IN DEMAND

The changing need for repayable finance in the charity sector

March 2014

Registered charity number 268369

CAF Charities Aid Foundation

About Charities Aid Foundation

Charities Aid Foundation (CAF) is an international charity registered in the UK. Its mission is to motivate society to give ever more effectively and help transform lives and communities around the world.

Our award-winning social investment arm, CAF Venturesome, is one of the most established and active players in the social investment market. Over the past 12 years, CAF Venturesome has supported more than 400 charities and social enterprises with £33 million of affordable finance, enabling them to flourish.

Data provided by Lake Market Research in partnership with Diagnostic Decisions

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Foreword

Where cash is a finite resource and where returns can be generated to meet the costs of investment, there will always be a latent demand for finance. This is as true for the charity sector as it is in the commercial world. However, there was once a perception in the banking world that lending to achieve primarily social outcomes was a risky proposition, inappropriate for the charity sector where revenue streams are perhaps not quite as obvious.

In 2002, the social investment arm of the Charities Aid Foundation – CAF Venturesome – was set up to show that providing capital to high impact charities was not as risky as the mainstream banking sector thought. In doing so, CAF Venturesome aimed to meet an acute need for unsecured risk capital to the sector, and to set an example that others could follow.

Whilst CAF Venturesome has shown, through a low historic write-off rate, that unsecured lending to charities is possible, the wider investment industry has been slow to join in. Rather, a distinct social investment sector has developed in the UK to meet the needs of charities and the social sector more widely.

However, changing circumstances have meant that, despite the growth in supply of capital specifically to ensure social impact, the demand for it has grown too. The financial crisis and pressure on public finances has resulted in a fall in grant funding and an environment where commissioners are increasingly inclined to pay for work in arrears or by results. This means that charities, more than ever before, need affordable capital to scale their work, transition to new operating models and carry on business as usual.

As providers of social investment, a form of repayable finance, it is essential that we understand the market that we seek to serve. CAF Venturesome commissioned the research that is presented in this report to improve understanding of demand among charities for repayable finance and how this is changing.

We hope that in sharing this research, we can help the social investment market design new products and services that will allow charities to continue their invaluable work and achieve their aims.

Dr John Low
Chief Executive
Charities Aid Foundation

Executive summary

This report summarises the key findings of research commissioned by CAF Venturesome, the social investment arm of the Charities Aid Foundation, and undertaken by Lake Market Research in partnership with Diagnostic Decisions. It maps out the current state of play in charities' demand for repayable finance by looking at charity attitudes to social investment, the changing nature of demand for finance and the perceived barriers to accessing it. The findings of this report are taken from 1,811 charities screened to take part in the research and 252 detailed surveys, making it unique in its scope.

Our research has produced the following key findings:

- 61% of charities with an annual income of £60,000 or more have no experience of taking out repayable finance and no expectation of doing so in the future
- Positive management and trustee attitudes to social investment correlate strongly with likelihood to take on repayable finance over the next five years
- Charities with annual incomes in excess of £1 million and with past experience of taking on repayable finance are significantly more likely to consider taking on finance in the future
- Information on accessing repayable finance, and knowing where to find that information, would help to stimulate demand
- The average annual demand for repayable finance by charities over the next five years is estimated to be £765 million
- Borrowing intentions over the next five years indicate a strong demand for unsecured products
- 37% of charities surveyed self-identify as a social enterprise and exhibit more positive attitudes to repayable finance than other charities.

In order to better meet the repayable finance need for charities, we recommend that:

- More needs to be done to increase the provision of affordable risk capital, available for borrowing at lower amounts
- Social investors should play a bigger role in providing charities and their trustees with information on what repayable finance products are available and how they can access investment.

Setting the scene

Over the past twenty years, civil society has moved from being fuelled solely by grants and donations to a more sophisticated funding ecology. There are a growing number of funders and investors, using a variety of financial products to support community groups, charities and social enterprises.

The majority of funding for the charitable sector still typically takes the form of grants and donations, rather than repayable investment into an organisation. But the use of social investment, which we define as the provision of finance for social as well as financial returns, is increasingly important given the wider range of revenue generation opportunities available to charities.

In the UK, there is an emerging social investment sector. Over the last decade, the market has witnessed a growing number of funders and investors available to support charities. CAF Venturesome, founded in 2002, has been a pioneering contributor in the field, leading the way in developing new financing mechanisms, sharing best practice and perhaps most importantly, making social investments: in the last 12 years, CAF Venturesome has provided £33 million to more than 400 charities and social enterprises.

This report aims to understand charities' changing needs for not only social investment, but repayable finance more broadly. In other words it considers all forms of repayable finance available to charities, irrespective of whether the investor makes an explicit trade-off between social and financial returns.

In the current political and economic context, the charity sector is facing greater demand for its services, more competition for statutory funding and the increasing effort required to secure public donations. The repayable finance to which charities have access, including social investment from specialist intermediaries, can go some way to alleviating the funding pressures for the sector. However, it will require that investors, intermediaries and policy makers have a greater understanding of charities' funding needs and their relationship with the various types of repayable finance.

Recent research in this area[1] has focused on the more specific repayable finance category of social investment, and has analysed its relationship with a range of different organisations within the social sector, from charities to social enterprises. The research underpinning this report is different in that it focuses on a discrete group of organisations, namely charities, but expanding the finance category to encompass a wider range of finance products. In our survey, charities were asked directly for their views on the following:

- Attitudes to the concept of social investment
- The changing nature of charities' demand for repayable finance, including analysis of how their borrowing intentions may change over the next five years
- Challenges to further growth in the social investment market for charities and how these may be overcome.

1 Big Lottery Fund, Big Society Capital, HM Government, City of London (2013) *Growing the Social Investment Market: The Landscape and Economic Impact*
Boston Consulting Group, Big Society Capital (2012) *The First Billion: A forecast of social investment demand*
Clearly So, New Philanthropy Capital, Big Lottery Fund (2012) *Investment Readiness in the UK*

Methodology

The research on which this report is based was undertaken through a quantitative online survey of 252 UK registered charities, developed by CAF and Lake Market Research in partnership with Diagnostic Decisions. Recruitment of participants in the survey was undertaken by telephone, to ensure that only the correct participants were selected to take part.

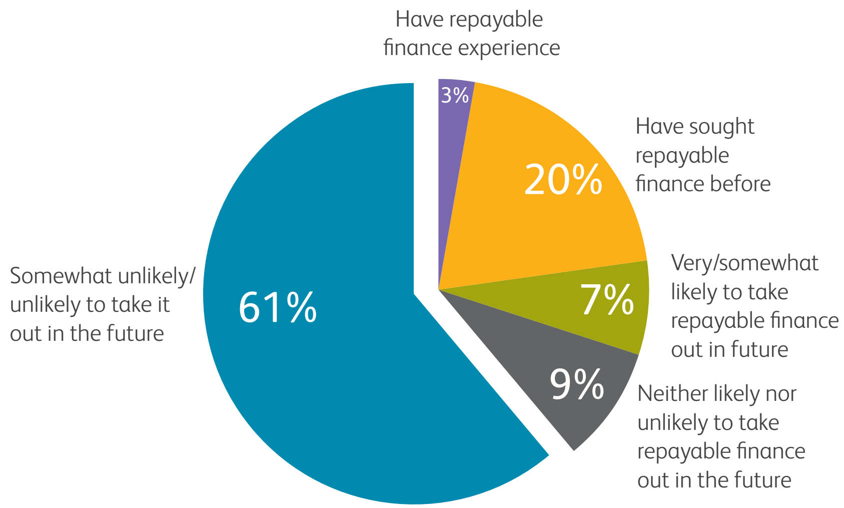
To take part in the survey, prospective interviewees had to:

- Be either primarily or jointly responsible for financial decision-making in the charity, or be senior members of the charity's executive
- Represent a charity with an annual income of £60,000 or more, as this is the minimum level of turnover required in a charity for CAF Venturesome to consider providing financial support
- Either have experience of taking on finance or be 'very likely', 'somewhat likely' or 'neither unlikely or likely' to take out repayable finance in the future.

Of the 1,811 charities with an income of £60,000 or more screened in this recruitment phase, 39% fell into these criteria (see ' Market Overview' chart below). It is indicative of the undeveloped nature of the market that 61% of charities with an annual income of £60,000 or more either do not have experience of taking on finance or see themselves as unlikely to take out finance in the future.

Finally, a note on terminology. CAF Venturesome believes that to do good, charities need to have access to affordable finance, of which social investment is a subset. However, social investors are not the only providers of affordable finance – high street banks, charitable trusts and high net worth individuals can also, in principle at least, lend funds at rates of return that a charity can pay. Therefore, except for a specific section in the survey pertaining to charities' relationship with the term 'social investment', 'repayable finance' has been used throughout to understand charities' views of affordable finance across the whole spectrum of capital providers.

Market overview



Base: All screened (1,811)

How do charities feel about social investment?

Before considering the current state of the market and the expected changes, this section looks at the attitudinal context in which decisions to take on finance are made.

Social investment – the provision of capital for both social and financial returns – remains a relatively new concept in the voluntary sector. As part of our research, we were interested in exploring charities' awareness of the term and their attitudes to it, as distinct from the wider category of repayable finance.

Our research found that only 37% of charities have a fair or better understanding of the term with 'social investment'. Despite this, the findings suggest that in principle, charities are open to the idea of new funding models. Two thirds of charities surveyed expressed an interest in being innovative in the way their activities are financed.

Among those charities that are aware of the term, attitudes are positive, with 71% agreeing that it is an appropriate financing option for charities. It is particularly encouraging for providers of social investment to charities that over half of respondents agreed with the statement 'social investment is better for charities than mainstream commercial finance'.

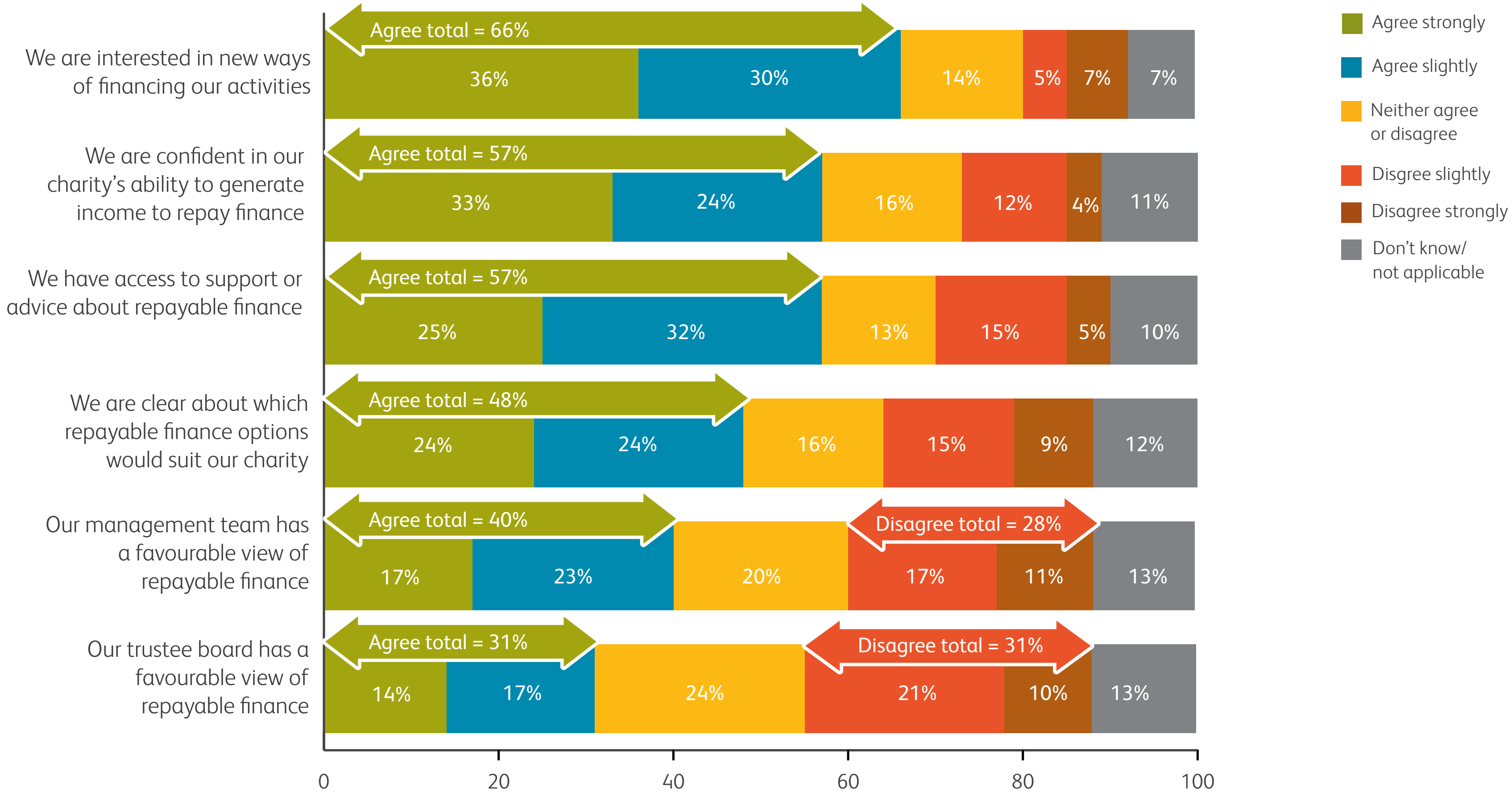
It is the bigger charities – those with an annual income in excess of £1 million – that are more familiar with the term 'social investment' and are more receptive to the prospect of taking on finance. This may be because larger charities are likely to have a more experienced management team and trustee board.

It also helps to have previous experience of taking on repayable finance – having a wider experience of finance than purely social investment. Charities that have taken on repayable finance before are far more likely to be confident in their ability to repay new finance, to feel that they have access to the right support when considering borrowing and to have leadership attitudes more open to the prospect of social investment.

The charities that expressed a clear intention to take on repayable finance over the next five years were more likely to have the following discernible characteristics:

- Trustees and Executive team are open to the idea of repayable finance
- Past experience of repayable finance
- Income in excess of £1 million.

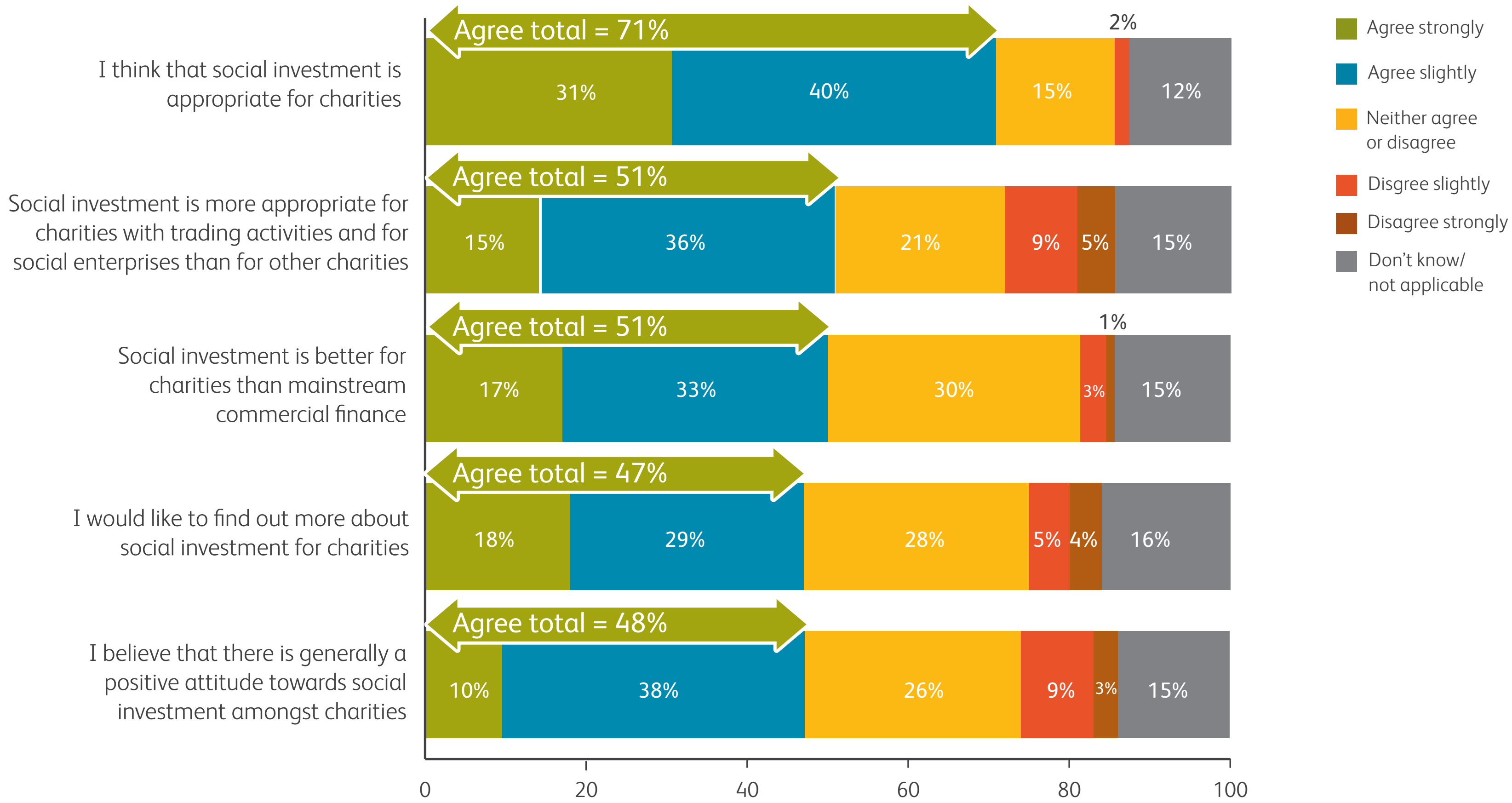
How strongly would you agree or disagree with the following statements about your charity...?



Base: All answering (252)

Due to rounding, some bars add up to 99% or 101%.

How strongly would you agree or disagree with the following statements about Social Investment...?



Base: All those aware of Social Investment (172)

Due to rounding, some bars add up to 99% or 101%.

How will charities' demand for repayable finance change?

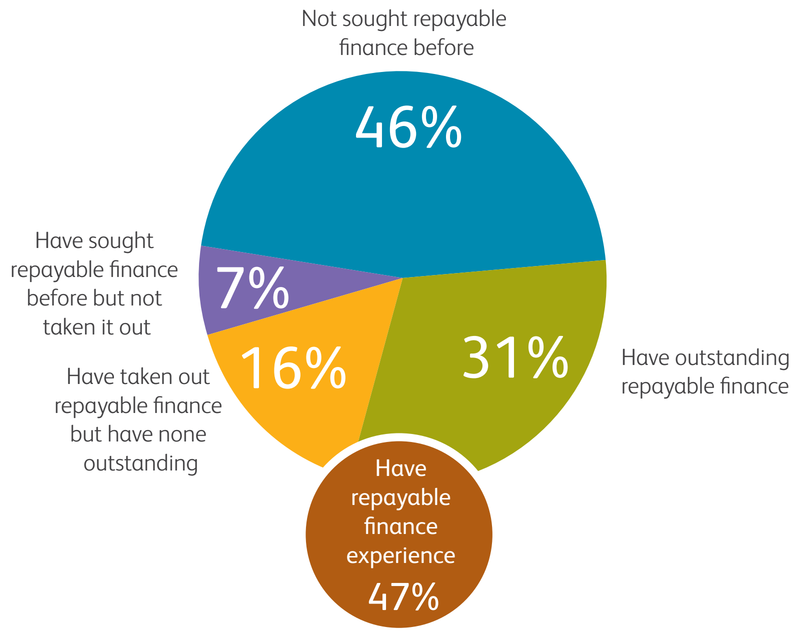
One of the aims of this research was to understand the changing demand for repayable finance from charities. By not restricting our analysis to social investment products only, we aim to understand the wider need for finance accessible to charities. We look at this by analysing:

- Borrowing characteristics in relation to the last finance facility taken on, compared with expectations of future borrowing decisions
- Attributes of borrowers
- Size of borrowings, current and anticipated.

The results shown here are those of the 252 charities that took part in the full survey commissioned as part of our research and were identified through a screener of 1,811. As the respondents were a self-selecting subset of the charities that met the criteria to take part in the survey, their borrowing characteristics are not reflective of the wider market characteristics identified on page 7.

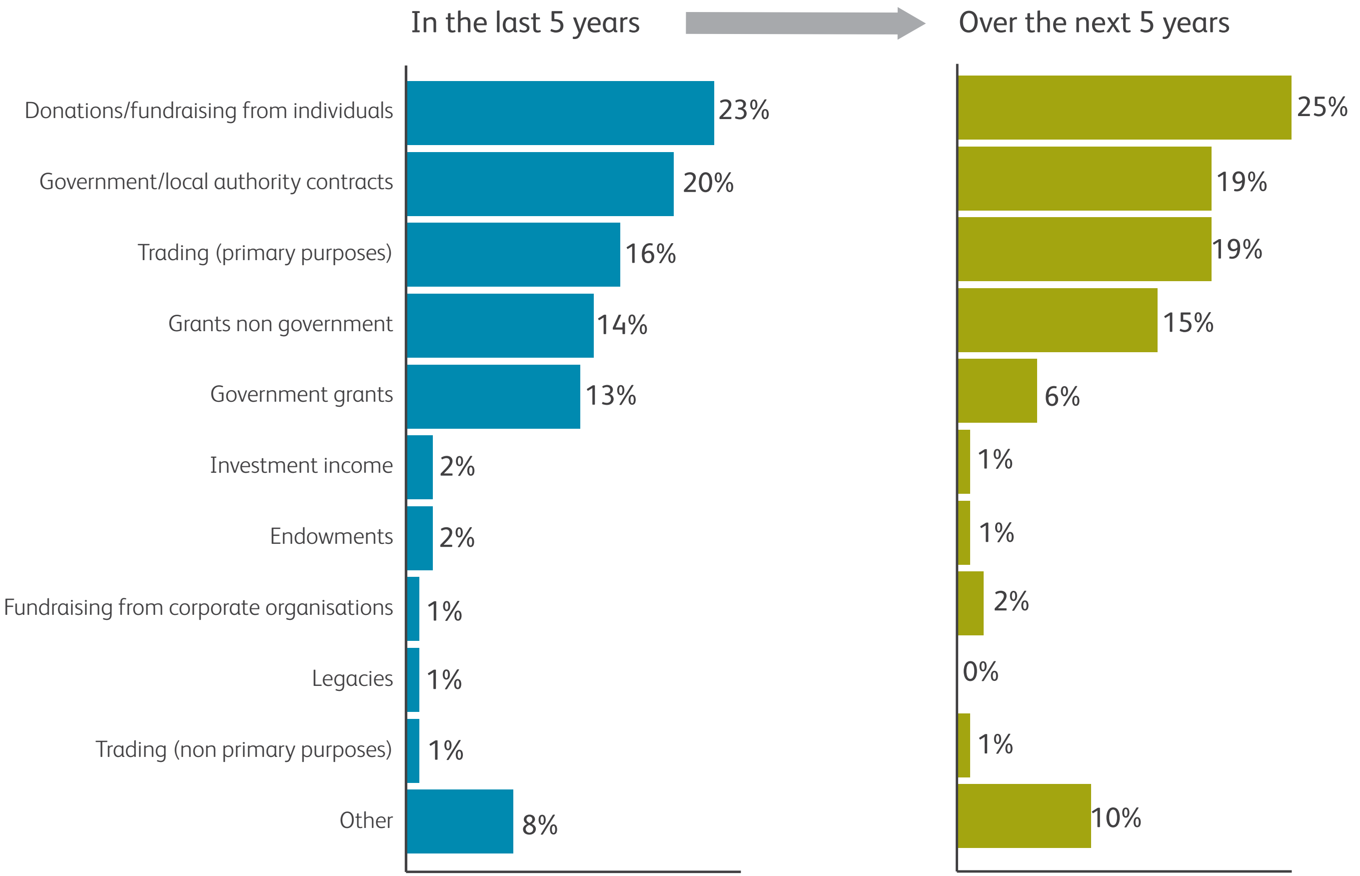
The changing purpose, type and source of repayable finance taken on
Charities expect significant changes regarding the reasons for why they will need repayable finance, what financial products they will use and who they will get them from. Before looking at this however, it is important to consider their perceptions of the funding environment as charities' activities and financing needs will be shaped, to an extent, by that environment. As part of the research, we asked charities how they expect their largest funding source to change over the next five years compared with the last five. The significant but unsurprising perception is that government funding, either through grants or contracts, will decrease. In the last five years, 33% of charities identified government funding as their main source of income. Looking ahead, only 25% of charities believe that government funding will be the main source.

Summary of of repayable finance experience



Base: All answering (252)

Which of the following is your charity's largest source of funding...?



Base: All answering (252)

In looking at the changing characteristics of investment taken on, we assessed the purpose, type and source of charities' last instance of repayable finance and compared this with the borrowing expectations over the next five years.

Why is finance taken on?

Nearly 60% of all finance taken on historically has been for the purpose of asset acquisition – the most prevalent asset class being property (52%). Working capital to fund refurbishments and cover shortfalls in cash is the second most significant purpose of finance. It is surprising that no respondents took out finance to bridge to a confirmed grant, as this does not accord with CAF Venturesome's experience in providing bridging finance. However, 18% of charities believe that this may be a purpose in the future, which reflects the increasing number of grants that are expected to be paid in arrears.

Our research found that the anticipated make-up of future borrowing purposes is significantly more varied. Although the acquisition of a building is still the most prevalent purpose, there emerge a number of other purposes that can broadly be classified as capital to develop the organisation or working capital to carry on business as usual.

What financial products are used?

Corresponding with the prevalence of borrowing for the purpose of acquiring property, mortgages have been the most widespread finance product. Going forward however, charities anticipate an increase in the use of non long term products – unsecured loans and overdrafts in particular.

Who provides the finance?

53% of finance historically taken on by our respondents came from high-street lenders. This is unsurprising given the aforementioned need for mortgages and the prevalence of high-street lenders providing these. The financing ecology looks more diverse over the next five years, with the use of specialist third sector banks and lenders, including social investment and finance intermediaries (SIFIs), envisaged to increase. Charities anticipate that charitable foundations and trusts will be seen as a major source of repayable finance in the future, despite them having limited involvement in the market to date.

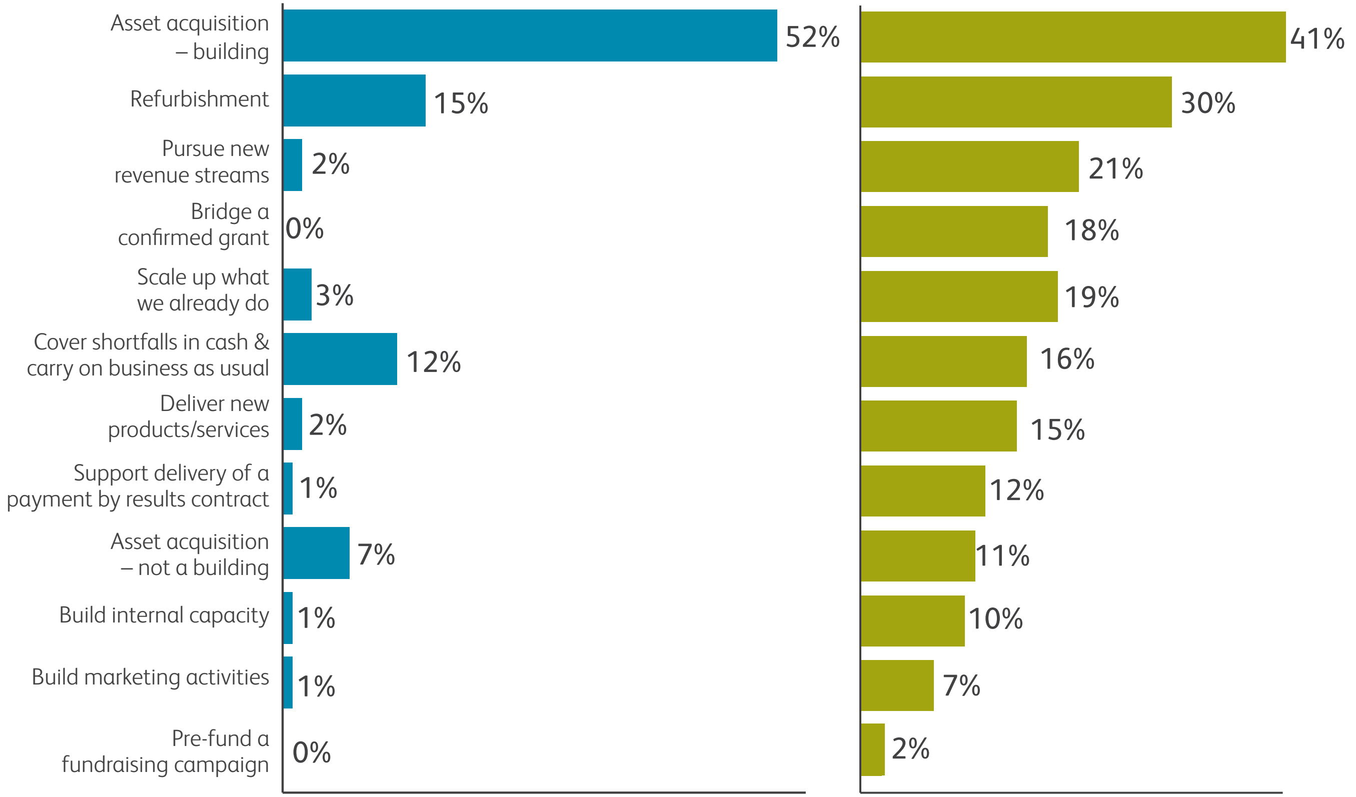
Further analysis suggests that it is the larger income charities (£1 million+) that are significantly more likely to include high-street lenders within their future funding mix. This may suggest a real need for specialist providers of finance to cater for the needs of smaller organisations.

It is clear that charities anticipate significant change in the nature of their borrowing. Repayable finance will be more likely to be unsecured, non-long term in nature and called upon for a wider range of purposes,and it is increasingly expected to be drawn from third sector orientated providers. This may reflect the growing profile of 'social investors' or be a realistic reflection of the risks involved in this type of finance and therefore the reduced likelihood of receiving it from high street banks.

Why is finance taken on?

Which of the following best describes why your charity took out this repayable finance?

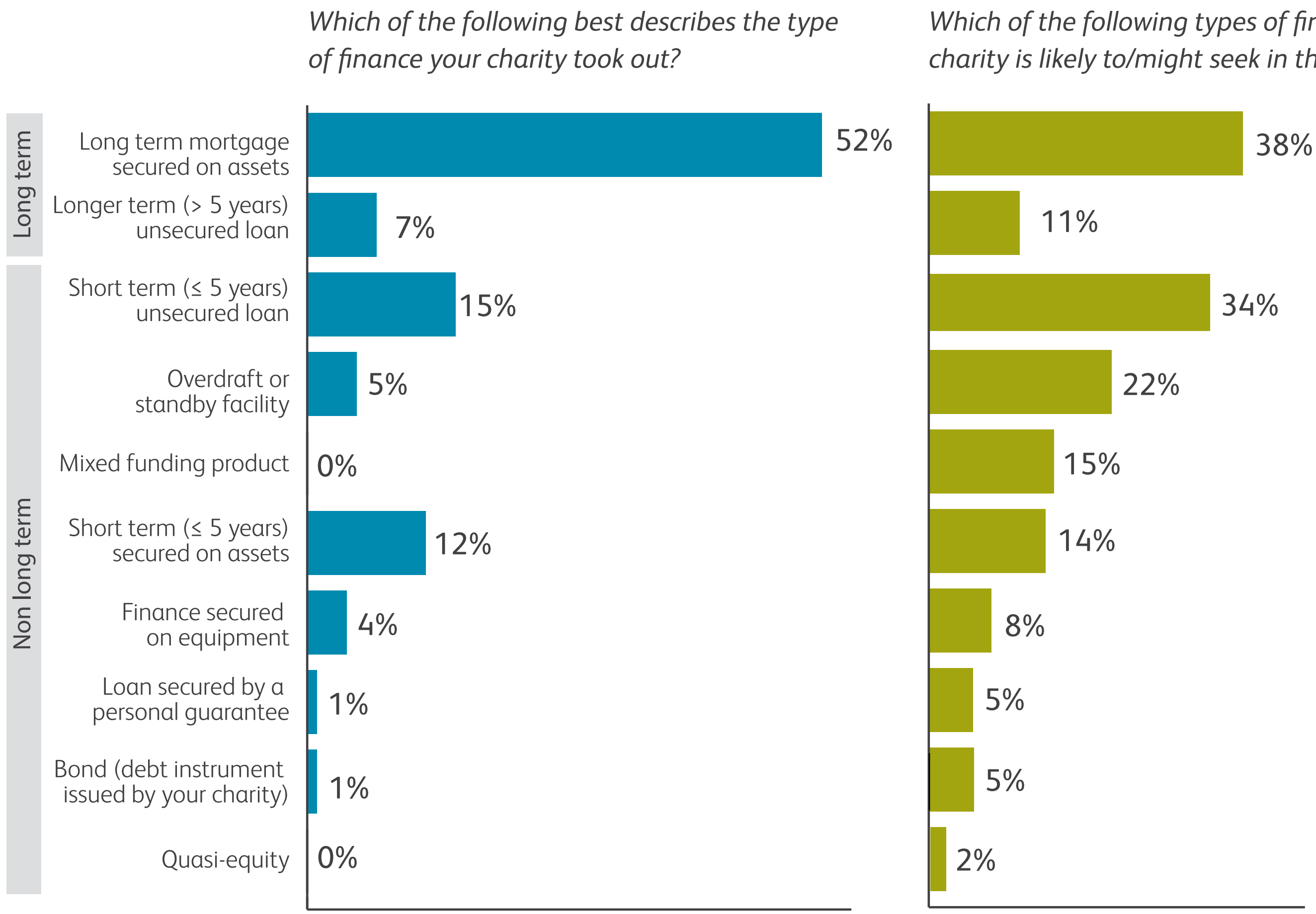
For which of the following reasons do you think your charity is likely to/might seek repayable finance in the next 5 years?



Base: All current finance agreements answered on (126), All likely to/might seek finance in the future – excluding 'none of these /don't know' (183)

* Please note that participants were given the opportunity to select more than one option when considering 'likely future repayable finance' options; therefore the sum of percentages > 100%

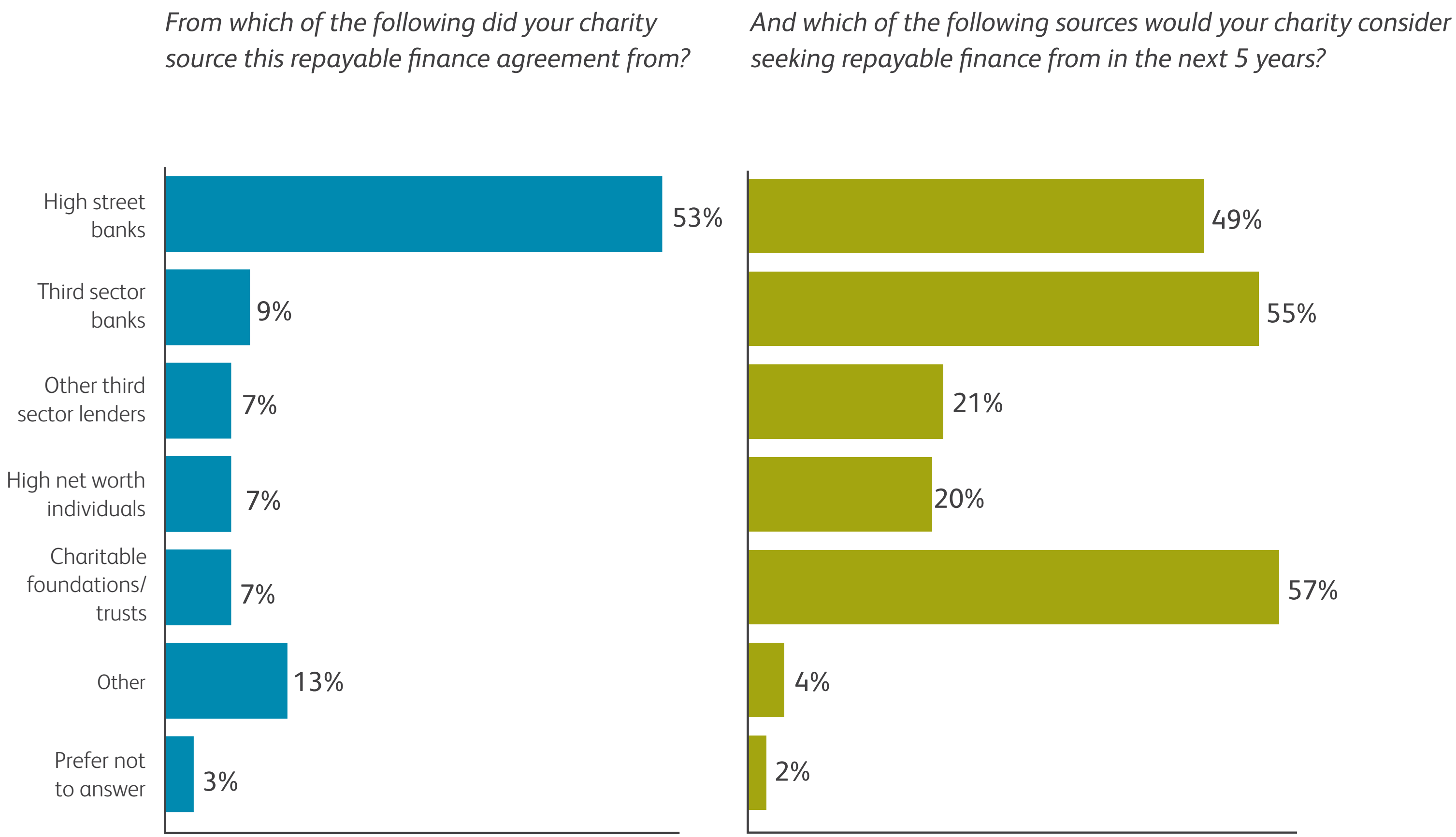
What financial products are used?



Base: All current finance agreements answered on (126), All likely to/might seek finance in the future – excluding 'none of these/don't know' (160)

Long-term finance: 'Longer term unsecured loan > 5 years' and/or 'long term mortgage secured on assets'.
Non long-term finance: 'Short term unsecured loan ≤ 5 years', 'overdraft/ standby facility', 'finance secured on equipment', 'loan secured by a personal guarantee', 'bond', 'quasi-equity', 'equity' and/or 'mixed funding product'.
Long & non long term proportions are primarily driven by charities of £1 million + income (21% vs. 7% of charities under £1 million income).
Please note that participants were given the opportunity to select more than one option when considering 'likely future repayable finance' options; therefore the sum of percentages > 100%

Who provides the finance?



Base: All current finance agreements answered on (126), All likely to/might seek finance in the future – excluding 'none of these/don't know' (173)

* Please note that participants were given the opportunity to select more than one option when considering 'likely future repayable finance' options; therefore the sum of percentages > 100%

Size of charity borrowings: now and in the future

Just under half of the 252 charities interviewed (46%) have acquired repayable finance in the past and under a third currently have finance outstanding on their balance sheet – in other words, borrowings that are not yet fully repaid.

The average amount outstanding for a charity that has acquired repayable finance in the past correlates strongly with levels of income. Charities with an annual income of less than £1 million – the majority of charities in the sample – have an average of £109,000 outstanding. Charities with an annual income greater than £1 million have around £1.1 million outstanding.

As part of the survey, we wanted to understand how much repayable finance charities have successfully received in the last 12 months to gauge the total market size in the period. Although this process is methodologically challenging due to the variance in borrowing amounts, we estimate this to be between £320 -£980 million, with a midpoint of £650 million.

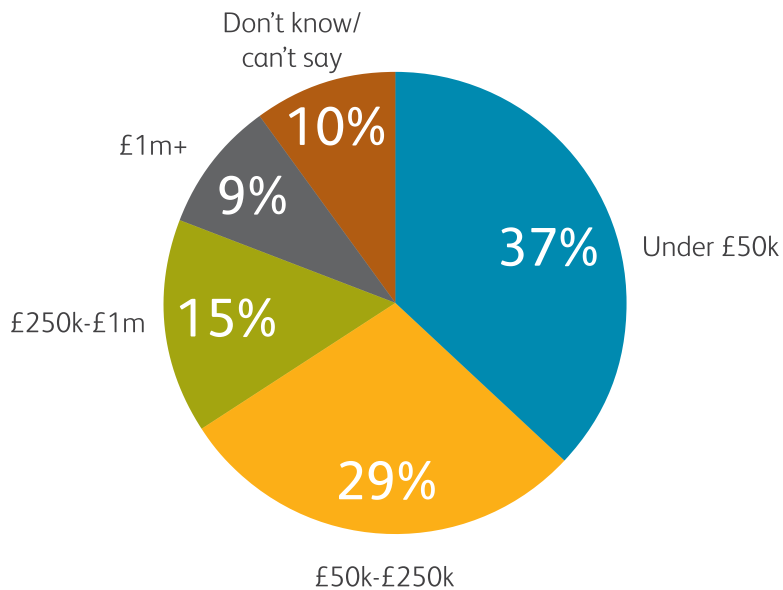
In terms of borrowing over the next five years, 38% of respondents describe themselves as being certain to or likely to seek repayable finance, 27% are unsure and 35% are unlikely or certain not to.

When asked about how much charities would like to borrow in this future period, the majority of charities give a figure of under £250,000 for a given loan purpose and over a third would like to borrow less than £50,000. However, our results show that those charities that are more certain about their borrowing intentions intend on borrowing larger amounts.

On the whole, over half of charities interviewed are also confident in their ability to repay any finance taken on. However, there are significant variances depending on charity size, previous experience of finance and intention to borrow in the future: bigger charities, those with finance experience and those that are more certain to borrow over the next five years demonstrate greater self-confidence in ability to repay.

Taking the results for the question 'How much repayable finance is your charity hoping to receive in the next five years?' together with the estimated number of charities in our repayable finance target market allows us to form an estimated average annual market size for the next five years. We have estimated that the average annual demand for charity finance over the next five years will be £765 million. £530 million (70%) of this is expected to come from charities with an annual turnover of £1 million or more.

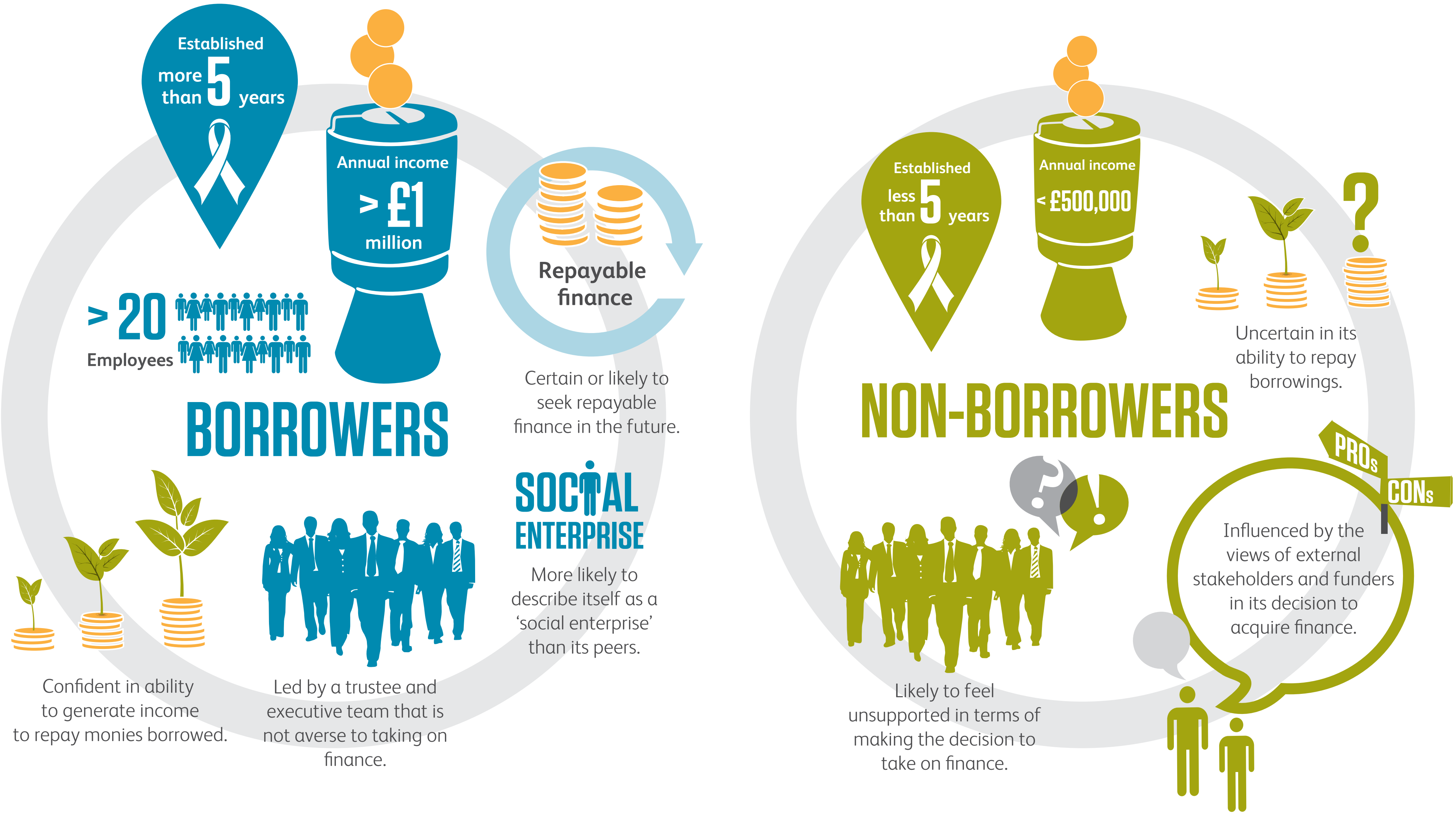
What amount of finance are charities hoping to receive in the next 5 years?



Base: All future purposes combined + those without a purpose (400), Mean score calculated at charity level

Borrowers and non-borrowers – what do they look like?

What does a typical borrower look like? Here we look at previously successful borrowers and contrast them with organisations that have no experience of repayable finance:



Challenges and accelerants for the charity repayable finance market

What are the barriers to accessing repayable finance?
Analysis of the attitudes to repayable finance reveals the following characteristics of those charities that are either unsure, unlikely or certain not to take on repayable finance:

- Management and/or trustees that do not have a favourable view of repayable finance (or uncertainty as to their perspective)
- Lack of confidence in their ability to generate income to repay finance
- Uncertainty over what repayable finance options would suit the charity
- Uncertainty over whether they have access to support or advice concerning repayable finance.

These findings are supported by the responses charities gave to questions directly relating to the challenges they face when seeking repayable finance.

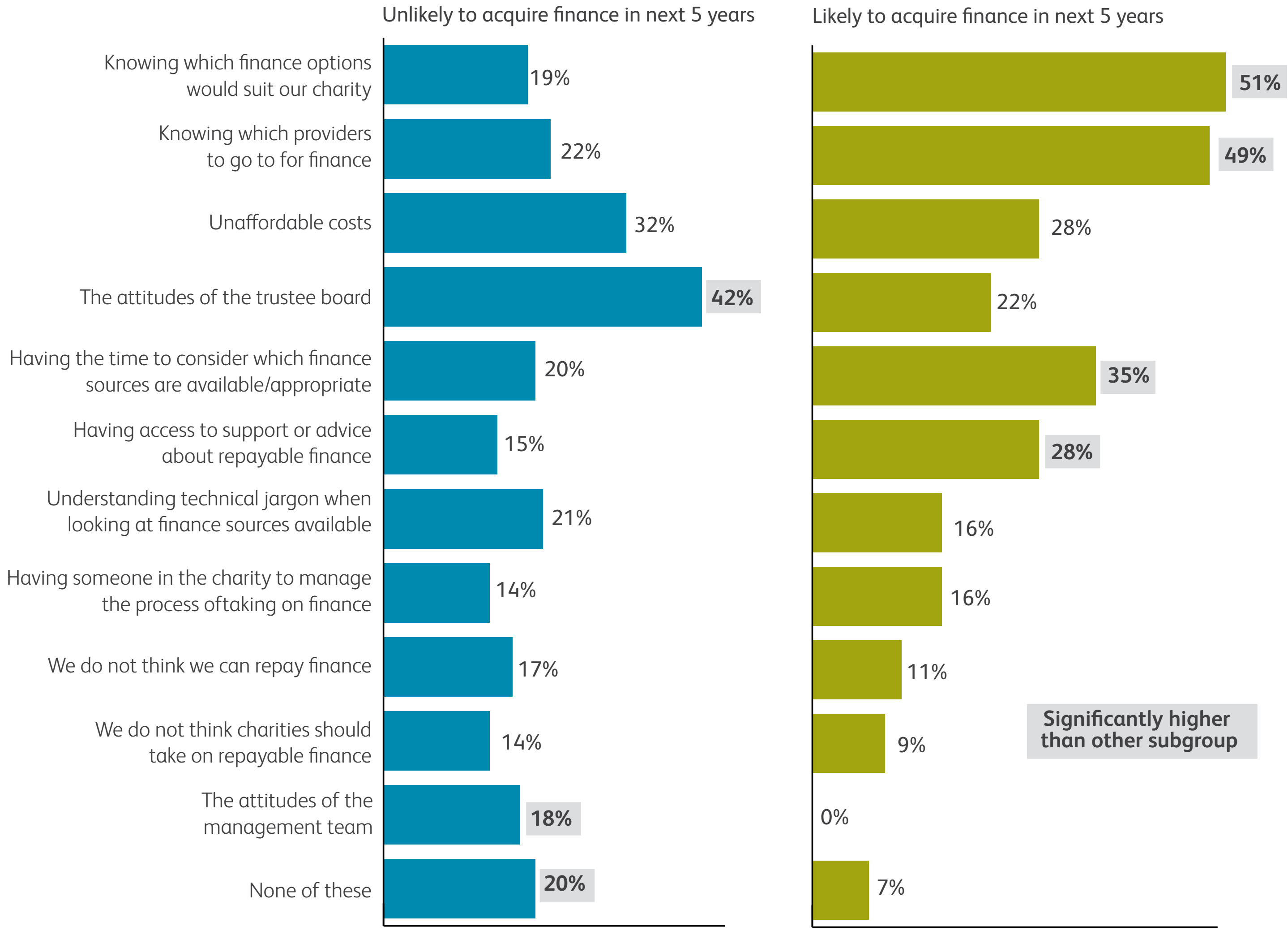
Those charities that are unlikely to acquire finance over the next five years consider the attitudes of trustees to be the most significant barrier. Unaffordable costs, knowledge of finance options and providers as well as the prevalence of technical financial language rank among the other significant barriers.

For charities likely to take on finance over the next five years, the hierarchy of perceived challenges radically changes. Knowledge of finance options and providers, as well as having access to support rank highly. Having time to consider the availability and suitability of differing finance options is also considered important. Amongst this group of respondents, trustee attitudes slide down to the sixth most significant barrier, which further supports the finding that trustees are a major enabling factor in the decision to take on finance.

What would help charities access repayable finance?
A guide to accessing finance is identified as the most useful piece of support by all charities, irrespective of their likelihood of taking on finance over the next five years. Given that such guides exist already, this suggests challenges in terms of accessing already available information. The question this poses for Social investment and Finance Intermediaries (SIFIs) is how they can more effectively disseminate information about their own products and services.

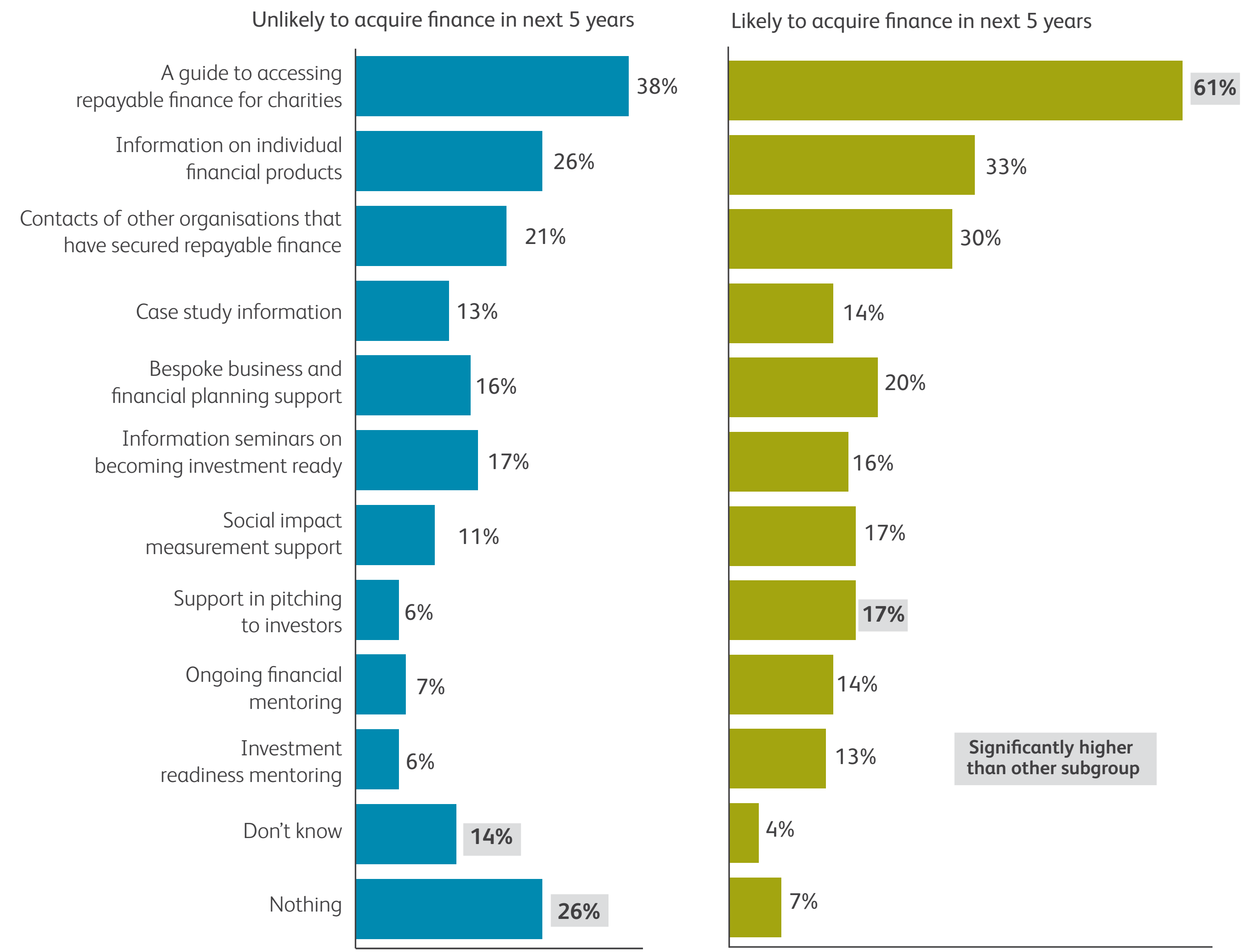
In terms of finance products, further analysis shows take up of repayable finance is most significantly affected by the interest rate, followed by the size of up-front fees. The affordability of finance remains a key issue in terms of accelerating demand for charities.

Which of the following do you believe are the key challenges that your charity could face when seeking repayable finance?



Base: Unlikely to acquire (92), likely to acquire (93)

Which of the following do you think your charity would find useful in supporting any future repayable finance plans?



Base: Unlikely to acquire (92), likely to acquire (93)

Recommendations

CAF Venturesome has undertaken this research in order to have a sound evidence base from which we can develop our social investment products to better meet the needs of charities. But we believe that these findings will be useful for the repayable finance market more widely, by giving investors and intermediaries an insight into a relatively discrete segment of their client base.

Our findings show that charities' demand for repayable finance is significant, with much opportunity for social investors. However, there are currently a number of constraints that prevent the market from growing to its full potential. These constraints primarily concern the availability of appropriate capital and the provision of adequate information on repayable finance. The following table outlines our recommendations as to how these constraints may be overcome:

Appropriate capital	Adequate information
■ As charities anticipate requiring a wider range of financial products in the future to satisfy a wider range of needs, the capital on offer needs to be more willing to tolerate a higher level of risk ■ Repayable finance must be made more affordable as the cost of borrowing (comprising interest rates and up-front fees) is a significant factor in a charity's decision to take on finance ■ Repayable finance must be made available at smaller amounts as the majority of charities anticipate a borrowing need of less than £250,000 in the next five years.	■ SIFIs that provide finance to charities need to raise the profile of their products and services to the sector in order to raise awareness of repayable finance as an option ■ In particular, information should better target charity trustees as they are the key decision makers in charities' decisions to take on finance.

Whilst it may not be surprising that charities need relatively small amounts of risk capital at an affordable cost, this need poses a considerable challenge to financiers who need to remain financially sustainable. Although it is outside the scope of this report to offer detailed analysis of the possible solutions, the following table is a starter for the inquisitive:

How could risk capital be unlocked for investment into charities?	Examples
Increasing the use of philanthropic 'gift' capital that carries a much lower expectation of financial return.	CAF Venturesome manages philanthropic funds that do not carry an expectation of return in excess of capital donated, which means that our investments in charities can remain affordable.

How could risk capital be unlocked for investment into charities?	Examples
Grant-making trusts becoming more involved in social investment, with grants having a repayable element where appropriate.	The Esmée Fairbairn Foundation is one of the largest independent grant-makers in the UK. In 2008, it launched the Finance Fund, which aims to generate financial and social returns through investment in frontline charities and social enterprises as well as social investment intermediaries.
Use of government, HNWIs or grant-makers as guarantors for repayable finance provided to charities.	In 2011, CAF Venturesome provided Oxford charity Arts at the Old Fire Station with a loan to redevelop its premises to become a new arts hub for the city. The loan was guaranteed by Oxford City Council.

How can capital be provided affordably to charities?	Examples
The cost of repayable finance to charities should reflect the level of risk taken on by the investor. Initiatives that help communicate the level of risk to investors should therefore help them price their products accordingly.	Government initiatives like the Investment and Contract Readiness Fund and the Social Incubator Fund have a role to play in reducing the perception of risk in the social ventures that have benefited from them.
Tax reliefs for social investors, as well as attracting new capital into the sector, may also result in tax savings for investors being passed on to investees in the form of reduced costs.	The social investment tax relief announced in the 2013 Autumn Statement has the potential to reduce cost of repayable finance taken on by charities.

How can charities access repayable finance at smaller amounts?	Examples
Crowd-funding can be a way for charities to raise smaller sums from individual supporters by creating a sense of co-ownership and participation in the project that is being fundraised for. The return on investment for supporters may be financial or in the form of gifts in kind.	Buzzbnk, an online crowd-funding platform has helped raise over £630,000 for 73 socially and environmentally minded projects since 2011, many of which have been led by charities.

CAF Venturesome has a history of pioneering new approaches to financing the social economy – from developing new financial products to being a thought leader in the space. Looking ahead, we will continue to closely follow the above initiatives, remain vigilant of new solutions and contribute to the discussions where appropriate. The demand for our unsecured risk capital has increased greatly over the last 12 months and we anticipate this growing further still. We would welcome the growth of the UK's social investment market in line with the above principles to help us meet that demand.

To find out more about CAF Venturesome visit:
www.cafonline.org/venturesome

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