Review on Financing Social Enterprises

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Abstract: A social enterprise is a business with strong emphasis on social and environmental objectives. Several issues are affecting the financing of social enterprises among which, are the nature of its assets and liabilities; the need for a working definition, standards and measurements and the valuation of its source of value and competitive advantage. Although its products and services are considered breakthrough in concept and design, it is still perceived to be untested and unsustainable.

Key Words: Social Enterprises; Financing; Capital Structure; Blended return; Social Finance;

1. INTRODUCTION

1.1 Background

An estimated USD6 trillion is expected to be invested to social enterprises by 2052(Kickul, 2013). The requirement demands innovative and impactful designs aimed to make expensive investment in social enterprises more accountable, transparent and able to demonstrate a robust return on investment. The social enterprise' objective attempts to make money and meaning intersect. The review will exhaust existing literature adequate to achieve the objective. Moreover, the paper will assess Kickul's(2013) interesting issues about how well these mechanisms work and under what circumstances, how investment decisions are made, how social entrepreneurs can accurately determine what financing is most appropriate to their needs, and how social enterprises can best be positioned to obtain the financing they require.

2. REVIEW OF CONSTRASTING THOUGHTS

Social Enterprises is a business with a social or ethical purpose(Social Economy Backgrounder, 2013). The definition of the idea is growing for a conceptual clarity. The ambiguity in understanding more often obviates lending and credit analysis to allow access to mainstream funding in financial services and products(Forester, 2013)..

Wuttunee et al(2013) cites that blended return or double bottom line, and triple bottom line characterizes a social enterprise. It implies a -profit enterprise that places a strong emphasis on social and environmental objectives.

Recently, the definition is found to be different as applied in the United States, in UK and Australia and even in Canada. Mitchell et al(2008) as cited by the Forrester study(2013) examined several entities housed under social enterprises. Although Wuttenee et al(2012) states that ownership and legal status are not the defining criteria, social enterprises take on a number of forms: share capital corporation, non-share capital corporation (commonly called "non-profit"), cooperative, partnership, or sole proprietorship. Profits can be as diverse as breakeven to minimal, to very profitable.

2.1 Types of Social Enterprises

Table 1. A Typology of Social Enterprise (Foresters, 2013)

Type of Enterprise /Business	Definition
(1)Microfinance	(1.)Commercial venture by individual or household excluded from mainstream employment to secure a stable livelihood.
(2)Social Enterprise	(2)Social objective, limited distribution of profits with the purpose of maximizing social impact. Mix of capital inputs: blending earned income with grant and philanthropic income. Three types: Type A: social objectives and social outcome Type B: employment creation of social firms for people excluded from the workforce. Type C: social wealth generation, non profit organization with social objectives.
(3)Community Enterprise	(3) Focus on local or specific issues: could be local social issues, ecological or cultural issues using enterprise means
(4)Social Business	(4)Commercial business with social objectives, income from commercial undertaking than from gifts or grants.
(5)Eco/Green Business	(5)Commercial business with environmental objectives, either profit or non profit, commercial entity with income derived from commercial undertakings not through grant or subsidized income.

Table 1 exhibits the types of enterprises categorized under social enterprises. Three features stand out from among the several categories(Foresters, 2013)

1. Social purpose is core to its focus, business and structure.
2. Significant portion of income comes from the business activity and not from grants or philanthropy.
3. Profit distribution is for benefit beyond wealth creation.

Moreover, the nature of the enterprises are likely to service gaps, deficiencies and shortages not conventionally explored or are ignored by mainstream business. The risk exposure is also high but the impact is powerful. Foresters (2013) cites the following enterprises:

- Employment of people excluded from employment market
- Fair Trade
- Arts and cultural development
- Local development
- Ecological sustainability/recycling
- Local food system development
- Development of micro and social enterprises.

The characteristics of these enterprises are cast as traditional forms of social enterprises although several options are already gaining popularity in the market. Audacious ideas come in forms of greening the ozone layer, ventures associated with space, building skyscrapers made of wood and use of technology in all forms especially in education.

2.2 Financing Realities and Needs and Financing Implications of Social Enterprises

There two contrasting views of the lifecyle of social enterprises. Forester(2013) cites Morris(2007) and Anderson(2009) revenue versus time component. Morris(2007) uses the conventional start up, growth stage, mature stage lifecycle while Anderson(2009) differentiates by looking at concept, start up, take off an growth and stability expansion. Both authors seem to imply that during initial and first initial stages of the social enterprise, the need for financing is bigger than during maturity and stability expansion. This is similar for conventional businesses as funding and capital requirements are greatest when cash flows are unstable. Once maturity in cash flow is achieved, the need for financing becomes secondary to zero.

Table 2: Profit/Loss of four large enterprises over 2008,2007, 2006

Social Enterprise	2008	2007	2006
1	Na	3,800	6,580
2	49,300 total (36,300) operating	44,442 Total (1,130) operating	11,096 na
3	3	(55,000)	15,000
4	(38,000)	12,970	na

Table 2 indicates that the profit and loss financial performance among the selected four social enterprises in the Forester study(2013). The sample exhibits fluctuations in earnings seemingly skewing towards more losses in the later years. This trend implies additional risk arising from unstability in cash flow causing strain in the working capital of the social enterprises

Working capital management is similar with a normal business in effect, requiring social entrepreneurs be trained and capable of managing the spontaneous short term capital requirements of the firm. A tradeoff between between profitability, liquidity and risk will have to be clearly defined as financial planning and budgeting will also be required to be able to forecast adequate funding requirements for a particular period. The ability to forecast future and immediate funding requirements will allow time on social enterprises to secure flexilibity in loan agreements at cheaper cost of capital. An expensive cost of capital means social enterprise are charge with a heavier interests and penalties in cases of default. However, similar financial techniques and principles would also be needed and applicable.

2.3 Raising and Costing of Capital

Table 3: Differences between Social Enterprise and Social Business(Forester, 2013)

Characteristics	*Social Enterprise*	*Social Business*
(1)Origins	*(1)Starts with a charitable intent*	*(1)Starts with a business intent*
(2) Size/scale	*(2)small turnovers*	*(2)larger turnovers*
(3)Funding/Capital	*(3)blended capital; some grant, some earned and the balance shifts over the course of life of enterprise*	*(3)concentrate on earne income and commercially oriented capital*
(4) Balance between social and commercial	*(4)skew more towards social*	*(4)skew more towards commercial*

objectives under pressure	*objectives*	*objectives*

Table 3 illustrates differences in funding and capital sourcing of a social enterprise and a social business. The blended capital mix of a social enterprise will require a reengineered weighted average cost of capital technique, allocating the proportion of each capital in the measurement of capital structure. The grant or subsidies can be costed using the derivative cost in lieu a debt or loan agreements from banks.

2.4 Determining Capital Structure of Social Enterprise

Capital structure decisions are made as a function of the cost of capital as an optimal capital structure is achieved when the cost of capital is at minimum. There is no formula for a perfect capital structure for all businesses. Capital sourcing speculates on which capital cost the least and then use such source extensively as possible. Similar implications will affect social enterprises. Certain adjustment will be made however given the nature of the enterprise. In effect, a more expensive cost of capital will be imposed given nature of assets of the social enterprise, risky assets requires higher cost of capital. As such there is a need to properly classify the nature of assets of a social enterprise.

The literature however is silent on the nature of assets of the social enterprises under the Foresters(2013) study. Similarly there are not much information about the characteristics, tenure, period and interest rates of its liabilities.

Decisions between debt and equity is heavily a function of the accessibility of debt from mainstream financial institutions and lending firms as one can not borrow when no one is willing to lend. Banks are less likely to lend money with firms assessed to have risky assets arising from the unpredictable nature of business. Although the allocation of capital from grants and donations will substitute for the expected minimal debt in capital sourcing, expectedly, less participation from mainstream lending institutions require owners and investors of social enterprises to invest their own money.

2.5 Financing Social Enterprises across the lifecyle: different capital needs for different phases(Forester, 2013)

Table 4: Financing Social Enterprises across the lifecyle: different capital needs for different phases(Forester, 2013)

Phase	Capital Required	Often involves
1.Start up	1.Start up capital	1.Loans from family and friends 1.1sweat equity and voluntary labour 1.2personal finances, equipment, no wages and benefits High risk and low to zero positive return, chance for bankcruptcy high.
2.Seed capital	2.Dev't phase	2.1Grants 2.2low to no interest of loans from family and friends
3.Fixed Asset Capital	3. Dev't Phase	3.Capital needed to purchase equipment needed to support growth. 3.1Debt, some form of grant or donation

4.Working Capital	4.Dev't Phase	4.Safety net capital needed for lumpy cashflow for overdraft and standby facilities
5.Growth and Dev't capital	5.Growth Phase	5.Particularly difficult period for social enterprise to finance. 5.1Equity, quasi equity and like equity capital 5.2Debt capital in terms of long term loans
6.Sustainability and consolidation capital	6.Maturity Phase	6.Capital for long term sustainability and asset dev't; mortgases for purchase of premises.

Table 4 shows that different stages of a lifecycle of social enterprises requiring different sets of financing structure. This is not entirely different from conventional firms, the issues however are on the nature of assets of firms and the source of its competitive advantage to be able to secure an adequate financing for the enterprise at a cheaper cost.

3.GAPS AND DISCUSSION

Several gaps are still existing in terms of acceptable standards, metrics and indicators defining a social enterprise. Similarly, gaps are prevalent on the nature of its assets and liabilities. Both financial structure accounts are clearly manifested in the formation of the capital structure of the enterprise.

The nature of the product and service is more often perceived to be breakthrough, innovative but untested, maybe unsustainable and lacks track record. Arguably, its social impact is powerful but its cost of financing is just too high. There is potentially high default risk associated with social enterprises. Although this risk is tempered by the availability of grants, donation and other incentives expectedly, there is less participation from mainstream lending institutions. This situation often requires owners and investors of social enterprises to invest and use their own money to operate and sustain the firm.

4. CONCLUSION

Social enterprises is a business with a social or ethical purpose. Although there are still many issues to resolve in the enterprise, most of the firms operating under this category will be affected by similar and existing principles on financing of a functional business entity. This would mean that the social enterprise will best be served if its managers and decision makers are adept and trained to manage and sustained the financial condition of the entity including financing.

5. ACKNOWLEDGEMENT

The paper acknowledges the assistance of Jade Alyssa Gonzales; student assistant(STUPAF), in retrieving materials from the web.

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