Ontario Co-investment Fund Feasibility Assessment

Completed by Community Forward Fund Assistance Corporation (CFFAC)

October 2016

This feasibility assessment was completed with assistance from the Ontario Ministry of Economic Development and Growth. The opinions expressed are solely those of CFFAC and should not be interpreted to be those of the Ontario Government or its representatives.

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Project objective

Community Forward Fund Assistance Corp. (CFFAC) is a non-profit entity that makes loans to or arranges financing for, non-profits and charities across Canada. The Fund addresses a gap in access to patient capital, providing loans to non-profit and charitable organizations across Canada for a variety of purposes. This includes revolving credit facilities, bridge loans, term and capital loans. In addition to lending from the Fund, CFFAC provides contracted underwriting services to other parties lending to not-profit organizations and for-profit social enterprises. CFFAC provides financial review and coaching services and assessment tools to help build financial skills and capacity in the non-profit and charitable sector. CFFAC has recently contracted to manage a third party investment fund targeted to the co-operative sector, including co-operative enterprises.

In the 2010 Social Finance Census a capital demand of $170 million was identified in Ontario, and over 70% of respondents reported that access to capital was an impediment to growth. While the survey did not identify the particular forms of capital that would enable growth of social enterprises the results point to the need for research into models that have the potential of attracting more capital to this sector. One such model, a social enterprise co-investment fund, was proposed during consultations in 2015 on the Ontario Social Enterprise Strategy.

CFFAC has undertaken to:

- Assess the opportunity for a co-investment fund in Ontario
- Propose objectives for such a fund
- Identify the potential operating and financial parameters of such a fund
- Identify options for the management and delivery of such a fund

In approaching the research on a co-investment fund, CFFAC is seeking to answer three questions:

- Is there a need for a co-investment fund?
- How is a co-investment fund best structured and managed?
- What are the economics of a co-investment fund?

The approach taken by CFFAC was to conduct a series of interviews with organizations and individuals currently engaged in providing or receiving investment for social enterprises. Due to the time and resource constraints for this project, an extensive survey of a broad range and number of organizations was not possible.

Context - Social enterprise in Ontario

The social enterprise sector is active and growing, and is a significant contributor to the Ontario economy. According to SEOntario.org:

> *"The social enterprise sector has a positive effect in Ontario by creating jobs, growing entrepreneurship, protecting the environment, promoting local food, helping and empowering Ontario's most vulnerable residents, reducing poverty, and having other impacts.*
>
> *Social enterprises create opportunities for the people they work with and the communities they serve. With more than 10,000 social enterprises in Ontario, employing an estimated 160,000 people and serving 3.4 million customers per year, the influence of the sector is important and growing".*[1]

While there is little dispute of the value of social enterprise, finding a common definition of what these entities are or what is included in the use of the term is more challenging. The SEOntario.org web site states:

> *"Social enterprises are organizations that produce goods and services for the market economy and that manage their operations and redirect their surpluses to achieve social and environmental goals. Social enterprise activity gives public benefit organizations an alternate source of funds to better fulfill their mandates. It is a way for the nonprofit sector to be more sustainable and continue to act as a solutions provider for communities across Ontario."*[2]

This definition may be somewhat limiting in that it does not explicitly include those enterprises that are "for-profit" and have as part of their mission to achieve social and environmental benefits while also including in their stated goals a return of profits to individuals (whether shareholders or members of a co-operative.)

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[1] Social Enterprise Ontario, http://seontario.org/what-is-social-enterprise/

[2] Ibid

For the purposes of the investigation into the opportunity for and potential structure of a co-investment facility for social enterprise in Ontario, the definition offered by Social Enterprise UK may be more appropriate;

> *"A social enterprise is a business that trades for a social and/or environmental purpose. It will have a clear sense of its 'social mission': which means it will know what difference it is trying to make, who it aims to help, and how it plans to do it. It will bring in most or all of its income through selling goods or services. And it will also have clear rules about what it does with its profits, reinvesting these to further the 'social mission."*

Surveys of social enterprise in Canada and Ontario use a broader definition, and include organizations that have a clear social and/or environment mission, but that do not necessarily exclusively use commercial or business models in their work and may be to a significant degree reliant on revenues not earned form commercial activities.

A survey of literature on social enterprise indicates that there are a great variety of social enterprise business models and that these range in the degree of social return generated as well as the financial returns – from enterprises that require on-going subsidies to those that generate sufficient returns to support their current and future capital needs. For the purpose of the current research into co-investment funds, the focus is on this latter group. Social enterprises are organizations, both non-profit and for profit, that generate a significant majority of their revenues from the sale of goods and services.

For-profit and non-profit social enterprises

For the purposes of this assessment both for-profit and non-profit social enterprises are included. There are many similarities between the two forms of enterprise and the requirements for access to capital are similar in many respects.

There is not necessarily a difference in outcomes being sought, and both should seek to operate businesses with reasonable rates of return in order to generate revenues for growth and/or return to investors. There are also some obvious differences between the two groups of enterprises.

Non-profit enterprises may seek external sources of capital, but this will rarely come in the form of equity.[3] Non-profit funding is generally in the form of grants. For-profit social enterprises can access venture capital and investors can take a measured risk on the potential of the enterprise to generate a return to investors over time. As for-profit enterprises grow and stabilize they have a choice of whether to use debt or equity capital. For-profit enterprises at or near maturity will likely have choices about sources of capital (debt and equity).

Non-profits do not have the ability to use equity and even at mature stages of operation may face barriers to access to capital.[4], and are restricted to use of debt (or additional grant capital). Therefore debt investment vehicles may not have the same importance for for-profit enterprises as they may for non-profit enterprises.

Social enterprise capital

As noted above, access to capital is identified by social enterprises as a barrier to growth. The 2010 survey estimate of a need for $170 million will have grown since then with continuing resource constraints and a greater awareness of alternative financing strategies. A portion of this demand will also have been satisfied by increased investor activity over the past 5 years – including social finance funds, credit union and bank lenders and direct investments. The survey did not assess whether the demand identified could be supported by existing or planned cash flows. With a conservative estimate that only half of those identified in the survey can be supported as loans or investments, there would remain a significant demand for capital. There is less information about the form of capital that is being sought and the impact of cost of capital. Social enterprises typically require different forms of capital at different stages of growth and development.[5]

The use of non-grant capital in the non-profit sector is growing. There is greater access to this capital than in the past with the introduction of targeted funds, such

[3] A new start up social real estate non-profit development company has structured a limited partnership to aggregate investor capital, and will lend this capital to the non-profit an a quasi-equity basis

[4] This was reported during interview from two midsize social enterprises that were limited on how much capital should be made available from conventional lenders, even though the businesses were successful and generating healthy revenues.

[5] This is an estimate and is likely conservative. It is based on the lending activities of existing social finance funds and known community bond issuances and direct loans from charitable sources. All of these activities are at or mean market rates.

as the Canadian Alternative Investment Co-operative (CAIC); Community Forward Fund Assistance Corp., targeted credit union lending initiatives, and direct lending by foundations. These sources of financing do not usually meet all forms of capital demand, and may not be able to meet the cost of capital expectations of social enterprises in start-up phases.

The illustration below[6] shows that different forms of capital are used at different stages in the growth of a social enterprise that is engaged in commercial activities. In the founding stage grants, founder capital, parent organization contributions and other sources of "no cost and no recourse" capital are common. Often sweat equity is not recorded or assigned a value on the enterprise books, but there may be an expectation of some form of return such as shares or compensation when the enterprise succeeds. Where this capital is recorded it usually postponed to the interests of later lenders or investors. Investment in the start-up phase usually carries high risk and usually does not attract fund investment.

Concept stage and start-up capital:

This capital comes from three primary sources:

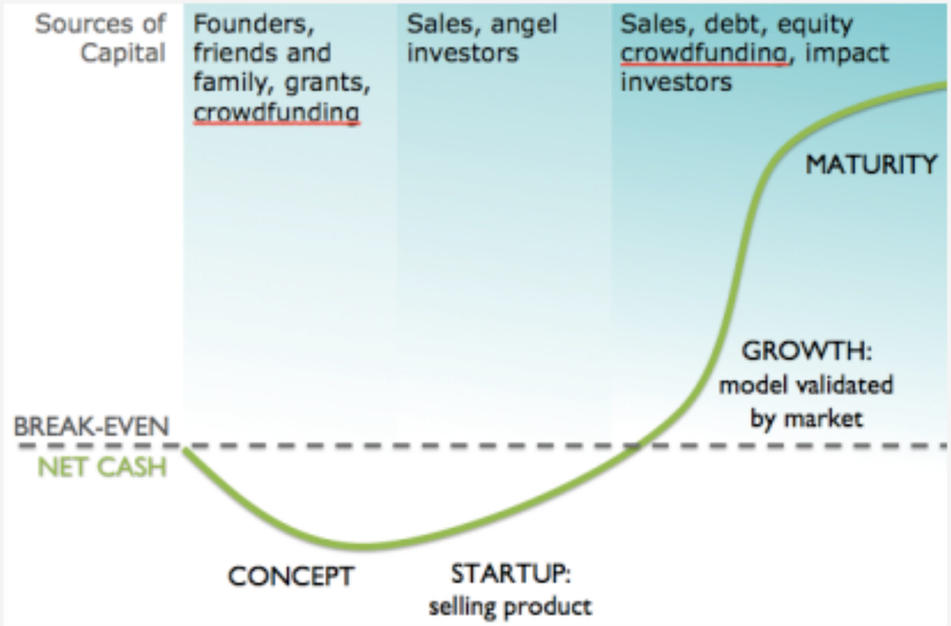
- Sponsorship from a parent organization (investment of operating surpluses, targeted grants, in-kind contributions)
- Grants (usually small in size and designed to develop and test business models
- Self-sponsorship, owner or group generated (personal investment, crowd funding - formal and informal).

Concept and Start-up Stage

Planet Bean, Guelph is a fair trade coffee retailer and wholesaler, owned by a worker co-operative. Initial capital for Planet Bean was raised through individual investments (RRSP eligible) and sweat equity, redeemable in time for Class B shares in the enterprise.

The Funeral Co-operative of Ottawa raised its initial capital from individuals (loans and loan guarantees), and loans from community investment funds and a

6 https://impactentrepreneurs.wordpress.com/2012/05/10/funding-your-social-enterprise-part-1-grants-donations-and-crowds/



Social Enterprise Capital Curve

Where there is organizational sponsorship, it appears that there are usually more resources available to support developing enterprises. This will depend on the size and financial capacity of the sponsoring organization, and its ability to absorb the potential of enterprise failure. Grant sources and self-sponsorship generally Provide limited capital.

There are some examples of start-up capital coming in the form of loans. This is not common as lenders generally use credit assessment approaches that require an enterprise demonstrate an ability to generate revenues and support positive cash flows. These factors are often absent form an enterprise at this stage, and any investment is high risk. In two examples where early stage lending was identified, the projects both had significant organizational sponsorship, commitments from individuals and were implementing known business models (precedent businesses).

Growth (maturity) stage: Capital for growth more commonly comes from debt and quasi-

Growth Stage

Mustard Seed Co-operative is a non-profit food retailer in Hamilton Ontario. Seed capital was provided by sale of memberships and member loans. Additional start-up capital was borrowed through a syndicated loan (three participants with a lead syndicator). The loan has three components to it, all with different terms with a portion structured as quasi-equity. The three partners in this loan have collaborated together and separately on different transactions supporting other's social enterprise ventures. This limits individual deal exposure and allows for a blended capital cost that meets the enterprise's equity investment. Where there is an operating enterprise (going concern), a balance sheet and a track record of sales it is possible for lenders to assess the business risk on loans and identify sources of repayment. In examples of quasi-equity investment the loans are higher risk but there generally is sufficient business experience and understanding of the markets in which the enterprise operates to offer this form of investment. Lending sources vary from commercial lending institutions (more typically for for-profit enterprises that can meet commercial underwriting requirements); financial institutions that have targeted lending approaches (CSR or community loan programs to support community enterprise); loan funds established to support non-profit organizations or from philanthropic lenders.

At the growth stage grants may continue to be an important source of revenue for a social enterprise, particularly non-profits. While beneficial to the enterprise, a continued reliance on grants may limit the interest of lenders to support the organization as it may have financial risks if these grants are no longer assured. At the growth stage lenders generally look for self-sustaining business models that use investor capital or loans to meet capital demands.

Growth Stage

JUMP Math is a charitable organization working to create a numerate society. It became a registered charity in 2002. It provides programs and materials to support numeracy.

Jump Math has depended on donations (corporate, foundation and individual) for its start up. Subsequently sales have provided the revenue to cover operating expenses. Further grants have permitted expansion of operations

The 2010 Social Finance Census is helpful in understanding overall capital demand for the non-profit and social enterprise sector. However there is limited data about the specific capital requirements by stage of enterprise development. What is highly probable is that current demand for capital for social enterprises exceeds the supply of this capital from conventional financial institutions and impact investment sources. This is based on interviews conducted and the demand placed on existing funders (funds and direct investors). Social finance lenders interviewed report that there is accelerating demand for capital.[7] Therefore any increase in the supply and access to capital for social enterprises will have a positive impact in the sector.

Recently Co-operatives and Mutuals Canada has launched a national investment fund for co-operative enterprises. With an initial capital base of $25 million, the fund aims to invest in co-operative enterprises using loans, equity and quasi-equity. The Canadian Co-operative Investment Fund has assessed that market demand in that sector is not being met from current sources, and may be as high as $100 million.

[7] Community Foundation of Ottawa, CAIC, CFFAC

Financing and financial capacity of social enterprise sector

Interviews with social finance intermediaries and investors demonstrate enthusiasm for increased investment in the sector.[8] Existing entities that support loans to social enterprises are at or near capacity and are finding new investment opportunities with some regularity.[9] This is attributed to an increased awareness of alternative financing and a gradual understanding of risk and risk management in the non-profit sector. There is a hesitation of putting a dollar-figure on the amount of demand for capital as most current lending is reactive and is not supported by marketing efforts designed to promote capital investment approaches. It is reasonable to assume currently in Ontario that there is annual lending in the non-profit sector in excess of $20 million[10], excluding affordable and non-profit housing conventional mortgage lending.

Investors in social enterprise also raise a note of caution.[11] Non-profit organizations with existing or planned social enterprises are seen as generally risk averse. That is, there is a hesitancy to use debt as a lever for growth of enterprises, preferring organic growth based on earned revenues and profits. In addition, some concerns were expressed about business capacity and expertise in the non-profit sector. There is a view that additional capital for social enterprise should be accompanied by increased access to financial capacity building for staff and volunteers. [12]

This same caution was made about the for-profit social enterprises, particularly among start-up ventures. Additional capacity to assist in business development and management were seen as necessary to the creation of a viable sector. Additional capital is a critical component for the development of social enterprise, but alone will not create a successful sector. For-profit enterprises were seen as more willing to take risks and more focussed on growth. These enterprises can also attract needed expertise and assistance through recruitment of board members and investors.

[8] This included both funds and fund investors.
[9] CFF and CAIC have placed most of their available capital in loans.
[10] [10] This estimate is conservative. It is based on the lending activities of existing social finance funds and known community bond issuances and direct loans from charitable sources. All of these activities are at or mean market rates.
[11] Hamilton Community Foundation and OCLF highlighted this.
[12] CFFAC has conducted 10 workshops on building financial knowledge and capacity in the non-profit sector. Most participants indicated that there is significant reluctance on their part, or the part of boards to use alternative financing mechanisms.

All intermediaries and investors in social enterprise feel that increased access to capital is beneficial, provided that this does not distort the financial performance of enterprises and that they remain focussed on their mission and being able to generate returns that meet their operating needs.

Co-investment approaches

The concept of a co-investment fund is based on wanting to increase access to capital as well as provide capital at a reasonable cost. Currently in Ontario there are sources of capital in the form of community loan funds available to non-profit enterprises and some credit union lending programs. In addition, some foundations have shown a willingness to invest directly in social enterprises that have benefit in the area of their interest or in the communities that they serve.

Ontario has also supported social enterprise development through support to initiatives such as the Ontario Catapult Microloan Program and Verge Social Enterprise Loan Fund. Later stage capital for certain social enterprises is available from the MaRS Catalyst Fund and other sources. The social enterprise investment ecosystem is improving rapidly but based on responses in interviews conducted by CFFAC and anecdotal information, there remain gaps in access to capital at all stages of enterprise development. There are currently no investment funds with significant scale and access to investment capital or dedicated sources of capital at scale[13] that focus specifically on social enterprise. In the growth phase of enterprises the capital demands can escalate rapidly, and it is not uncommon to see transactions at and above the $1 million mark. A capital provider at this scale requires a large diversified portfolio in order to be able to take the risk on this sort of investment (for example an investor is unlikely to want to expose more than 10% of their capital base in one transaction. Therefore as the size of transactions increases (a sign of a maturing sector) the nature of capital demand changes and the size of demand are likely to outstrip the capacity of current facilities.

Existing sources of capital for social enterprise are constrained by two factors – the overall availability of capital for investment and the need to achieve benchmark returns on said capital. Social investment funds such as Community Forward Fund (CFF) establish lending rates based on the assessed risk of proposed loans. A minimum lending rate must be achieved in order to provide a

[13] Determining the supportable scale of social enterprise investment is challenging, the experience of CFFAC would indicate there are sufficient enterprise opportunities to support a fund of $10- $20 M. The recently formed CCIF will likely target 50% of its capital base to co-operative enterprises. Existing sources of capital are relatively small, and any sizable deal may exceed the capacity for these funds to invest, as they would have disproportionate exposure to an individual investment.

return to investors in the fund. This is similar for the Social Enterprise Fund (SEF) in Edmonton.

The constraints facing social finance funds and investors in Ontario are similar to those in other jurisdictions and have provoked a variety of policy responses. At a national scale, the UK has made available capital for social finance with a specific interest in developing intermediaries that can use government funds to seed funds that attract private capital and on financing to social enterprises directly. This has assisted in lowering the cost of capital, reducing financial risk for other lenders in the market, and to build both enterprise and intermediary capacities.

A review of co-investment in Canada, the UK and the United States did not reveal specific co-investment funds with a social impact focus. However, in all three jurisdictions, there are approaches being taken to reduce investor risk in social enterprise and use government capital to incent non-government investment. These funds or agencies may use co-investment as a tool in making impact investments and supporting social or other enterprises. [14]This can take the form of:

- Collaborative lending – the syndicating of loans among one or more social finance lender in order to generate sufficient capital, reduce single fund risk. This is usually done deal-by-deal and among lenders that have a high degree of confidence in each other
- Catalytic investment – where a government may provide capital in order to stimulate or incent additional funds being invested into a fund or deal (reduced return expectations and/or first loss provisions)
- Provision of financial guarantees – can be provided by any order of government and used to attract conventional and non-conventional investment into funds or deals (usually as loans). Financial guarantees lower rates for conventional lenders, as there is absorption of first losses to the limit of the guarantees.

Co-investment is a form of financing. It is not in itself, substantially different from other forms of financing. Co-investment generally has three purposes:

- An additional or augmented supply of capital where existing sources cannot meet the needs of a project or a portfolio of investments
- A capital facility to share risk in certain investments, reducing risks to the transaction originator

[14] The US Small Business Administration supports Small Business Investment Companies and makes direct investments in impact initiatives. This can take the form of loans, loan guarantees, contracts, counselling sessions and other forms of assistance to small businesses, including co-investment.

- A capital source that may offer concessionary rates or subordinate its interest to third parties in order to facilitate a transaction

Co-investment can be made at the fund or transaction level.

Social enterprise financing – sector views

The investigation in co-investment by CFFAC indicates that there is general support for any social enterprise investment vehicle that provides greater access to investment capital.[15] For social enterprises this support is generally for reduced cost (loans and quasi-equity). For investors (direct and intermediary structures) the benefit is largely related to increased attraction of capital from private and institutional investors and the reduction of specific deal risks.[16] While there is no indication of an immediate lack of capital supply, growth of social enterprises requires increased capital, and this means attracting new investors to existing funds or directly into transactions.

Among the parties interviewed there was not agreement on whether eligibility for co-investment should be to both for-profit and non-profit enterprises. This was in part a question of for-profit enterprise already having access to conventional financing whereas non-profits generally do not and whether it is best to build up the sector no matter what the ownership form is. One respondent indicated they felt large non-profits have the same advantage as for-profit enterprises and that a co-investment fund should be reserved for smaller enterprises. There was agreement that whatever direction might be taken; enterprises should be able to demonstrate a level of mission direction that is built into the governance and operating practices and use measures of outcomes to remain eligible for financing.

Three respondents raised the issue of the strength of a pipeline for social enterprise financing.[17] This is a matter of both the level of current activity, the presence of intermediary organizations that can support the inception and development of social enterprises, and willing financial partners (intermediaries). As noted previously, there is a perceived (and likely actual) need to increase financial capacity in social enterprises and to build a stronger culture of entrepreneurship in the non-profit sector.[18] Interviewees saw several important

[15] Four respondents were specific about the need for alternate and additional sources of capital; 2 respondents felt co-investment could assist but that the social enterprise sector needs development in order to absorb new capital
[16] The National Impact Investment Practitioners Table (NIIPS) has proposed this approach to the federal government in the context of a national social finance strategy.
[17] One respondent does not currently fund social enterprise and two respondents provide loan capital.
[18] This point was echoed by two grant funders and one loan fund

roles for government in supporting the social enterprise sector, some of which could be compatible with the development of a co-investment facility. These included:

- Legitimizing investment in social enterprise (Government leadership)
- De-risking investment (reduced rate, first loss provisions, financial guarantees)
- Catalyst for attraction of new capital into the sector
- Strengthening the financial/investor intermediaries in the sector
- Early stage capital (equity and quasi-equity) for social enterprises

While all persons interviewed identified the need for access to grants and other forms of initial enterprise funding, there was no specific comment made that a co-investment facility should fulfil this particular objective. Respondents generally indicated that a fund should see the return of its capital and serve a permanent purpose, rather than be a time limited facility.

Of interest in this research is whether a co-investment approach is of value and assistance to social enterprises in Ontario. A co-investment facility or mechanism is a way to deliver capital or financing to social enterprises. Therefore, the question is whether this particular form of capital assistance is useful in relation to other forms of access to capital. From most respondents the answer was “yes”. No respondent was negative about the approach. However, during interviews the respondents were not asked to rank their preferred capital delivery mechanism, and it is not known whether on a comparative basis there would have been stronger views about alternatives.

Co-investment options

The options for a co-investment facility for social enterprise vary based on the objectives to be achieved. Five options are outlined in the table below. Within each model there are choices to be made related to:

- Enterprise investment stage (early, mid, mature)
- Form of investment (equity, quasi-equity, loan)
- Type of investee (non-profit or for-profit)
- Type of enterprise (level of commercial activity; demonstrated level of social, environmental or community impact)

Selecting the most appropriate co-investment option depends to large degree on the specific objectives to be achieved and the level of direct risk that the government wants to take in providing capital for social enterprises. There may also be other considerations related to constraints on how the government can make capital available more generally, and the rules related to government spending, granting and investment expenditures.

Investment intermediaries interviewed were universal in their view that a co-investment fund should have a dual purpose – to direct needed investment to social enterprises and to build and strengthen the existing intermediaries. Having a healthy intermediary sector is felt to be a pre-requisite to seeing growth and development in the social enterprise and non-profit sectors. These responses may be biased as the interviewees were largely engaged in the social lending sector. However, the responses parallel the development of other parts of the financial sector such as venture capital and capital for small and medium enterprises where intermediaries play an important role in the flow of capital.