the cost per organisation, encourage inter-organisation accountability, encourage sharing of resources and skills and provide default diversification for investors. Again, we believe that the government, through CDFIs, is well positioned to create such a platform.

Lesson # 3: Avoiding the Pitfalls

As we establish a new way to fund the social economy sector which inevitably imposes performance benchmarks and reporting requirements among other things, it is important that we avoid the potential pitfalls that come with it. From the perspective of an ethical investor, the social impact (measurable or not) is as important as financial returns therefore being cognizant of anything that might compromise on the social impact is part of our mandate. Some of the pitfalls are outlined below:

1. Focus on Milestones: As organisations are required to deliver certain milestones (e.g. number of youths rehabilitated per year) it is important that the focus remains on the quality of the services provided in order to achieve those milestones. It is important to realise milestone establishment may distort service delivery therefore a healthy balance and analysis beyond the numbers is warranted.
2. Market Forces: As the social economy sector enter the broader capital markets, it is important to realise that the organisations become susceptible to market forces which drove the rise and fall of markets around the Global Financial Crisis. It might be helpful to put structures in place that limit both the excessive growth and potential decline that was experienced in other sectors driven purely by market forces.
3. Crowding Out Philanthropy: It needs to be clear from the beginning that the establishment of capital markets for the social economy sector should complement not supplement philanthropy. Indeed, current donations and grants to the social economy sector are important in stabilising cash flows and providing a revenue diversification tool.
4. Burden of Reporting and Measuring: As important as it is for organisations funded through the public to properly measure performance and report in a standardised way, it might be a significant cost burden as the organisation may need to hire skilled staff to carry out those tasks. This impacts the financial health of organisations due to the added costs and reduces the quality of the service delivery as greater focus is placed on measurement and reporting. A way to streamline the accountability mechanisms through existing funding structures like DEEWR and FaHCSIA might be helpful to minimise the costs associated with providing much needed disclosure to investors.

Conclusion

As a keen potential investor in the social economy sector, we have realised the importance of government involvement especially through direct funding and loan guarantees as well as heavy participation of CDFIs as conduits to most of the government's efforts. Such collaborations between CDFI and the government and the resultant innovation have allowed Christian Super to seriously consider investments in the sector. As part of this inquiry, we recommend seeking feedback from the potential investors so that their insights and opinions can also shape the direction of this discussion. Christian Super would be more than happy to contribute to a public hearing on this inquiry if needed. We believe that our perspective and experience as an investor may help to create a robust capital market for the social economy sector.