BUILDING *the* INCLUSIVE ECONOMY

# FINANCING SOCIAL ENTERPRISE

## Strategies for Financing the Inclusive Economy:

**Financing social enterprise as a tool to create jobs and build community wealth**

Marjorie Kelly, Violeta Duncan, and Steve Dubb *for The Democracy Collaborative*
With contributions by Oscar Perry Abello

This paper is an adapted excerpt from *Strategies for Financing the Inclusive Economy,* the third report in Citi Community Development's Building the Inclusive Economy series.

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**Building the Inclusive Economy series:** Through three groundbreaking reports funded by Citi Community Development, the *Building the Inclusive Economy* series sets out effective, cutting-edge economic development models for city leaders and community development practitioners interested in embedding equity, community wealth, and sustainability into their local economic growth plan. This series, authored by The Democracy Collaborative, the Democracy at Work Institute, and Project Equity, lays out key tools and building blocks for equitable local economic growth through which all residents are able to maximize opportunities, thereby expanding urban economies where all can meaningfully participate and benefit.

**The Democracy Collaborative:** This nonprofit, founded in 2000, is a leader in equitable, inclusive, and sustainable development. Its work in community wealth building encompasses a range of advisory, research, policy development, and field-building activities aimed at enhancing the economic prospects of low- and moderate-income individuals. Its mission is to help shift the prevailing paradigm of economic development—and of the economy as a whole—toward a new system that is place-based, inclusive, collaborative, and ecologically sustainable.

**AUTHORS**

**Marjorie Kelly** is Executive Vice President and Senior Fellow with The Democracy Collaborative, where she oversees consulting and research projects as a member of the executive team. She is the author of *Owning Our Future* and *The Divine Right of Capital*.

**Violeta Duncan** is an Associate in Community Wealth Building Research and Strategy at The Democracy Collaborative, where she specializes in collaborative local economic development planning.

**Steve Dubb** is Director of Special Projects and Senior Advisor to the President at The Democracy Collaborative, whose current projects include the Anchor Dashboard Learning Cohort and community wealth building policy.

**Oscar Perry Abello** is a New York City-based journalist whose community economic development writing has appeared in publications such as *Fast Company* and *Next City*.



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DEMOCRACY COLLABORATIVE

The Democracy Collaborative
The Ring Building
1200 18th Street NW
Suite 1225
Washington, D.C. 20036
Phone 202/559-1473
www.DemocracyCollaborative.org

Broad-based ownership models bring substantial benefits to communities and workers, particularly those of low and moderate income.

# INTRODUCTION

And in an economy where wages have been stagnant for decades—and a disturbing 40 percent of jobs are now part-time, temporary, or contingent—broad-based ownership models offer a promising alternative.[1]

Given their impact, worker-owned companies, employee stock ownership plan (ESOP) companies, social enterprises, municipal enterprise, and new hybrid models with broad-based ownership are increasingly viewed as highly valuable tools for stemming and reversing rising economic inequality. But how to hasten their growth and build an inclusive economy, in which quality jobs are bountiful and ownership opportunities are widespread? How to increase understanding and comfort levels in these businesses' financing— *financing* being a key contributor to enterprise growth?

This paper—adapted from the *Building the Inclusive Economy* series' third report, *Strategies for Financing the Inclusive Economy*—begins to answer this question. It focuses specifically on how financial service providers, impact investors, foundations, local government, community development leaders, and others can finance cooperatives to build community wealth. As cooperative models spread, the role of lenders and investors will grow in coming years. That makes it critical to increase the field's understanding of the role of finance in supporting these models, how that role differs from traditional finance, and how that role is evolving.

Social enterprises, in many cases, employ traditional financing. The basic tools of debt and equity still apply. Yet because social enterprises have worker and community benefit as part of their core purpose, they often need special financing approaches. Among the characteristics of financing social enterprise models that build community wealth for low- and moderate-income residents are:

- **Investor returns on financing social enterprise vary across the spectrum from competitive to below-market returns.**
- **Philanthropic and government funding are important, particularly in early stages of social enterprise development.**
- **Non-traditional, specialized, and innovative forms of finance are often involved.**
- **Ecosystems of support are needed to reduce risk and increase likelihood of success.**

In the sections that follow, this report offers innovative financing strategies, case studies of social enterprise financing, and additional resources to help scale social enterprises as a tool for creating jobs and building community wealth.

Social enterprises, broadly construed, are organizations that employ commercial strategies to achieve a social mission.

While definitions of social enterprise vary widely, for the purposes of this report, social enterprises can best be thought of as being divided into two broad categories.

# Financing Social Enterprises

One category—which we might informally term *nonprofit social enterprise*—includes nonprofit organizations and their subsidiaries that have a revenue-generating model covering part or all of their operating costs. These nonprofit social enterprises are the ones most likely to call themselves social enterprises, and to belong to social enterprise associations, such as the Social Enterprise Alliance, which has close to 1,000 members. Often, these social enterprises have a primary purpose of employing residents in underserved communities.

Estimates of scale vary widely. The Great Social Enterprise Census, launched by Pacific Community Ventures, found $300 million in revenue and 14,000 employees in 2012. Although modest (and also likely a considerable underestimate), these counts represent more than a doubling of capacity in the preceding six years, since 60 percent of the businesses that responded had been formed in 2006 or more recently.[2]

A second category—which we might term *for-profit social enterprise*—embraces companies that are more traditional in their business models and have a strong social mission, thus may be viewed by investors as social enterprises. These are the kinds of companies most likely to be capable of attracting financial capital and providing a competitive return.

## Traditional Financing for Nonprofit Social Enterprises

**Foundation funding:** Foundations remain a starting point for funding many social enterprises. In essence, nonprofits typically initiate social enterprise as a method by which they can stretch grant dollars further, by generating earned income that can supplement grant and donor funds. The businesses developed often enable nonprofits to do their core mission work better—for example, having a client work at a social enterprise consistently results in job placement outcomes far superior to a simple job training program. Occasionally, fellowships through organizations like Ashoka or Echoing Green—which provide networking, capacity building, and stipends for social entrepreneurs—can help finance social enterprises. Echoing Green's fellowship program is almost three decades old, and its alumni include founders of social enterprises such as Hot Bread Kitchen, which employs immigrant women and helps transition them to long-term careers in the baking industry.[3]

**Program related investments (PRIs):** Once there is reliable revenue coming into the social enterprise, it may qualify for program related investments. These are typically below-market rate loans, considered part of the foundation's annual 5 percent distribution. To qualify as a PRI, an investment must have a charitable purpose consistent with the foundation's mission. A PRI helps establish a track record of repayments that may help attract other investors in later stages of growth.

### SOCIAL RETURN ON INVESTMENT

For nonprofit social enterprises, return on investment is sometimes measured in social terms. A 2015 study, for example, found that for every $1 spent by social enterprise, society nets a 123 percent return on investment. Taxpayers see a quarter of this return, as the reliance on government benefits is lessened and revenues bolster financial independence.[4]

One example is DC Central Kitchen, which reduces prison recidivism through culinary job training and placement. Reporting on its economic impact, DC Central Kitchen notes that by serving up to 5,000 meals a day to nonprofits and schools it saves these organizations around $3.7 million in annual food and labor costs.[5] The organization reports a job placement rate of 90 percent and says that it trains the unemployed for less than half the cost of other organizations.[6] And since it helps ex-offenders graduate and find work, with an average recidivism rate of only 2 percent (compared to a more typical rate of 50 percent), taxpayers are spared the expense of law enforcement, homeless services, and welfare payments.[7] All told, DC Central Kitchen finds that this adds up to a "350 percent return on investment for our community each year."[8]

### Challenges, Solutions, Opportunities

- **Nonprofit social enterprises often make low or no profits,** making it difficult to qualify for loans and investments. Among financing solutions are loan guarantees by foundations or other stakeholders, the growth of specialized nonprofit financing funds, and the ability to make the case for a social return on investment above and beyond financial return.
- **For-profit social enterprises can possess unique advantages in seeking financing**. As Tasha Seitz, chief investment officer of Impact Engine, a social enterprise accelerator in Chicago, said to Forbes, "Social enterprises can find sources of funding aligned with their mission that your typical firm doesn't have access to."[9] They also can sometimes combine philanthropic with other forms of financing.
- **New IRS clarifications for mission-related investments** by foundations were issued in 2015. This clears the way for more impact investing for social enterprise development.[10]
- **Growing investment by large players** is another sign of increasing potential for social enterprise investment. Larger financial asset management firms, such as JP Morgan, Morgan Stanley, Deloitte, Deutsche Bank, and Goldman Sachs, have all established impact investing portfolios in recent years to focus on the social enterprise space.[11]

## Innovative Financing for Nonprofit Social Enterprises

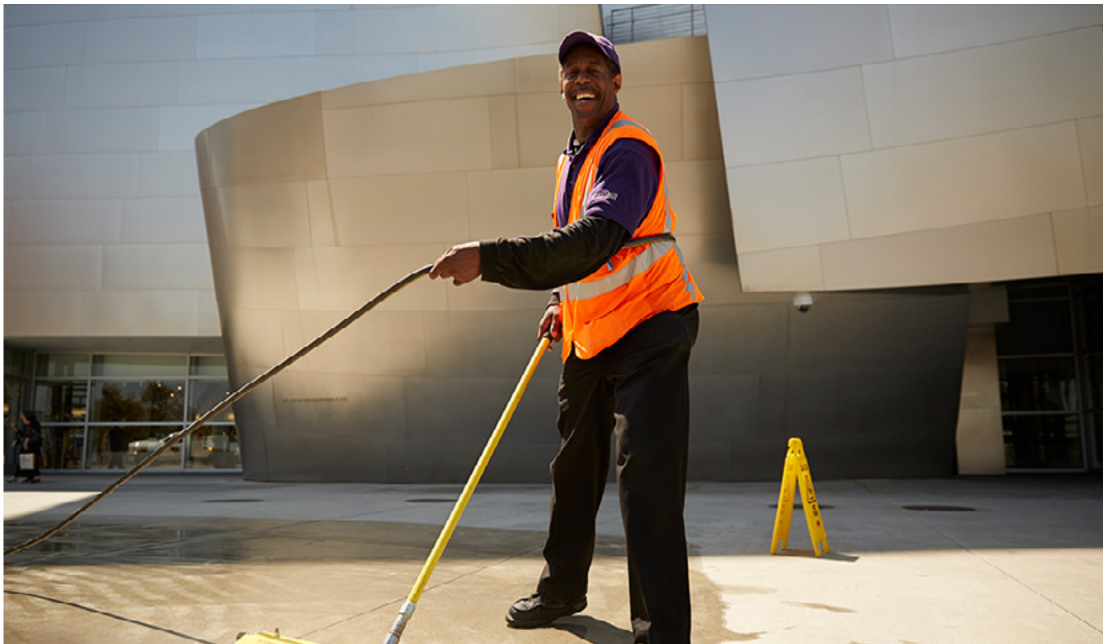
**Mission-related investments (MRIs):** Beyond grants and PRI, more innovative is the growing use of mission-related investments in social enterprises. MRIs are made by foundations with the expectation of generating social or environmental benefits, as well as risk-adjusted, market-rate returns. Unlike PRIs, MRIs are made from a foundation's asset base, endowment, or corpus. MRIs, too, are a form of impact investing; some foundations may have engaged in this practice for some time without naming it at all. A 2015 report from Arabella Advisories, a philanthropy consulting firm, reports that only one in ten small foundations is participating in impact investing, but those that are doing it are doing a lot.[12] For small foundations participating in impact investing, the average share of portfolios in impact investments is 40 percent, according to data from Exponent Philanthropy, a membership group of smaller philanthropic organizations.[13]

**Combining grants and investments:** Some forward-thinking funders—such as RSF Social Finance, the F.B. Heron Foundation, and the Omidyar Network—have reoriented themselves to combine various kinds of capital in support of social enterprises.

**Social impact bonds:** These bonds, also known as pay-for-success bonds, are an emerging area of finance that is helping social enterprises scale. Social impact bonds create a unique partnership among government, philanthropy, and nonprofit organizations. States issue bonds to private companies and philanthropies that are repayable only if the social enterprise meets its stated social goals. The idea is that government pays only for positive outcomes and investors share the risk of achieving these outcomes. One organization working with social impact bonds is Social Finance in Boston, which brokered an arrangement with the state of New York to bring in $13.5 million to the Center for

One of the nation's most prominent social enterprise accelerators is REDF, which has supported more than 60 social enterprises, helping to create more than 11,000 jobs, particularly for the most marginalized. This San Francisco–based organization has received two multimillion-dollar grants from the Federal Social Innovation Fund, which will allow REDF to expand to regions outside of California, including Seattle; Chicago; Denver; Austin, Texas; and Portland, Oregon.

**Photo c/o REDF**



Employment Opportunities (CEO) in 2014.[14] CEO is a nonprofit which prepares the formerly incarcerated for employment, saving $4,100 in criminal justice costs per participant.[15] This social impact bond, paid for by private investors putting in a minimum of $100,000 each, helped CEO provide job training to 2,000 new clients. New York State will repay investors, with a premium, if performance targets are met.[16]

**Federal Social Innovation Fund:** Created in 2009, this federal grant-making body funds proven social innovations that help low-income communities, with grants that generally require one-to-one matches. One social enterprise organization receiving a grant is REDF (formerly the Robert Enterprise Development Fund), one of the nation's most prominent social enterprise accelerators. This San Francisco–based organization has supported more than 60 social enterprises, helping to create more than 11,000 jobs, particularly for the most marginalized—those with backgrounds of homelessness, incarceration, addiction, or mental illness.[17] REDF has received two large grants from the Social Innovation Fund, for $7.5 million in 2010[18] and another $7 million in 2015, which will allow REDF to expand to regions outside of California, including Boston; Seattle; Chicago; Denver; Indianapolis; Austin, Texas, and Portland, Oregon.[19] The majority of the funds, 95 percent, will be disbursed as sub-grants to 22 social enterprises that aid those with barriers to employment.[20]

## Innovative Financing for For-Profit Social Enterprises

Well-established networks and gatherings exist among impact investors seeking to invest in the second category of social enterprises, those that are more like commercial businesses. Most prominently there is the annual Social Capital (SOCAP) Markets Conference, first held in 2008, which draws upwards of 10,000 attendees to its annual Bay Area gathering.[21] The Global Impact Investing Network (GIIN), established in 2009, now counts around 200 members among investors, asset managers, and service providers.[22] While many investors in these networks invest globally, the United States is an increasing focus of these groups.

The financial ecosystem for social enterprises continues to evolve. Public, private, and philanthropic sectors all invest in social enterprises. One of the chief early complaints from early actors in this space was that there were not enough investable social enterprises. Part of this was due to the fact that many investors wished to see substantial social impact, but were unwilling to accept below-market returns, which narrowed the universe of investable options.

**Impact investing:** Impact investing is debt or equity capital (not grants) that seeks to create social returns along with financial returns. It is generally available only to firms with a proven business model and an established track record of profitable operation. Impact investor capital can come from socially responsible investment firms, most of which are members of the Social Investment Forum trade group. Other impact investors can be local angel investors. New players are emerging continuously. One example is ImpactAssets, which offers philanthropist and individual investors impact investing opportunities through donor advised funds and impact investing notes. Regenerative Finance, which attracts funds from wealthy millennials—who are helping finance the Renaissance Co-op in Greensboro mentioned above—is another example.[23]

**Blended finance:** Social enterprises with the ability to scale and make a profit can find success in attracting both grants and equity financing. One social enterprise that has accomplished this is Jail Education Solutions, which sells a wireless, tablet-based education system for the incarcerated. Since its launch three years ago, this Chicago firm has raised $1.5 million in equity and $500,000 in grants, including a grant from the MacArthur Foundation, a PRI from the Patricia Kind Family Foundation, and venture capital from Kapor Capital, Serious Change, and SustainVC's Patient Capital Collaborative.[24]

CASE STUDY

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## OMIDYAR NETWORK SEEKS CATALYTIC IMPACT

The Omidyar Network—established in 2004 by eBay founder Pierre Omidyar—consists of both a 501(c)(3) grant-making foundation and a for-profit limited liability company that makes investments. The aim with both sides is to support market-based approaches that have the potential for large-scale, catalytic impact.[25]

Since its inception, the Omidyar Network has invested $461 million, as well as disbursing $508 million in grants.[26] Its first investment in the social accountability space was in SeeClickFix, which builds open-source, customized platforms for individuals to report and monitor non-emergency issues in their communities.[27] The Omidyar Network joined with another impact investment group to make an equity investment of $1.5 million in SeeClickFix in 2011, and joined a second equity investment of $1.4 million with a larger group of impact investors in 2014.[28]

The Omidyar Network also invests in other fund managers that seek to invest in social enterprises, such as Core Innovation Capital, which makes investments in financial services and technology firms that create consumer financial products, particularly for those who have traditionally lacked access.[29] Core Innovation launched in 2010 with $45 million in capital,[30] and has invested in thirteen companies.[31] One firm that Core Innovation invested in is Atlanta-based L2C, which developed tools for lending to individuals with limited credit histories.[32] L2C's tools and models were so promising that it was acquired in 2014 by TransUnion, one of the big three credit rating companies, which sought to provide more data to financial services clients seeking to increase lending to individuals from underserved backgrounds.[33]

Finance has a vital role to play in advancing cooperatives as a tool for job creation and reducing wealth inequality.

# CONCLUSION

This survey shows key areas poised for growth and social impact, indicating where finance can play a vital role.

It is clear that community wealth building approaches centered in broad-based ownership of business are poised to grow and can be important tools for addressing the economic inequality challenges that we face. Finance cannot do it alone. Yet it is an essential partner, and potentially a powerful force in leading this work. The social enterprise models highlighted here shine light on diverse ways to build the partnerships between development and finance. And, by forging these connections, finance and community development can work together effectively to build community wealth and a truly inclusive economy.

## ADDITIONAL RESOURCES

- ***Impact to Last: Lessons from the Front Lines of Social Enterprise,*** REDF, 2015, http://redf.org/learn-category/impact-to-last/
- **Social Innovation Fund,** Corporation for National and Community Service, http://www.nationalservice.gov/programs/social-innovation-fund
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