Balancing financial risk and social return

Venturesome

May 2008

charities aid foundation

CAF

Venturesome is a social investment fund, an initiative of the Charities Aid Foundation (CAF). Venturesome provides capital to civil society organisations, operating in the space between providers of charitable grants and providers of bank loans at market rates. Since launch in 2002, over £12.5 million has been offered to some 200 organisations. In addition to accumulating practical deal experience, Venturesome has endeavoured to play a central role in building a robust social investment market, adopting an open-book approach to share knowledge and build experience, but also ready to operate in competition so as to raise standards.

For more information, visit *www.venturesome.org* If you wish to receive information from Venturesome, please send your contact details to *venturesome@cafonline.org*

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When assessing organisations, Venturesome seeks to understand and balance the financial risk and social return of supporting those organisations.

The bulk of financing available to the charitable sector takes the form of grants, although an increasing amount is available through bank lending. Grants are made in the expectation of social return; loans are made with the expectation of a financial return (interest and capital). Since 2002, Venturesome has been exploring the middle ground between bank lending and grantmaking, providing new ways of supporting and funding charities.

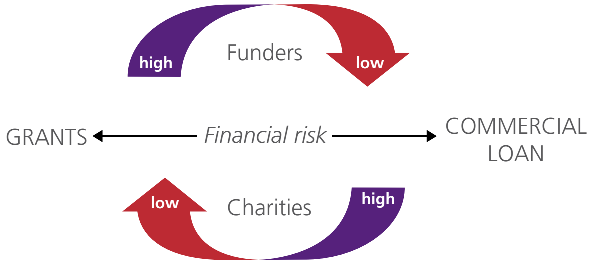
In this middle ground, the total return on any investment is expected to be made up of both social and financial return (in varying degrees). Such investment has been described as 'social investment'. Historically, there has been a gap in the funding market for charities, where grantmakers have considered only the social return, and commercial funders just the financial return, and neither have found their criteria met.

In general, the 'social return' requirement for charities and grant funders is in alignment. The grant funder exists to give money away to achieve social return, and the charity wishes to receive money to enable it to bring about that return. However, in each specific case, a grant will only be given when the charity's proposal meets a grant giver's criteria. When this is not the case the charity has to seek alternative funding. In addition, charities find it difficult to raise grant funding for investment or working capital purposes (ie not project finance).

In terms of financial risk the profiles of the charity and the grantmaker are opposite. The recipient of funds takes no financial risk, whereas the grantmaker, by definition, accepts 100% default risk. Similarly, if a charity takes out a commercial loan from a bank the risk profiles for it and for the supplier of funds are opposite – the risk to the lender is low; to the borrower, high.

These different financial risk profiles of charity and funder are illustrated in Figure 1 below.

Figure 1: Grants and loans present converse risks to charities and funders



Venturesome mitigates against this apparent mismatch by:

1. Assessing the business risk in the context of the charity's finances as a whole. For example, debt is an appropriate way to finance the purchase of a long-term asset such as property when the charity has high trustee unrestricted reserves. It would not be an appropriate way to fund a speculative fundraising project.

2. Using financial mechanisms where the risk/return profile to us is more closely aligned to the risk/return profile of the charity. In the private sector, this would be called 'mezzanine finance', and the funder would be expected to be rewarded for taking an extra risk with increased financial return. In social investment, the reward is increased social impact.

Putting the theory into practice

When making social investments, Venturesome aims to achieve a social impact. We also seek to achieve a financial return, so that our resources can be recycled in order to create greater social impact. An organisation that looks to be of high social impact[1] but with no ability to repay funding would not be accepted, as it should be grant funded. On a similar basis, a proposal with a cast iron financial plan but no social benefit would not be in Venturesome territory, as it should be funded by a bank.

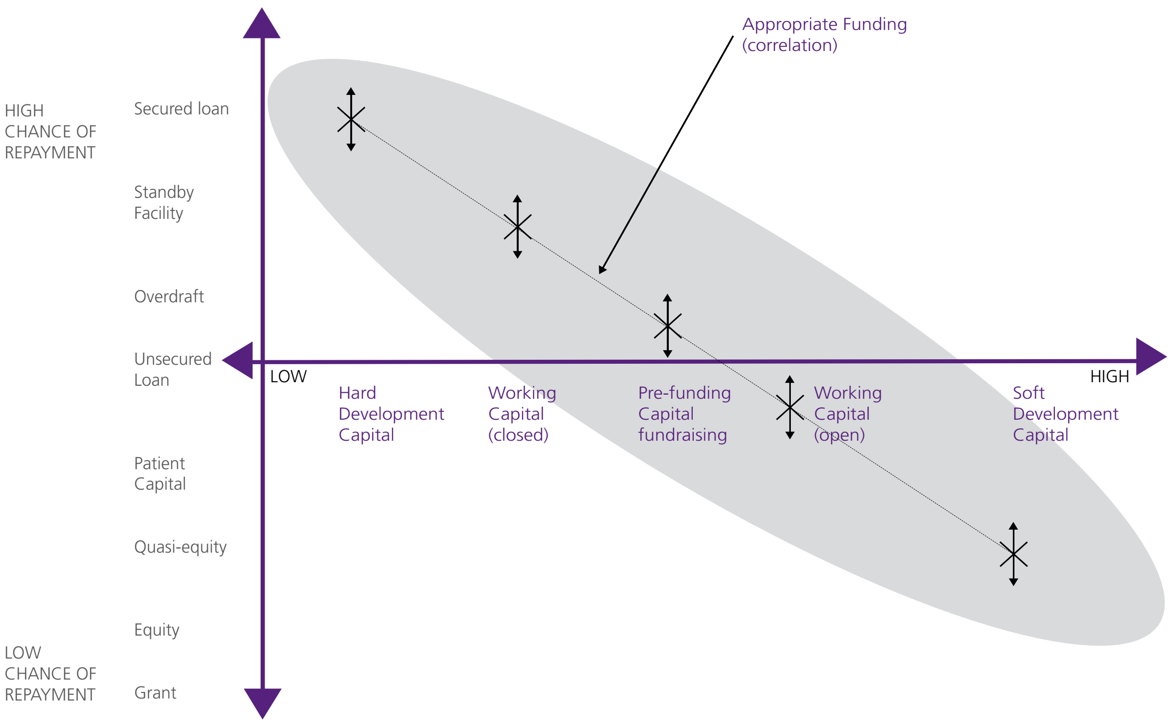
It is important to understand the finances of the charity as a whole, and the riskiness to the charity of the proposed project or development. A high risk development should be financed with a low risk product, eg a grant where

1 For more information, see *"Balancing financial risk and social return "* - available from the Venturesome website: www.venturesome.org

no return on investment is required. Conversely, a low risk development, eg acquisition of a currently rented property, may be appropriately financed by a bank loan. Investment plans with a risk profile in between these two are most likely to be in social investment territory.

Over the years, Venturesome has developed a framework for thinking about matching the right type of funding to the financial need in question. This is reflected in Figure 2 below.

Figure 2: Funding needs and financial instruments



Venturesome works with an organisation's management to determine the risk in the context of the charity's finances as a whole, in order to ascertain the most appropriate source of funding. This may or may not involve Venturesome funding. If grant funding or a commercial bank loan are accessible, it would not be an appropriate use of Venturesome's resources.

Once the nature of the financing risk (and therefore the risk to the organisation) is understood, a decision can be reached on the appropriate financing tool. If it is likely that a loan could be repaid, the extent of the risk that Venturesome will take relates to the perceived social impact of the organisation; generally the higher the social impact, the higher the risk we are prepared to take.

0688L/241108

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Registered charity number 268369

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