Raising Finance for your Enterprise

An information booklet
for co-operatives and social enterprises in the UK
by
Co-operative Assistance Network Limited

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1. Introduction

A well-run enterprise has a medium to long-term strategy running which ensures that it is sufficiently capitalised (i.e. it has sufficient money from loans, share investment and retained profits) to enable it to pursue its business development plan. If this is not the case the enterprise can find itself in a number of difficulties. For example:

- The enterprise operates at a level where its entire capital base (loans, share investment and retained profits) is insufficient to cover a loss which, in turnover terms (the level of sales), is relatively small. This is known as over-trading.
- The enterprise is unable to respond to demand because it is unable to afford purchases such as labour or raw material. This is referred to as being cash poor.
- The enterprise is unable to respond to new opportunity because it cannot afford to expand its productive capacity (the amount of sales the existing set up can generate). In this case, the business would be under-capitalised.

There are a variety of different sources of finance available to social businesses. The types of finance, as with private business, fall into the three types:

- Grants: A grant is a contribution, gift, or subsidy (in cash or kind) bestowed by a government or other organisation for specified purposes. Grants are usually conditional upon certain qualifications as to the use, maintenance of specified standards and/or a proportional contribution by the recipient or other grant funder.
- Debt: Debt finance commonly comprises of: short-term bank borrowings (such as overdraft); cash raised through debt instruments (such as bonds); financing such as operating leases; and trade credit.
- Equity: Equity capital is money that is invested in an enterprise that, in contrast to debt capital, is not repaid to the investors in the normal course of business. It represents the risk capital staked by the owners through the purchase of ordinary shares.

There are finance options available only to social businesses, by virtue of their social purpose and their engagement with community and social investors. The main alternative financing models used by social businesses are:

- Community shares: This is a term used to describe withdrawable share capital, a form of equity unique to registered co-operative and community benefit societies.
- Social investments: These are investments partially or completely made for social rather than financial returns.

Having worked through the business planning process, you should be clear on:

- How much capital you need for fixed capital investments (money that is invested in assets of durable nature for repeated use over a long

period), long-term investment in invisibles (e.g. investment in skills, market development and product development) and working capital (the cash available for day-to-day operations of an organisation)
- Your ongoing capital requirement.

You can then go onto establish:
- What is a balanced investment strategy for your social business.
- Whether seeking investment is necessary – are there alternative strategies for financing?

2. Defining how much you need

There are three main areas to consider. These are
- Fixed capital investments
- Long term investment in invisibles
- Working capital

Fixed capital investments

This is the purchase of capital goods retained within the enterprise and forming the core of the productive capacity, along with its people. The defining characteristic is that these are required by the people to carry out their work. Capital goods can include improvements to property, fixtures and fittings, trademarks and patents, as well as machinery.

Whether any individual investment is a good idea can be assessed through a calculation of Return On Capital Employed; by how much does the value of increased production or reduced cost – of labour or external purchasing – exceed the cost of purchase over its useful life, and does this rate of return exceed the cost of borrowing the capital? This is the ROCE test.

The proper enterprise attitude to the purchase of capital goods is very different to the proper attitude to the purchase of capital goods in private life. In our private lives we tend to feel that we should purchase capital goods like cars or freezers when we can afford the money. In enterprise the purchase of capital goods is not spending money, it is merely changing the form in which the money is held from liquid to fixed asset and we do this in order to be able to produce, thereby being able to afford our costs. The more that we can appropriately invest in capital equipment, the more productively and profitably we are able to work. The proper enterprise attitude to purchasing capital equipment is not "we will buy it when we can afford it" but "we must be able to afford it as soon as we predict that the ROCE test will be proven".

Investment in invisibles

Invisibles include training, market research, marketing planning and production of marketing materials, product research and development where these are not routine ongoing work but geared to the launch of an enterprise or its re-launch into a higher turnover bracket or different market, the benefit of which will be realised over the years ahead. The same means of calculation as for fixed capital investment is appropriate to test viability of such investments. They are more problematical for an enterprise because they often cannot be shown as assets in the balance sheet of the company and look like cash flowing out instantly instead of gently over time by the mechanism of depreciation. For this reason under capitalised enterprises often under invest in people, product and marketing.

Working capital

If we look at the cash-to-cash cycle of the typical enterprise, we see that cash is paid out on staff costs and material costs before it is received back from customers. The money that is tied up in stock and work in progress plus what customers owe for earlier deliveries is the working capital requirement of an enterprise. The more an enterprise expands the greater its turnover and the greater the working capital requirement will be. Many enterprises have failed because they have missed this simple point and despite operating profitably and marketing successfully have been unable to raise the cash to pay for inputs, thus entering a tail spin of dislocation, low productivity and loss making.

3. Calculating the ongoing capital requirement

An enterprise should seek to have in place a capital sourcing and investment strategy to cover its needs in the above areas for some years ahead. This will obviate the need for recurring panics every couple of years and the casting around for emergency (and usually expensive) sources of funds. It will also enable an enterprise to form long-term relationships with sources of investment in which both parties feel secure. An enterprise expecting to be profitable should not expect to be immune from the need for outside financial backing. A profitable enterprise may well wish to expand faster than it can provide finance through retained profits. Those who run the enterprise may wish to have some of the profits distributed and/or used for other social outputs. There is something to be said for jam today as well as jam tomorrow.

Someone should therefore be addressing the issue “How much will we need to invest each year for the next five years and where is it coming from?” Of course this person will be operating with very little guidance if there is no enterprise development plan and no forecasts of future turnover to work from.

Assessing fixed capital requirement

What increases in production are expected? (This question works equally well for a new start enterprise, the increase is merely from zero.) Could production department give guidance on what additional equipment will be required to churn it out? Could they provide specification, get quotes? How many more workers will be expected to come on stream and when? Will they require desks, computers? Can the ICT manger provide information on what expenditure will be required to ensure that the system does not fall over under the strain? Budget setting is a process by which each part or department of an enterprise, probably with the help and guidance of the Finance Department / Worker, assesses its financial needs to hold its end up in meeting the targets set by the overall plan. Capital budget is a part of this.

Investment in invisibles

Broadly the same as above, but the calculations tend to be more difficult since they involve estimates of time commitment as well as external purchasing. It is also necessary to ensure that people are not double counting in their budgeting process by counting time invested in research and development again in the general costs of production element of their department.

Working capital requirement

There are two methods and it is probably best to use both to check one another.

The first is to prepare a cash flow projection, which shows:

- Income based on sales as that income is expected to be received
- Expenditure on inputs such as material and sub contractors as it is necessary to spend to meet costs of production at those required levels
- Expenditure on overheads like premises cost, core staff etc. but not counting depreciation (this is a cost of enterprise in profit and loss terms but not a cash expenditure)
- Capital expenditure as it is necessary to invest to create the capacity and infrastructure to meet these levels of activity
- Investment in invisibles
- Sufficient investment income to pay for the investment in fixed capital and invisibles as those investments fall due
- The expected schedule of repayments, interest payments and profit distribution read off the bottom line of closing balances.

These may well be negative showing a need for a cash flowing or working capital facility. If this cash flow projection is on a month-by-month basis it is necessary to add on a safety margin to allow for “swing on account”, meaning that the way the bank account behaves may not mirror this exactly. It is

possible that payments out are made before payments in are collected and the full safety margin would be to add a month's expenditure onto the worst negative figure on the cash flow, though some enterprises, particularly retail enterprises with daily cash inflow, can reduce this safety margin substantially.

One extra warning: Remember that time spent on invisible investment (research and development, special marketing initiatives, setting up time on new equipment) cannot be spent on production or fee earning work. This may not reveal itself in the cash flow as additional labour cost if it is achieved through redirection of existing staff time. However, it should be allowed for in both projected cash flow and projected profit and loss as a reduction in maximum potential sales turnover.

The second method is to work backwards round the cash to cash cycle working out the amount of cash tied up at every stage. For the level of enterprise projected

- Multiply the sales value of the average daily output by the average number of debtor days (the length of time it takes the customers to pay you) thus arriving at an average value for the amount of money tied up in debts owed to you by the customers.
- Add the amount of completed stock at input prices (cost of production including target contribution to overheads but not profit) the enterprise needs to carry to support the projected sales volume.
- Add the value of the work in progress which will be needed to ensure that stock levels of finished product or uninterrupted supply to the customer which will be required (cost on the same basis as finished goods)
- Add the value of material stocks that will be required to ensure that work can be carried on without disruption.
- For retail enterprises the last three headings will all be the same, for service enterprises there may well be no material stock or finished stock but there will certainly be work in progress.
- Deduct the amount of credit that will be extended by suppliers on this stock or by sub contractors on their part of work in progress.

This will give a figure for the amount of working capital tied up in the enterprise on average. An allowance for variation should be added on a similar basis as for swing on account under the cash flow method.

The second method will be the more accurate in assessing how much working capital is required by the enterprise, the first will be more accurate in assessing when it will be required allowing for seasonal factors, and the balancing of investment in fixed assets and invisible assets with the drawing down of investment finance. Whichever gives the worst result at any period in time is the one to work with.

4. Sources of finance

When identifying sources of finance, you need to consider:

- Cost of the finance, both to raise and service the capital
- How much, if any, control the investor can have in the social business
- Personal risk
- Repayment terms
- Convenience
- Whether you are willing to put at risk the particular investor's money.

You need to ensure that you have a balanced investment strategy. You should also consider alternative strategies to finance your social business that you could, should or must follow.

Here are some of the types and sources of finance relevant to social businesses:

- Debt finance
- Equity
- Grants
- Supply chain finance (e.g. credit from suppliers)
- Crowdfunding
- Social investment
- Venture capital & business angels
- Reinvestment of retained profits
- Member / stakeholder investment
- Financing by family and friends.

4.1. Debt finance

Debt finance comprises of:

- Short-term bank borrowings (such as overdraft)
- Cash raised through debt instruments (such as bonds)
- Off-balance-sheet financing (such as operating leases)
- Trade credit.

There are many types of debt finance, including:

- Overdrafts
- Loan stock and bonds
- Debentures

- Factoring and invoice discounting
- Leasing
- Credit cards
- Non-bank lenders
- Bank loans.

Debt finance is often secured against capital assets or personal guarantees.

Overdrafts

An overdraft is a sum of money extended to you as credit by your bank, set at a pre-arranged limit when your account balance drops below zero. Banks usually charge interest on any amount of overdraft you use, but the terms and price of overdrafts will vary between providers.

You can use a bank overdraft to manage your cashflow, but it is very unlikely to be not suitable if you’re looking for long-term funding.

The bank is your friend. Cash flow support is what they are really good at. They know that you have money going into your current account all the time and they know that they can stop it going out any time they want to. They are therefore a lot less sticky about overdrafts than loans.

Smoothing out the cash flow is what overdrafts are for. They are an expensive way of getting core borrowing. If you are overdrawn more than half the time then you are proven to not have a good investment strategy.

Always give notice of your requirements; never spring it on the bank with little notice – that suggests bad management and makes them twitchy. Always act like it is the most natural thing in the world to expect, they tend to share your confidence levels.

Make sure that the relationship is not limited to the times you need a bit of cash flow support, building a relationship through techniques like dropping them a copy of the quarterly management accounts and a compliments slip with the edited highlights like “trade up 40% year on year again” scribbled on is a good one.

Loan stock

Loan stock is stock issued to an organisation in return for a loan. Loan stock earns interest. Loan stock is a form of debt but it has many of the features of a risk investment.

A bond is a written and signed promise to pay a certain sum of money on a certain date, or on fulfilment of a specified condition. All documented contracts and loan agreements are bonds. Traditionally, bonds are traded (i.e.

transferred from one owner to another for a price agreed between the vendor and purchaser) but, in a social business, bonds and loan stock are the effectively the same.

Loan stock and bonds give no say in running the business. They may be secured against capital assets or personal guarantees.

In a company limited by guarantee where there is no share capital, loan stock and bonds are useful as they are a regarded as quasi-equity. As long-term investments they support the financing of the business rather than being regarded as a liability that must soon be paid back to the investor.

Loan stock is often used by enterprises formed with a clear social purpose of community benefit. Loan stock provides a low cost route to small-scale investment by supporters, but is probably under-utilised by enterprises generally.

There is an added tension about taking real live peoples' money and gambling with it beyond that experienced when taking a financial institution's money and gambling with it. This is an assertiveness issue and a clear pointer that you need to have a credible business plan and financial projection.

Many people have a legitimate interest in the establishment of development or growth of an enterprise. These include potential customers looking for a new or alternative source of supply, potential suppliers looking for a market, potential project partners looking for a strong ally. Many other people would welcome an opportunity to make an investment at a few points better rate of return than a bank would offer them whilst supporting local enterprise and local people.

Particularly when dealing with people with a personal connection, it is important to have these things dealt with on a professional basis, properly recorded and documented. Soft loans are not soft loans if the lender thinks that they have a right to ask for the money back because *it is Christmas, and surely they made that clear when they emptied the jam jar and handed the money over did they not?*

Loan stock is ideal for a highly targeted ethical investment because it does not require legal advice to issue, and so is available to smaller organisations. Legal advice may be necessary for larger and more complex issues. All issue of loan stock should set out:

- A maximum amount that can be issued
- A clear date of maturity (sometimes referred to as the 'closing date')
- A rate of interest (or a clear statement that no interest is payable or how the interest is to be calculated).

Unicorn Grocery (www.unicorn-grocery.coop), a worker co-operative in Manchester retailing local, organic, fairly-traded and wholesome food products, has made use of loan stock issues. In 2005, the owner of the co-operative's rented store wished to sell the property. To avoid losing its premises and to ensure its long-term sustainability, the co-operative raised the finance required

to purchase the property itself. This was achieved through £350,000 raised from loan stock bonds bought by customers and loans provided by The Co-operative Loan Fund in partnership with Co-operative & Community Finance.

Debentures

A debenture is a corporate bond (a written, signed, unconditional, and unsecured promise by one party to another that commits the maker to pay a specified sum on demand, or on a fixed or a determinable date) which is backed generally by the borrower's specific assets.

Debentures have similarities to equity. They can be transferred from one investor to another. They are subordinate to other creditors (except for shareholders). As 'financial securities' they will need to comply with Financial Services and Marketing Act 2000 which can require costly legal advice.

Because they behave like equity but are not, they are of use to companies limited by guarantee that cannot have shareholder equity.

Factoring & invoice discounting

Factoring – also known as 'debt factoring' – involves selling your invoices to a factoring company. In return they will process the invoices and allow you to draw funds against the money owed to your business. They will also take responsibility for your sales ledger. You can use factoring to improve cashflow but it can also be used to reduce administration overheads.

Invoice discounting is similar but your business retains control over your sales ledger.

In trades where large invoices are issued and the trade norm is for a long period of time to elapse before payment it may be worth considering factoring. A factoring company will pay a large proportion of invoice value (normally around 85%) immediately and then collect the money from customers forwarding the balance after fees are deducted. This removes credit control from your concern and hands it over to experts; it also brings a lot of the debtor balance straight into cash where you need it. It costs money. The improvement in cash flow is once and for all but the cost goes on for ever because you never dare drop out of the system and lose a month’s cash flow. Think hard before getting addicted.

Leasing

Your business might need to acquire assets (like furniture, computer equipment or company vehicles) or capital equipment, such as plant or machinery.

You could buy your assets or equipment outright, or you might decide to rent them instead. This allows you to get the equipment and assets you need that you might otherwise be unable to afford. It can also free up working capital for use in other areas of your business and save you from having to take out a large loan to buy equipment outright.

You may want to lease or rent equipment that has high maintenance costs, can quickly become outdated, or is only used occasionally.

There are 3 main types of lease agreement – finance leasing, operating leasing and contract hire – and you should carefully consider which one is right for your business.

Debit & credit cards

Credit cards are generally used in cash transactions (i.e. purchases that need paying at the time of purchase). Credit card holders (who may pay an annual service charge) draw on a credit limit approved by the card-issuer such as a bank or service provider. If the transaction takes the cardholder's account over the approved credit limit, the transaction is not completed. Cardholders normally must pay for credit card purchases within 30 days of purchase to avoid interest and/or penalties.

Debit cards are also generally used in cash transactions. A debit card differs from a credit card in that, in a debit card transaction, the amount of a purchase is withdrawn from the available balance in the cardholder's account. If the available funds in the bank account are insufficient, the transaction is not completed.

A social business may be wary of using cards as this may lead to lack of control over spending. However, good governance leading to clear guidelines around when spend is permitted together with an appropriate level of credit on a credit cards / appropriate maximum monthly spend on a debit cards will keep adequate control of costs and cashflow within Finance Department.

A disadvantage of the credit card is the high rate of interest if you miss paying off the total of the balance on the card at month end. Costs can escalate if you end up using the credit card's credit limit as a form of loan. Credit cards and debit cards are a way of paying for goods and services quickly and easily without having to go through a long-winded process with the Finance Department; if the credit card is going to be needed for providing debt finance beyond the monthly repayment date then seek other forms of finance immediately!

Non-bank lenders

A loan is an amount of money borrowed for a set period within an agreed repayment schedule. The repayment amount will depend upon the size and duration of the loan and the rate of interest.

How to apply for and get your loans:

- You need to have a plan for the development of your enterprise and you need to have one at all times. This requires an annual revisit and reworking to keep the plan looking forward into the medium term. It should set targets over five years and a sensible level of detail over the next two.
- The finance plan is a sub set of, and geared to, the enterprise plan. You need to know how much, when and what for.
- If you know how much, when and what for you can decide who is the appropriate supplier or rival potential suppliers for each element. Spread the requirement around more than one source. Start talking to targets in advance, prepare them for the fact that you are going to give them an investment opportunity and that they are gratefully going to accept it.
- Having talked to the target enough to establish rapport and learn their predilections and methodology present them with the facts in the order most suited to their needs. Take a customer-centred approach. What are their needs? What do they need to know and what is merely noise and distraction, what do they need demonstrated or proven and what is time wasting pedantry? Remember the customer’s concerns are: Can these people do what they say? Can a good enough income stream be generated to make the repayments? Is there sufficient excuse for me to feel relatively secure?
- Answer the main concerns. Concentrate on the most important thing, the ability, qualifications and spirit of the team. If the enterprise has a track record then ensure that its achievements are properly explained. Demonstrate that the strategy has been thought through. The enterprise plan will ideally mention that calculations such as return on capital investment and income generated against repayment schedules have been looked into and met the demanding criteria laid down by the enterprise’s management. Ringing endorsements from customers are highly persuasive.
- Invite them to visit and/or meet with you. When they do, use the opportunity to illustrate your story. Your story is of course about where you are coming from, where you are going to and why you are sure you can get there. All presentations, all answers to questions should be geared to this story.

The following finance organisations lend to social businesses:

Baxi Partnership
www.baxipartnership.co.uk
01383 749672

Big Issue Invest
www.bigissueinvest.com
0207 526 3434

Co-operative and Community Finance
www.co-opandcommunityfinance.coop
0117 9166750

CAN Invest
www.can-online.org.uk
020 7922 7757

The Co-operative Bank
www.co-operativebank.co.uk
08448 44 88 44

Charities Aid Foundation
https://www.cafonline.org/charity-finance--fundraising/borrowing/social-investment.aspx
03000 123300

Charity Bank
www.charitybank.org
01732 744 040

Ecology Building Society
www.ecology.co.uk
0845 674 5566

Finance Wales
www.financewales.co.uk
0800 587 4140

Radical Routes
www.radicalroutes.org.uk
0845 330 4510

Robert Owen Community Banking
www.rocbf.co.uk
0845 313 8458

Triodos Bank
www.triodos.co.uk
0117 973 9339

Unity Trust Bank
www.unity.co.uk
0845 140 1000

Bank loans

Banks usually charge interest on any loans that you get, but the terms and price will vary between providers.

Bank loans are still the number one source of lending to small enterprises. Of course, usually they ask for joint and several guarantees from Directors, which in real life means they are borrowing money from the person with the largest personal asset, such as a house, at nil interest and then lending it to the enterprise at a very healthy interest rate. In general terms our hero guarantor

would be better off raising a second mortgage and lending the money themselves. Some banks can actually be persuaded to forego these guarantees if sufficient assertiveness is demonstrated and there is genuine financial strength in the enterprise. Others can be persuaded to at least accept individual guarantees of limited amounts adding up to the total, again with sufficient assertiveness.

Different types of bank loan include:

- Working capital loans – for short notice, emergency situations or simply to provide on an on-going basis sufficient funds to be able to pay debt obligations and other business related expenses while your cash is tied up in stock and money owed by debtors
- Fixed asset loans – for buying assets where the asset itself is used as a collateral.

If you are looking for finance to cover small monthly fluctuations (e.g. occasional and unpredictable delays in receiving payments against invoices), it may be that a bank overdraft is a more appropriate financing method for your social business.

Personal guarantees

Most lenders require some form of security on the money that they are lending; if the borrower can no longer repay the loan, then the lender wants to maximise the likelihood of getting their money back.

The lender may take the security against assets held by the business or effectively by assets held by the individuals involved in the business.

Fixed and floating charge

A charge is an asset pledged to guarantee the repayment of a loan. This security gives a lender a legal right of access to the pledged asset and to take their possession in case of default for a foreclosure sale (i.e. the business goes into liquidation).

A fixed charge is a lien on a specific fixed-asset (such as land, property, equipment or vehicle) to secure the repayment of a loan. In this arrangement the asset is signed over to the creditor and the borrower would need the lender's permission to sell it. Incorporated organisations are required to file the detail of the charges with their registrar – with Companies House (if registered as a company) or with Financial Conduct Authority (if a Registered Society or Community Benefit Society). This information is then available by anyone from the registrar, usually on payment of a fee.

A floating charge is a lien on an asset that changes in quantity and/or value from time to time (such as stock), to secure the repayment of a loan. In this arrangement, no charge is registered against the asset and the owner of the asset can deal in it as usual. In the event of liquidation, this floating charge

then transfers to a fixed charge on particular assets at that point in time, making the lender a priority creditor.

Personal guarantee

A personal guarantee is a financial obligation for which an individual is responsible and which may be satisfied out of his or her personal assets. Most lenders demand this sort of guarantee, often in addition to a fixed or floating charge. While the governing document of the social business may state that the liability on individual members is limited to the level of guarantee (usually £1) or the level of shares held, a personal guarantee circumvents this limited liability for the individual or individuals signing up to the personal guarantee.

Think carefully prior to signing a personal guarantee – you are now risking your money, your house and your own personal bankruptcy. Not all lenders demand personal guarantees: Co-operative & Community Finance (www.coopfinance.coop) have grown their lending service to social businesses over 40 years on never taking personal guarantees, but by basing lending decisions on the business plan, good loan appraisal and fixed & floating charges where appropriate.

Joint and several liability

"Joint and several liability" is a term used commonly in loan agreements involving two or more borrowers. Under the legal concept of joint and several liability, a lender has the freedom to claim the full loan balance from the signatories as a group (not necessarily on a proportional or pro-rata basis) or from each of them individually. The lender may sue any signatory who has enough free assets to satisfy the lender's claim, without taking any action against the others. As well as putting individuals' assets at risk, this can have the effect of skewing the democratic process in the social business as those with more assets to lose may be considered to have the right to more of a say; though not written as such in the governing document, there is a danger that decision making could work like this in practice.

4.2. Equity finance

Traditionally, equity finance is a way of raising finance from external investors in return for selling a share of your business.

A social business in general will use equity in a different way. Shares in social businesses in general are traded at par (i.e. they do not increase in value and would be cashed in for no more than the value they were purchased) though that does not necessarily have to be the case.

Equity in a business is the capital that owns the business. Your main stakeholders who are to have democratic control of the business can own the equity. Equity ownership outside of those main stakeholders can cause problems regarding who is actually in control of the business. Creating non-voting shares is a solution to this problem.

Unlike debt providers, equity investors do not have rights to interest or have to have their capital returned by a particular date. Equity investors in social business are long term investors who earn a return on their investment through dividends. They would usually expect a higher return than debt investors because the risk involved is greater though the motivations for investing in a social business may mean that investors invest without expectation of a high return.

Your business may be suitable for equity finance if it needs to purchase capital equipment, has fast growth potential or an innovative product needing significant investment in product and market development.

Equity finance is available from various sources including:

- Community investment
- Business angels
- Venture capital funds
- Family and friends
- Crowdfunding.

Other equity terms that you will come across that are important for financing your social business are:

- Sweat equity
- Quasi equity.

There are two types of share issues: private and public. Private means that you have to prepare a list of direct contacts and limit the invitation to buy shares to them. Public share issues entail a wider distribution with a sensible attempt to offer the shares widely and a published prospectus or a share offer document describing the status of the shares, what will be done with the money, the projected returns and the benefits. A prospectus will be expensive to produce as it needs considerable legal advice where a share offer document will be much cheaper but is only applicable to registered societies and community benefit societies.

In companies, there are many kinds of shares but, for the sake of simplicity, they broadly fall into two general types: ordinary (voting) shares and preference (non-voting) shares with marginally better likelihood of realising some of the investment if the company stops trading and goes into liquidation.

Registered societies and community benefit societies have withdrawable share capital, a form of equity unique to them. Community shares is a term used for this type of equity.

Distinctions between loans and equity finance

There are a number of forms of lending, such as loan stock, bonds and debentures, that mimic some of the features of equity. However, there are many reasons why they may still not be adequate:

- Bonds, loan stock and debentures grant no rights of participation in the organisation, they do not build a sense of community and membership
- Debt must be shown as a liability and so it can appear that no-one is willing to risk their funds on the organisation, making the business less attractive to additional investors
- Most loan stock, bonds and debentures have a date of maturity, so cyclical refinancing is necessary.

Equity, in the form of shares, is a secure, durable underpinning to an organisation, provided it does not inadvertently place the wrong people in charge of decision making.

Quasi equity

Quasi equity is a form of debt that could also be considered to posses some traits of equity: e.g. flexible repayment terms or subordinated debt (i.e. it is ether unsecured or has lower priority that other debt).

Loan stock, bonds and debentures could all be classed as quasi-equity.

Big Society Capital says "A quasi-equity investment allows an investor to benefit from the future revenues of an organisation through a royalty payment which is a fixed percentage of income. However the investor may gain nothing if the organisation does not perform. This is similar to a conventional equity investment, but does not require an organisation to issue shares. The share of future revenues that a quasi-equity investor receives is usually linked to income and not profit, as charities and social enterprises are often not structured to make profits for distribution."

Sweat equity

Sweat equity is the increased worth of a business (over and above the money invested) created by the unpaid mental and/or physical hard work of the founders, subsequent members and supporters.

In well-capitalised business start-ups, there is adequate financial capital investment to ensure that everybody who works on the setting up of the business is paid in full for their work. However, many small businesses do not have the luxury of adequate supplies of start-up capital and rely at least in part on the substitution of people working without pay. This is known as "sweat equity investment".

Community shares

This is a term used to describe withdrawable share capital, a form of equity unique to registered co-operative and community benefit societies.

Community shares (or community investment) is the investment by ordinary members of the public in enterprises that they wish to support. Those investing in the enterprises are generally becoming member shareholders of these enterprises with a governance role. If your social business cannot accept this community involvement in the governance then you should look at other forms of finance. There has been a significant upsurge in the use of community shares in recent years and in a variety of sectors:

- Community-owned shops and pubs
- Community renewable energy projects
- Agriculture, farming and woodland
- Community assets and buildings.

Incentives to invest
People invest in community shares for a whole variety of reasons:

- To save or create a useful asset for their community
- To achieve a desired outcome, such as an increase in green energy
- To get a small return on their capital (community investors are generally not investing primarily for financial return)
- To take advantage of the various tax reliefs available.

Legal structures
Community investment businesses are almost exclusively Registered Societies, which are specifically exempted from much of the restrictive provisions of the Financial Services and Markets Act 2000. They are democratic structures, which issue "Withdrawable Shares" that do not increase in value and cannot be traded or sold on.

Further resources
For a complete overview of community investment and community shares, there are comprehensive guides, case studies and other resources available through the Community Shares Unit (www.communityshares.org.uk), in particular the Community Shares Handbook (www.communityshares.org.uk/resources/handbook).

4.3. Grants

A grant is a sum of money given to an individual or business for a specific project or purpose. A grant usually covers only part of the total costs involved.

Grants may be linked to business activity, employment creation or a specific industry sector. Some grants are linked to geographic areas, e.g. those in need of economic regeneration.

Most grants don't have to be repaid and are not shown as debt in your balance sheet. However, the application process can be time-consuming, there is a lot of competition, you may have to demonstrate progress of the project to the

grant body and you may need to match funds (as grants do not usually cover the full cost of a project).

4.4. Supply chain finance

Supply chain finance is minimising your cash that is held by your suppliers, tied up in stock held and waiting to be released by customers; thus maximising the amount of cash held by you.

Supply chain finance is perhaps the most common form of financing used by social businesses. Through maximising the amount of cash in your business, there may be no need to look at financing from external sources.

If we look at the cash to cash cycle of the typical enterprise, we see that cash is paid out on staff costs and material costs before it is received back from customers. The money that is tied up in stock and work in progress plus what customers owe for earlier deliveries is the working capital requirement of an enterprise. The more an enterprise expands the greater its turnover and the greater the working capital requirement will be. Many enterprises have failed because they have missed this simple point and despite operating profitably and marketing successfully have been unable to raise the cash to pay for inputs, leading to dislocation, low productivity, and loss making.

Working capital can be kept to a minimum through good management. Work backwards around the cash to cash cycle to see where you can make an impact.

Credit control

Credit control on debtors is obviously a very important area of work. The key elements are:

- Clear terms of trade
- Negotiate special small supplier status with the corporate customers
- Cultivate a good relationship with workers in the finance department of customers while making sure that they know they will get polite yet determined follow up if they go over time
- Discounts for prompt payment (built into the original price of course)
- Penalties for late payment (all backed by the terms of trade documentation).

Factoring

In trades where large invoices are issued and the trade norm is for a long period of time to elapse before payment it may be worth considering factoring. A factoring company will pay a large proportion of invoice value (normally

around 85%) immediately and then collect the money from customers forwarding the balance after fees are deducted. This removes credit control from your concern and hands it over to experts; it also brings a lot of the debtor balanced straight into cash where you need it. It costs money. The improvement in cash flow is once and for all, the cost goes on forever because you never dare drop out of the system and lose a month's cash flow. Think hard before getting addicted.

Invoicing

Invoicing can be a make or break area also. Obviously, accuracy is important since overcharges will usually be spotted, lead to customer dissatisfaction and delayed payment whilst undercharges will also be noticed and cause loss of image but will generally not be brought to your attention thus wiping out your profits. The way in which invoicing is carried out can make an important difference to the cash balances. Is the liaison between the person in charge of the project and the person who generates the invoices perfect? Does the person who raises invoices always know the minute that the project is finished, the goods despatched, whatever, and is getting the invoice out immediately their highest priority in life? It has been known for invoices to go out to have languished on the desk while workers have received pay cheques late. Does the person who raises the invoice have good information about when stage payments can be invoiced for? Time is money and cash flow is king.

Finished stock or stock for sale

Is the level of stock sufficient to meet demand (you cannot make profits on what is not available to sell) or is the level too high? There is a right and proper rate at which a product should turn over or it should not be held in stock and existing examples should probably be turned back into money even at a discounted stock clearance price. There is a right and proper level, based upon demand versus rate of production or ordering time for the stock level of any item. To go beyond this is laziness and the result is money tied up in wasting space. Of course management time also costs. A simple computer programme or home-made routine might help.

WIP

Work in progress (the value of partly completed jobs where value has been added, money is tied up but no invoice has yet been issued) is more difficult to interfere with from a financial point of view since production management have consideration about the best use of human power, equipment, space which requires enough juggling without interference from the financial management team. If the message that getting jobs out and invoiced is one of the priorities worth entering into the juggling equations, then the cash flow implications can be enormous. Also, work can be stuck in work in progress simply because no one has got around to raising a sales invoice. Getting the invoice out quickly

should bring the cash in sooner and release cash stuck in the cash to cash cycle.

JIT

Stock holding of inputs is often an area of weakness. Get everybody to understand the JIT (just in time) principle – that a supply should be there when you need it but that it doesn't help having it hanging around because you will need it sometime. Carrying material stock is often a sign of lack of effort in organising things to arrive when they are needed or of ordering in quantity to save having to do it again in a few weeks time. The discount is often not worth the space it takes up never mind the cash it ties up.

Creditor management

Creditor management is an area of activity as important as debtor management. An enterprise should always endeavour to be an honourable customer and pay accounts as they fall due. Ethical behaviour is actually appreciated and makes good enterprise sense. You will receive attention before the naughty enterprises. However, we should be assertive in obtaining the best possible terms of trade from suppliers and these should be kept under review.

Pay on account
Get everything dealt with on account as much as possible, for example an account with a local garage rather than filling up the tank using cash. If people have to travel on enterprise give them a company credit card; this means that travel bills, hotel bills can be paid over a month in arrears rather than issuing cash up front.

4.5. Crowdfunding

Crowdfunding (also known as crowd financing or crowd sourced capital) is a form of business angel investment. Usually conducted online, it allows a number of investors to individually invest smaller amounts of money into a business. The individual investments are then pooled together to help a business reach its funding target.

Crowdfunding can be a good option for businesses that have struggled to raise finance through loans or other conventional funding methods, but you should make sure your idea is protected before putting it onto a crowdfunding website.

4.6. Social investment

Social investment is equity in a social business where the investor expects a social return as well as a financial return. Whilst some social investors will take

a governance role in the social business being invested in, they often don't and most social investment to date has been debt finance. Apart from the delivery of a social return, social investment works the same as any normal debt or equity finance, although there are investment products such as Social Impact Bonds that are being developed specifically for the social investment market as a novel mechanism to deliver public services.

Social investors

There are a large range of social investors from philanthropic angel investors to government sponsored funds, ethical banks and charitable funds which are now willing to invest their capital funds in social business. Whilst requiring a social return on investment, social investors will generally be as diligent as more traditional investors in assessing the business that you are asking them to invest in. Indeed charitable trusts looking to invest will often take a more cautious approach to risk.

Further resources

Much of the growth in social investment has been driven by Big Society Capital (www.bigsocietycapital.com), an independent financial institution with a social mission, set up to help grow the social investment market in the UK. BSC have many useful resources, including a comprehensive list of funds, for those considering social investment.

The Big Lottery (www.biglotteryfund.org.uk) have produced an excellent guide, Social Investment Explained, which can be downloaded from their website.

The Social Investment Business (www.sibgroup.org.uk) has resources and a list of its own funds.

Community Investment Fund (www.wcva.org.uk). The Wales Council for Voluntary Action maintains a fund to provide loan finance to social businesses and the third sector in general.

Social Impact Bonds (www.socialfinance.org.uk). For an overview of SIBs visit the website of Social Finance, a not for profit organisation exploring social finance solutions to social problems.

4.7. Venture capitalists and business angels

Venture capitalists and business angels provide finance to start up and growth enterprises.

Business angel investors are individuals who are investing their own personal funds into a potentially rewarding business opportunity.

Venture capitalists are companies that use other people's money, which they have raised by offering investors the chance to take part in a fund that is then used to buy shares in a private company (i.e. a company that is not listed on the stock exchange).

These investors are certainly not angels of mercy but they may take an active role in your business and can be a useful source of knowledge, mentoring and contacts. The standard relationship is between a small enterprise that has proved product and market but is unable to finance establishment or expansion and a venture capitalist looking for high profits. The high profits are justified by the risk that investors in small enterprises take. The few that are very successful generate enormous equity growth, so the venture capitalists are trying to pick winners in a high-risk environment.

Here are some thoughts on the appropriateness of this source of finance to social businesses:

Venture capitalists and business angels usually require:

- A well balanced and qualified management team (preferably experienced in their trade and in working together)
- A seat on the board
- A large stake in the enlarged equity created by adding their cash to the balance sheet (often 50%)
- The right to cash in their stake after a few years
- A system of valuing that equity stake related to the performance of the company
- Ceiling on salary increases
- The right to take control of the company if the existing management does not deliver the performance targets specified in the enterprise development plan.

All the above add up to loss of control, surrender of cash profits generated for the foreseeable future and a problem in raising buy-out funding in a few years time. It is broadly unacceptable to people involved in social businesses. This type of finance is really geared to the aspiration of small enterprise owners who are looking to the possibility of say an OFEX (the UK stock exchange for shares in small companies) flotation in a few years time.

Before we dismiss the idea of capital partners altogether, there is always the thought that we could come up with our own set of criteria for capital partners. Here are the criteria set recently by a co-operative:

- No more than 25% of members to be capital participants
- One member one vote
- At least 75% of members to be worker members
- Minimum investment to qualify for membership as investor member £10,000

- Minimum term of investment five years, withdrawal of investment must be accompanied by resignation as member
- Investors to receive expenses for attendance at Co-op meetings
- Investors to receive payment for work done on behalf of the enterprise at agreed salary rate
- Investors to receive agreed minimum rate of return
- Investors additionally to share in profit distribution at the average rate for worker members per £10,000 invested.

And yes, investors did come forward.

The new social enterprise specific corporate structure "Community Interest Company Limited by Shares" (www.gov.uk/government/organisations/office-of-the-regulator-of-community-interest-companies) provides for an investor-led model of social enterprise. There is a cap on distribution of dividend; a maximum of 35% of the net profits can be set aside to reward investors (known as the "maximum aggregate dividend cap"). Previously in addition to the maximum aggregate dividend cap, dividends paid to any individual were not allowed to exceed a rate of return on their investment equivalent to 20% of the paid-up value of the share (i.e. no more than 20% return on investment); this "dividend per share cap" has now been removed (from 1/10/2014).

The balance between inside control, outside control, usage of outside resources, enfranchisement and disenfranchisement is not easy to get right. The best process is probably to decide what would be best for your own enterprises and then offer it to see if anyone is interested. You never know until you ask.

4.8. Reinvestment of retained profits

Clearly the optimum form of finance. An enterprise that is making profits can reinvest them to further improve profitability and balance sheet strength (i.e. further increase the value of the business without the commitment of liabilities).

Before forming an investment strategy that relies too heavily on this source, recheck and discount the basis upon which profit forecasts are made. If this is a new enterprise what exactly is the confidence level of the projections? Very few enterprises make profits in the first two or three years of trading which is usually spent learning the trade and finding the market. In fact many enterprises fail just as they prove that they have a product, a market and potential for profit-making simply because of shortage of working capital. More mature enterprises can look back on their own record of actual against predicted and base estimations on the emerging pattern. The pattern is usually an uphill struggle through break-even point (the point in time or number of units sold at which the business becomes financial viable and the revenue equals the total costs) over three or four years and then on to modest but gradually improving profits.

There are decisions to make about the level of reinvestment from profits as they are generated. Sharing profits is one of the ways enterprises justify their existence and retain the loyalty of members. 100% reinvestment forever means there is no financial reward for good performance.

Financing any business solely from retained profits is a prudent way of running a business but it can mean that seizing some opportunities is not possible and the chance to increase profitability and thus financial or social returns must be passed up. For example, investment in machinery that will enable twice as much production for the same level of labour may offer the chance of the machinery paying for itself in a year and subsequently the increased turnover will boost profits. If insufficient retained profits are available, without using other forms of financing, it would not be possible to take advantage of this excellent opportunity.

4.9. Member / stakeholder investments

A stakeholder is a person, group or organisation that has an interest (financial, social or environmental) in an organisation. Key stakeholders are employees, customers, suppliers, investors, community, bank, lenders, partner organisations and government. One or more of these groups of stakeholders may make up the membership of a social business and have democratic member control over the organisation. The members or the other stakeholders may wish to invest in the social business in order that it can better achieve what it is setting out to achieve.

Such member / stakeholder investment is good for the social business. It shows faith and commitment, important in the assessment of other investors. If invested as shares, the investment shows right down the bottom of the page on the balance sheet (rather than showing as a liability as a loan would, equity investment shows up along side retained profit as cash that belongs to the business with no imminent requirement to be repaid) and makes the gearing ratios (the proportion of the business “owned” by outsiders v. insiders) safer. It is the next best thing to retained profits. It reduces dependency on outside investors and does wonders for your credit rating (evaluation of the timely repayment ability of an individual or business) with suppliers.

Of course there is a lot of resistance to investing actual cash on the part of people who may also be investing vast quantities of sweat equity (underpaid or volunteer working time) or other stakeholders who might be focused on what the enterprise should do for them, or their community or raising money for their charitable purpose rather than on what investment is required. However, if the stakeholders want secure employment, achievement of social purpose, future revenue streams then they need to think about what they need to put in to make it happen.

Particularly in the start up or early stages of enterprise development this can be a critical part of the equation of a balanced investment strategy. Based on your own members investments or the business's own retained profits, you can look

to lever in outside investment. When funds are to be levered one has to start somewhere, to have something to ask the first outsider to match before turning to the second to match again. One start-up recently was peopled by four unemployed people each of whom reckoned they had zero pennies available to them. Three boot sales of accumulated life debris, one sale of a caravan, one downgrading of a car and the sale of a gold bracelet later there was £6,000 in the pot. Other start up and expansions have been financed by:

- Three months of window cleaning
- Dinner parties where the guests paid restaurant prices
- Mortgages on life insurance policies
- Personal loans from the bank
- Digging a trench
- Doing work for other enterprises that held the pay back until it was required.

4.10. Finance from friends and family

You should both get professional advice if the amounts involved are substantial. This will help you both consider factors objectively, without feeling under pressure and to reach a decision that you feel comfortable with. Many accountants will also advise on the issues and will draw up an agreement.

If you and your funding provider(s) agree to proceed, formalise the arrangement with a written agreement. This will help prevent future misunderstandings and provide a solid basis for the business relationship.

A loan agreement should cover the loan size and terms, the repayment plan and interest rates. Investment agreements are more complex and should include the amount invested, the allocation of profits and shares and the roles and responsibilities of both parties. You should seek professional advice to help you draft any written agreements.

4.11. Collective solutions

Enterprises are allowed to co-operate with each other. Among the ideas that could be worth pursuing are:

- Collective buying of capital items that everybody wants but no one enterprise can justify for themselves alone (e.g. training equipment)
- Setting up Enterprise Credit Unions: A saving and borrowing club. Invest your surpluses, draw down loans when you need to re-equip.
- Setting up local loan schemes. Give local people the opportunity to invest in a scheme to lend to local enterprises, thus spreading their risk while allowing them to do the right thing with their money.

- Setting up Mutual Guarantee Schemes. These collect small regular savings from members into a pool. The pool is then used to guarantee loans given to members by a Bank. Since the risk is spread the pool fund can be used to guarantee many different loans at the same time thus making many times the amount of deposits available as secured borrowing to members.
- Finding common needs and making applications as a group to the DfBERR (Department for Business, Enterprise and Regulatory Reform; was DTI), Learning and Skills Councils, European Funds to obtain finance to meet those needs. Especially useful for schemes to obtain training, employing people from excluded groups or to support product development, especially innovative, high-tech products.

5. A balanced investment strategy

Balanced use of capital

The fixed capital investment (money that is invested in assets of durable nature for repeated use over a long period) part of an investment strategy tends to be the most obvious and the most easily quantified. It is also the easiest to raise finance for since investment can to some extent be secured against these capital goods. For this reason these investments tend to receive an undue share of attention when it comes to raising finance. The result can be an unbalanced investment strategy with investment in productive capacity under-utilised because under-investment in invisibles (e.g. investment in skills, market development and product development) means there is insufficient skill to make full use of it, insufficient market development to keep it fully occupied or under-investment in working capital (the cash available for day-to-day operations of an organisation) means no cash to purchase the inputs required to feed it. As with most aspects of enterprise management, a good investment strategy is about balance, harmony, and synergy. It is better to do a small amount well and thoroughly than a large amount in a costly and unbalanced fashion.

Balanced introduction of capital

Similarly an investment strategy should be phased in a way to make it easily assimilated by the organisation and suited to its growth pattern. This requires a balanced strategy over a period of years. Long-term planning does help minimise mistakes that often occur when enterprises allow their investment strategies to be dictated by reaction to apparent bottlenecks, one by one on a case-by-case basis. Often the result of such investments is to reveal a further weakness elsewhere rather than increase productivity thus realising little or no return on capital employed.

Balanced sourcing of capital

An enterprise needs to spread its sources of finance across a range of options in order to ensure that it does not effectively fall under the control of some outside organisation, even if it is the nice, friendly bank down the road. Balancing the sources of investment is as important as balancing its use across the enterprise and across time.

6. Alternative strategies

Having decided what is needed to establish or develop the enterprise you should ask yourselves whether it is necessary to have this in house with all the investment that requires or to out-source. Is the investment down to you at this stage? Do you really need to take on additional investment? Or would it be cheaper, less risky or a way of testing how effective future investment will be by sub-contracting to another business that either can supply or is willing to invest in themselves to supply you? Also, you may not be in a strong enough position to secure investment and will need to seek alternative strategies.

You should go back to examine your business aims. It may be that it is important to make sure that every opportunity is used to expand the size of the operation, either to achieve critical mass, allow for specialisation or to create jobs, but equally this is not a necessary truth. For example, it often pays to have out-sourced work until it is proven beyond doubt that moving that function in house will save money. This minimises investment risk and maximises the case to outside investors. Cost reduction through substitution of a currently externally provided service with one that is provided in-house is probably the easiest investment case to prove.

Another alternative is to look around for another small enterprise in a related field to work with, leaving a share of the investment to them. The guiding principle here is that the job, the whole job, must get done and we must do what we are best at and can make a critical quality contribution to. It is not necessary that we do everything or retain absolute control over everything. The principle of enterprising and co-operative rather than paranoid and competitive solutions is a big recommend. You do not have to grow the wheat, mill the flour and bake the bread if your real added value is in making the sandwich.

Similarly, do we need to buy it or is there a rental / lease option and have we done a cost-benefit analysis on the different options?

7. Resources

Simply Finance by Co-operatives UK
(http://www.uk.coop/simplyfinance)

Community Shares Handbook by Community Shares Unit
(http://communityshares.org.uk/resources/handbook)