Charities and social investment revisited: an IVAR study

Briefing Two: Early Research Considerations

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IVAR Institute for Voluntary Action Research

Background

We've now spent time talking in depth with trustees and senior staff in 15 charities. Here are some of the points and issues they have raised. We're working with another 10 charities over the spring and plan to report in full during the summer. If you are reading this and think you would like to be a part of the conversation, please email: **Leila@ivar.org.uk**. A review of existing evidence can be found on the IVAR website.

Why small charities under £1million?

In 2015, the Institute for Voluntary Action Research (IVAR) initiated new research on small and medium-sized charities' experience with social investment. By concentrating on the voice of small and medium-sized charities and then communicating what we learn from them to charities and other investors as well as intermediaries, we aim to provide a bridge between these different actors in the field of social finance. The need for improved mutual understanding between investors and investees was a key finding of our 2013 study into charities and social investment on behalf of the Charity Commission[1].

Recent research from NCVO and IPPR tells us that, overall, smaller charities have lost more income proportionally than larger charities; have undergone substantial income fluctuation/volatility; and that the smaller the charity, the more they have lost in income from local and central government[2]. The small and medium-sized charities we have spoken to share this experience. They have felt blown about by changes in local authority contracting and commissioning arrangements and by turbulence in the policy contexts of their particular work. This includes changes in the criminal justice system and potential and actual changes to housing and other welfare benefits.

This new research on charities in England is being funded by IVAR, the Barrow Cadbury Trust and Access – The Foundation for Social Investment, and has the support of the Charity Commission.
There are three main elements to the research: a review of existing evidence for insights into the experiences of small and medium-sized charities; interviews with charities that have sought social investment; and interviews with charity infrastructure bodies.

This briefing is in three parts: the study, early findings and three emerging themes.

The Study

This briefing is based on in-depth semi-structured interviews and charity finance data collected from CEOs and trustees in 15 charities in England with income under £1million, offering a wide variety of services, activities and facilities. Income ranged between £21k and £995k with a majority in the middle and upper bands of the NCVO definition of 'medium sized'[3].

They are evenly distributed across three lenders. Our focus is social investment (understood as the provision and use of finance to generate social and financial returns). The majority of social investments were secured, one-off loans relating to the purchase and/or refurbishment of property.

The minority were unsecured loans for working capital, cash flow or new projects and most of these charities had borrowed more than once. No other forms of social investment were accessed.

Early Findings

Three main reasons why the charities applied for social investment

Necessity: Several charities needed funding fast in order to cope with a cash flow problem, the sudden need to move premises and/or to buy their own building because it was put up for sale. For most of these charities, a loan was the only type of finance they could obtain at the time; they would have preferred a grant.

Stability: These charities had been affected negatively by changes in the organisation of local authority contracts and wanted to protect themselves against further changes. Mainly, these charities had lost a contract or seen their share of a contract shrink considerably and they wanted such contracts to be a less significant proportion of their income in the future.

Development: A minority of the charities we have been speaking to had received three or more loans. These charities used loans to finance themselves through planned strategic change. In some cases, they borrowed to finance the set-up of new projects/income streams.

In every case, the charity's application for social investment was mission driven: they wanted to set up or maintain something that was central to their ability to fulfil their mission. But, despite being mission driven, some social investment purposes were not well thought through and led the charities into further difficulties.

What was the experience of charity trustees?

Charity trustees took seriously the decision to apply for social investment and took into account both their charity's mission and the financial assumptions about how they would repay a loan: *'We went into everything, we weren't blinded'*. Precisely how decisions were made and by whom varied but we can describe three quite common scenarios:

Heroic: The founder or a prominent trustee championed and 'pushed through' the decision to seek social investment. Trustees who championed the decision went on to help the charity manage the investment

by strengthening its board and/or supporting its CEO. However, in some cases, 'heroic' founders moved on, leaving behind financial crises because of poorly thought through financial assumptions and an unsustainable debt for incoming new or interim CEOs to inherit.

Stressful: For some charities, the decision to seek social investment and the process of applying could be described as a succession of unfamiliar experiences that were stressful and challenging. They were faced with an unfamiliar environment in which their previous skills in pitching for grant funding were no longer appropriate and lenders were assessing their capacity primarily on the basis of financial resilience and sustainability rather than mission and need. These charities tended to say that this decision was 'massive' compared with other major decisions that their board and senior staff had ever faced.

Coping: These charities did not take the decision to seek investment lightly, but they said that such decisions were on a par with other major decisions that they had taken such as entering a contract, closing a service or merger. In these charities, responsibility for investigating, championing and applying for investment was shared between at least one senior staff member and one trustee.

The process of seeking, receiving and managing a social investment did not change the way a charity's trustees thought about their finances overall. Several said that they were focussing back on which independent funders to approach for grants or said that it would be *'difficult to brave it again'* and certainly not until the current loan had been paid off. Another commented on the turbulent policy and funding contexts: *'A loan is permanent and everything is temporary'*. The exceptions were charities that have had three or more loans: they were in regular contact with their lender so that they could look to them for the next loan, as and when they needed it.

What have we learned so far about the relationship between charities and investors?

The charities provided us with a good spread of experience across three different lenders. Our purpose was not to pass judgment on individual lenders but to learn from the charities' experiences about what mattered most about this relationship. Overall, charities said that building a relationship with their investor was important and made the following comments:

- Having an ongoing relationship with a social investor means that the charity can move fast if they need further investment. Charities thought this was important given the number of them that had needed investment fast because of a cash-flow or property crisis.

- A relationship of trust featured social investment staff who understood the somewhat precarious nature of small charity finance: '[They] *understand that we, as small organisations don't have the cash flow or reserves to wait'.*

- Linked to this, some investors were better than others at explaining clearly and simply the due diligence and other processes involved in social investment decisions.

- Most investors appeared to aspire to a *'relational approach'* to managing their investments but not all were successful. Charities thought that a relational approach could be undermined by staff who quickly become anxious about charity finances perhaps because of a lack of familiarity with the charity sector: *'I want to say trust us we'll find a solution and if we're really in crisis we'll tell you';* and some lenders provide advice but *'still from a place of trying to make sure we can pay back than "we love what you're doing"'*.

- Charities wanted investors to be genuinely interested in their work and not just the finances. This reflects their rationale for seeking investment which is driven by mission first and business considerations second: *'they have come and looked at what we do in terms of a learning exercise'.*

Emerging themes

Journey

Social investment is one way to finance a charity's delivery of its mission and sits alongside other methods such as grants, donations, legacies and contracts. Each charity's journey is different, but from our interviews so far, we can discern some common issues:

- Although the idea of a loan rather than a grant may fit some charities' image of themselves as entrepreneurial and sustainable, for most charities a loan is simply the only kind of finance that was available when they urgently needed it.

- Charities said they needed someone to be a 'bridge' between the charity and the finance provider, to make sound financial judgments and understand well charity accounts and finance. This could be a treasurer (although not all charities had one), or a pro bono accountant working within the board or charity as a volunteer, but not a third party – this muddled things and charities felt that they were overcharged.

- Charities had arrived at a business 'model' or 'plan' in different ways, but in all cases these plans had evolved over time somewhat organically; simply sitting down and writing a business plan won't work they said.

- For charities, a loan can be a risk to their mission – a diversion or cul-de-sac on their journey: *'the risk is not so much the finances, but the other things that go with it'*. Put simply, if a building is purchased with a loan, the need to meet loan repayments may drive the organisation towards activities that do not fulfil the charity's mission. The most important considerations are therefore: is the investment essential/central to your mission? And will you be able to pay it back?

Complexity, finance, legal, property

Charities that purchase or redevelop their property will take on complex legal and property negotiations regardless of how they finance it. But, if they also take on social investment for the first time, then they add a third element of complexity to the process. For a charity with little prior experience of property acquisition or investment, this is like being in the eye of a storm. Most of the loans we looked at were part of a bigger financial package which the charities had assembled themselves. These comprised not only loans, but also multiple grants and contracts. In many cases, the loans and other kinds of finance were interdependent, leading to a race to secure the loan in order to not lose a grant or vice versa. We were not convinced in every case that either the charity or its investors had sufficiently interrogated the wisdom of purchasing a particular property or taking on debt to redevelop it.

Funders and charity accounts

How do funders read charity accounts when they are assessing grant applications? Is the approach consistent with assessing loan applications?

Grantmakers, social investors and blended finance providers need to improve and rationalise their reading of charity accounts in situations where that charity has a blend of grants, loans, contracts and/or income from some form of trading. Charities gave us specific examples of being turned down for grants or being refused a repayments decrease because of a misunderstanding about their accounts. Examples include: an investor not being able to distinguish between structural deficits and cash flow; a charity being refused a grant after slightly increasing its loan repayments; and a charity being refused a payments holiday because of its reserves. Overall, there is a lack of understanding about charity reserves and the level most charity trustees would ideally aim to have in reserve.

We welcome any comments or reflections about the experience of small and medium-sized charities, but we will be especially grateful for any insights into the experiences of organisations with an income below £100k.

To contact the lead researchers, Leila Baker and Niamh Goggin, and to be kept informed about the research, please email: **Leila@ivar.org.uk**

You can **read the full research proposal** and see the findings of the 2013 IVAR study for the Charity Commission on the IVAR website.

[1]Baker, L. and Goggin, N. (2013) *Charities and social investment: A study for the Charity Commission,* London: IVAR; Big Society Capital and ACEVO (2015) *What do charity leaders think about social investment?* London: Big Society Capital.

[2]NCVO (2016) *Navigating Change: An analysis of financial trends for small and medium-sized charities,* London: NCVO; IPPR NORTH (2016) *How small and medium-sized charities are adapting to change and challenges,* Manchester: IPPR NORTH

[3]Using NCVO definition, one was 'small' (10k-25k), the remainder were medium-sized charities (25k-1m). If we subdivide the medium-sized charities using the categories in NCVO's small and medium sized charities almanac then all but one of the medium-sized charities fell into the middle (100k-500k) and upper bands (500k-1million) with none in the lowest band (25k-100k). NCVO (2016) *Navigating Change: An analysis of financial trends for small and medium-sized charities,* London: NCVO