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EVPA REPORT

FINANCING FOR SOCIAL IMPACT

The Key Role of Tailored Financing and Hybrid Finance

Alessia Gianoncelli
Priscilla Boiardi

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FINANCING FOR SOCIAL IMPACT

The Key Role of Tailored Financing and Hybrid Finance

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European Venture Philanthropy Association
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CONTENTS

FOREWORD

This report is the final piece of the four-year collaboration between DG Employment, Social Affairs and Inclusion of the European Commission and the European Venture Philanthropy Association (EVPA) as part of the *EU Programme for Employment and Social Innovation ("EaSI")*. The partnership with EVPA as an EU level network aimed to establish a long-term cooperation and open dialogue between the European Commission and social sector funders, and thus improve knowledge and increase the effectiveness of both parties.

This report goes precisely in this direction, by proposing clear recommendations on how to better allocate funding to support social purpose organisations (SPOs) and on how to channel more resources towards social entrepreneurship through de-risking mechanisms. It closes the EVPA series on best practices on using the venture philanthropy approach and complements the research carried out so far on impact management and non-financial support.

Boosting jobs, growth and investment is one of the main priorities of the European Commission. In line with this, in November 2014, the EC launched the *Investment Plan for Europe*[a]. The plan recognises that entrepreneurship and small and medium size enterprises (SMEs) are vital for the growth of Europe and, in particular, it recognises the role of social entrepreneurs and social enterprises in developing innovative solutions and approaches to tackle societal challenges, making the use of public resources more effective and promoting a more sustainable and environmental-friendly growth in Europe. Funding is made available for social impact investments[b], complementing the instruments already developed under the EaSI Programme[c].

Making EU money available is a first step, but this is not enough. Knowledge is also needed on how to best implement the funding available on the ground, through relevant support, tailored to the needs of social enterprises, social finance providers and support organisations. The Commission has already received relevant information on how to make the implementation of EU funding relevant on the ground from its Expert Group on Social Entrepreneurship (GECES)[d].

This report is aimed specifically at helping social sector funders use their resources in the best possible way. It helps them understand if, when and how to use the different financial instruments available to support social entrepreneurs in the most efficient and effective way. It also helps clarify what hybrid finance is, and how it can be used to channel more resources towards social entrepreneurship, in a more effective manner, while highlighting some of the challenges this practice brings about.

At the Directorate General for Employment, Social Affairs and Inclusion we hope this report will help start a conversation around how to best use the resources available and on how all actors in the social innovation space can collaborate better and join the movement to reduce the high levels of unemployment and to lift people out of poverty and social exclusion.

Ann Branch
Head of the "Job Creation" unit in the "Skills" Directorate, Directorate General for Employment, Social Affairs and Inclusion, European Commission

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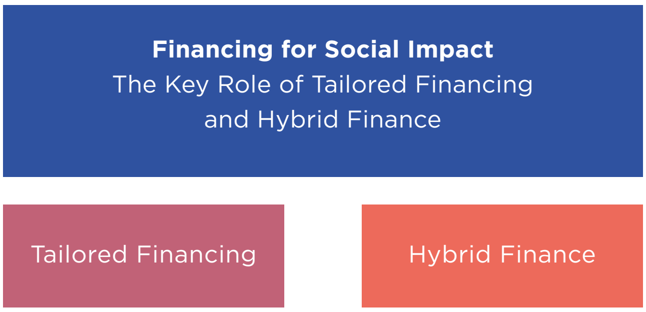
a For more info: https://ec.europa.eu/commission/priorities/jobs-growth-and-investment/investment-plan-europe-juncker-plan_en
b For more info: http://www.eif.org/what_we_do/equity/efsi/
c For more info: http://ec.europa.eu/social/main.jsp?catId=1084&langId=en
d To have access to the report **GECES (Commission Expert Group on Social Entrepreneurship),** (2016), "*Social enterprises and the social economy going forward – A call for action*", European Commission: http://ec.europa.eu/growth/tools-databases/newsroom/cf/itemdetail.cfm?item_id=9024

EXECUTIVE SUMMARY

This is a report about social impact and how to maximise it. It is not a technical report on finance, financial instruments or financing mechanisms. It is not aimed at analysing in-depth all the different financing structures used and built up to support social purpose organisations. It is about how funding can be shaped in such a way that it is aligned with the purpose of the investee, and how it thus can help both the venture philanthropy organisation/the social investor[1] and the social purpose organisations[2] maximise their impact. This report is also about how different actors with different risk/return/impact profiles can cooperate in the VP/SI space to leverage each other's resources and expertise.

The report is divided into two streams: the first dealing with **tailored financing** and the second dealing with **hybrid finance** (Figure 1).

Figure 1: Structure of the report (*Source: EVPA Knowledge Centre*)



TAILORED FINANCING

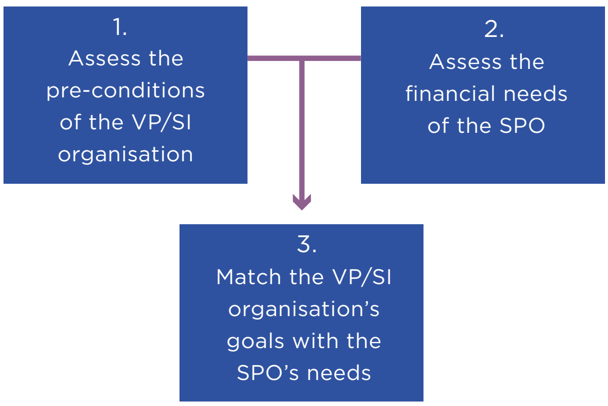
Tailored financing is the process through which a venture philanthropy organisation or a social investor finds the most suitable financial instrument (FI) to support a social purpose organisation choosing from the range of financial instruments available (grant, debt, equity, and hybrid financial instruments).

The choice of the financial instrument(s) will depend on the impact/financial return expectations and risk profile of the VP/SI organisation and on the needs and characteristics of the SPO.

Based on this definition we have designed a three-step process (Figure 2):

- Step 1 is the assessment of the pre-conditions of the VP/SI organisation
- Step 2 is the assessment of the financial needs of the SPO
- Step 3 is about matching the VP/SI organisation's goals with the SPO's needs, to design the best financial instrument to use.

Figure 2: Tailored financing as a three-step process (*Source: EVPA Knowledge Centre*)



1 Throughout the report we indistinctly use both the terms "VPO/SI" or "VP/SI organisation" to refer to venture philanthropy organisations and social investors.

2 EVPA define social purpose organisations (SPOs) as charities, NGOs without trading revenues, NGOs with trading revenues, social enterprises, social businesses or socially-driven commercial businesses.

In Step 1 we look at the elements of the VP/SI organisation's investment strategy that influence the choice of which financial instrument to use. We have identified the following elements:

- the VP/SI organisation's **impact/financial return expectations** and **risk profile**;
- the VP/SI organisation's **legal structure**;
- the VP/SI organisation's **investors/funders**;
- the VP/SI organisation's **life cycle**;
- the VP/SI organisation's **duration of commitment**;
- the VP/SI organisation's **non-financial support**;
- the VP/SI organisation's **team**.

In the report we discuss the impact of all these elements. However, we believe that the most important element is the impact/financial return expectations and risk profile of the VP/SI organisation, we introduce the concept of "impact strategies" of VP/SI organisations.

In terms of impact strategies, we see a two-phase process (Figure 3) that combines the three elements mentioned above: social impact, expected financial return and risk. When the VP/SI organisation needs to assess whether to invest or not, it starts looking at the potential social impact (Phase 1), considering also the risk associated to not achieving it. Then, the VPO/SI should consider the financial returns expected, taking into account the risks associated with them (as part of Phase 2 of the valuation process).

Figure 3: The valuation process (*Source: EVPA Knowledge Centre*)

PHASE 1 – Valuation of **social impact**

a. Impact potentially achievable
b. Risk of not achieving an impact

PHASE 2 – Valuation of **financial returns**

a. Expected returns
b. Risk associated with financial returns

We take this two-phase approach to underline that in the VP/SI space funders have as a primary target the achievement of social impact (which is what differentiates them from commercial funders), so that is where they start from. However, many of them also have to comply with financial return/risk considerations, which is what distinguishes them from traditional philanthropists.

Starting from the assessment of the social impact risks and returns is crucial, because too often only the financial risk/return profiles are considered, and impact is left as a side consideration. Putting too much emphasis on the expected financial returns increases the risk of distorting the discussion about social investment. In fact, a discussion on social investment which only focuses on financial returns without considering the social impact contributes to creating unrealistic expectations among VP/SI investors (Bolis et al., 2017). Often VPO/SIs have to consider how much of their financial returns they are ready to "sacrifice" to achieve higher social impact. For example, a matrix that combines only the risk and the financial return does not make this tension between social impact and financial returns explicit.

We then move to Step 2 of the tailored financing practice, which is the assessment of the financial needs of the SPO. In this section we look at the characteristics of the social purpose organisation that influence the choice of which financial instrument to use to provide financial support. We have identified the following characteristics:

- Internal factors:
  - the SPO's **business model**;
  - the SPO's **organisational structure**;
  - the SPO's **stage in the lifecycle.**
- External factors:
  - the **macro-environment;**
  - the SPO's **stakeholders.**

All the characteristics listed above are strongly connected to each other, and form the strategy of the SPO. In this research we take a **SPO-centred approach**, since we believe it is important to focus on the needs of each investee. Every SPO requires financial and non-financial support tailored to its needs to run its activities, to support its beneficiaries and – ultimately – to finance innovative and effective solutions that can solve specific societal challenges and generate social impact.

We start with the business model because, similarly to VP/SI organisations, also SPOs need to think about their strategy – in the form of a business model. Defining a business model implies making decisions about the product and/or service to develop, the potential clients, the type of activities, the final beneficiaries, etc. All the elements of the SPO's business model have an implication on the FIs needed.

So, the first question a SPO asks itself is: "**Does a market exist for my products/services or my activity?**" (Figure 4). Answering this question opens up four scenarios. If the answer to this question is yes (1), the SPO has a business model that allows it to become self-sustainable, so it will choose an organisational structure that is very close to a traditional commercial organisation (although its primary aim remains the achievement of a social impact). The SPO will most probably not change through its life cycle (although the amount of investment needed might change).

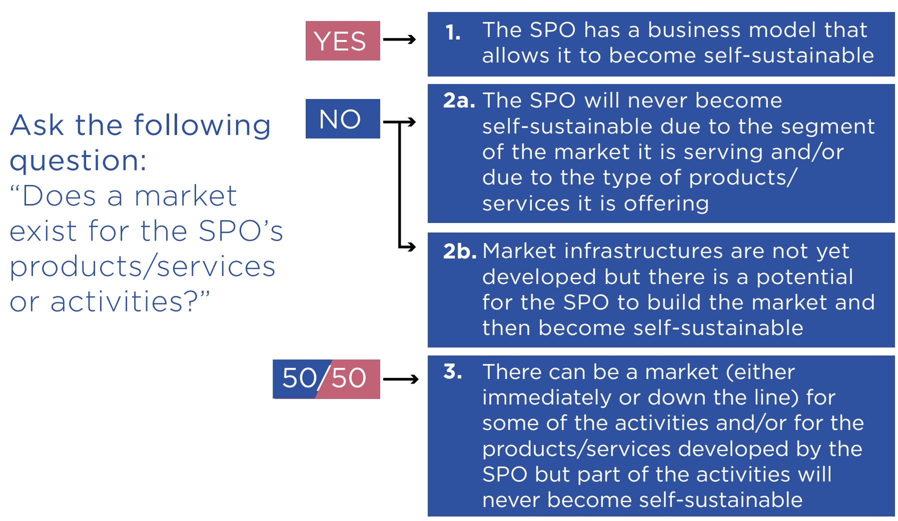
If the answer to this question is no, there are two options.

2a. The SPO will never become self-sustainable due to the segment of the market it is serving and/or due to the type of products/services it is offering. In this case the SPO will choose an organisational structure close to a traditional charity/NGO. The business model and the organisational structure of the SPO will most probably not change through its life cycle (although the amount of investment needed might change).

2b. Market infrastructures are not yet developed but there is a potential for the SPO to build the market and then become self-sustainable. This is one of those cases in which the SPO will need to change its organisational structure while it evolves, moving from a grant-based model to a social-investment model (with all that it entails, discussed largely in the report). After the grant phase the SPO will need to take a moment to re-assess its business model (by answering the first crucial question), to see whether the development towards a social investment model is happening as expected.

The answer however can also be mixed (3), meaning that there can be a market (either immediately or down the line) for **some** of the activities and/or for the products/services developed by the SPO but part of the activities will never become self-sustainable. This case implies that the SPO has a **hybrid business model,** which combines marketable products and services with activities for which there is no market and there

Figure 4: Path for the SPO – Define the SPO's business model (*Source: EVPA Knowledge Centre*)



will never be. The SPO will then have to set up a **hybrid structure,** and will need to combine different types of funding already at the early stage.

In this report we then discuss how the choice in terms of business model is influenced by the macro-environment and by the SPO's stakeholders.

Then, looking at the four scenarios above, we argue the following (Figure 5):

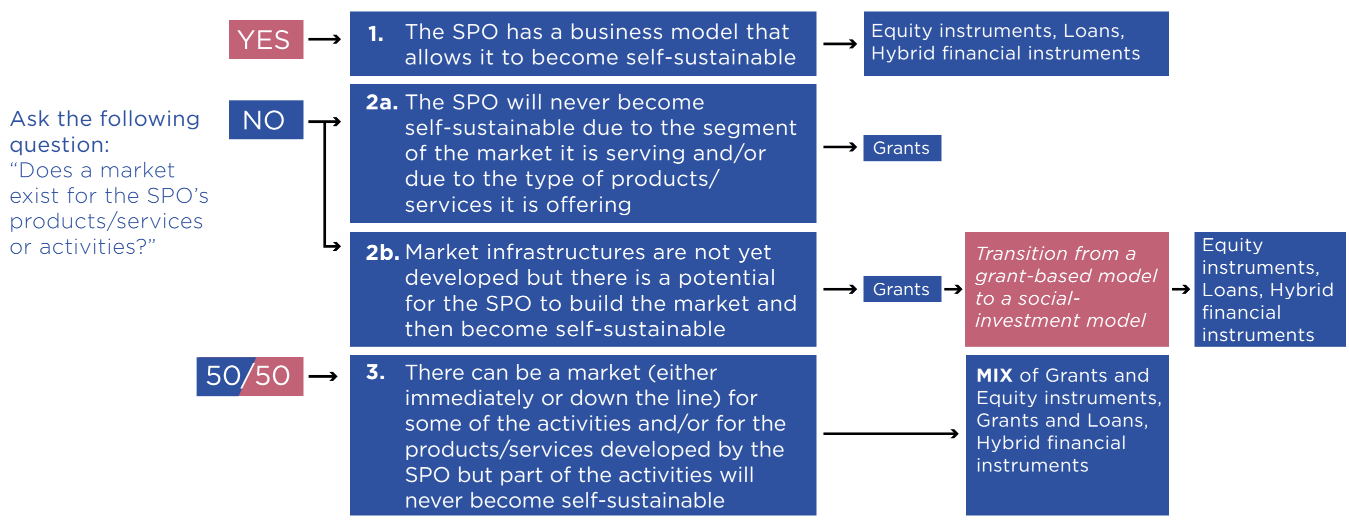
1. If the SPO has a business model that allows it to become self-sustainable, it will choose an organisational structure which is very close to a traditional commercial organisation. In this case the SPO ideally has access to social investment already in the early stage of development (so access to very patient equity, loans and hybrid financial instruments). In this report we underline how these organisations still might need grant in the seed stage, but should also have the opportunity to access patient social finance.

2a. If the SPO has a business model that will never become self-sustainable, it will take a charity/NGO status and will need to be financed through grants throughout its existence (eventually with different amounts, depending on the decision to scale or not to scale). Here we are thinking of SPOs that are, for example, active in advocacy, and that are the primary target for our members that do highly-engaged grant-making and for the public sector in the phase of scaling.

2b. If market infrastructures are not yet developed but there is a potential for the SPO to build the market and then become self-sustainable, we argue that the VP/SI organisation will need to provide first grants, and then social investment (in the form of patient equity, loans and hybrid financial instruments). This is one of those cases in which the SPO will need to change its organisational structure while it evolves, moving from a grant-based model to a social-investment model.

3. If there can be a market (either immediately or down the line) for **some** of the activities and/or for the products/services developed by the SPO but part of the activities will never become self-sustainable, the SPO will take a **hybrid structure** and will need to have access to a mix of grants and social finance, provided often by different actors. It is important to stress that, from the point of view of the SPO, the decision to set up operations as a hybrid structure (i.e. a combination of **a for-profit entity and a not-for-profit one**) is an innovative way to address the issue of access to finance. By setting up a hybrid structure, the SPO can attract grants through the non-profit entity and social investment through the for-profit entity, hence increasing the pool of resources available while channelling them in the most effective way.

Figure 5: Path for the SPO – Assess the SPO's financial needs (*Source: EVPA Knowledge Centre*)



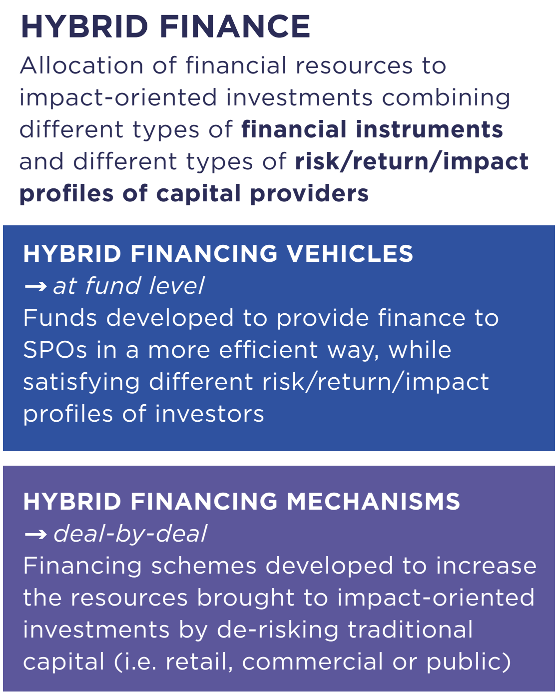
Lastly, we have Step 3 that is the matching of the goals of the VP/SI organisations and the SPO's needs. In this report, we look at how VP/SI organisations use different financial instruments to support SPOs with different business models and organisational structures at different stages of their development. In this section, we briefly discuss each financial instrument (grant, debt, equity and hybrid instruments). However, this is not a technical report, so we do not go into details, but just provide definitions and pros/cons of each FI.

At the end of this section, we briefly discuss the role of social investment intermediaries in supporting the matching between the VP/SI organisation's interests and the SPO's needs.

HYBRID FINANCE

We define **hybrid finance** as the allocation of financial resources to impact-oriented investments combining different types of financial instruments and different types of risk/return/impact profiles of capital providers (Figure 6).

Figure 6: Hybrid finance (*Source: EVPA Knowledge Centre*)



We define two main categories of financing structures developed **on the VPO/SI's side:**

- **Hybrid financing vehicles** are funds developed to provide finance to the SPOs in a more efficient way, while satisfying different risk/return/impact profiles of investors.

- **Hybrid financing mechanisms** are financing schemes developed on a deal-by-deal basis to increase the resources brought to impact-oriented investments by de-risking traditional capital (i.e. retail, commercial or public). Hybrid financing mechanisms include outcome-based mechanisms (such as SIBs, DIBs, Social Success Notes) and the guarantee scheme.

So, why is hybrid finance important, why does it matter? In this report we argue that hybrid finance has three main objectives, which constitute the added value of hybrid finance (Figure 7):

- **Increase the effectiveness** in supporting SPOs by providing them with the right support in the right form at the right time. This is particularly true for those SPOs that have the potential to become self-sustainable by generating revenues at a certain point in time and that might develop an appetite for diverse or more sophisticated FIs as their business moves towards self-sustainability.

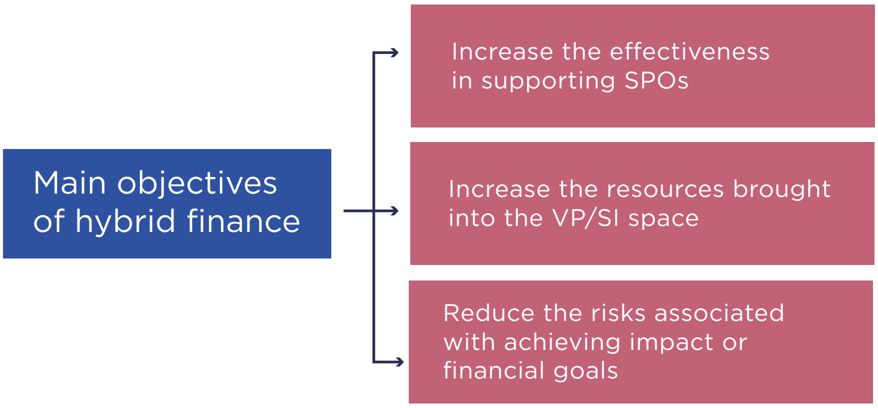
- **Increase the resources** brought into the VP/SI space – and the efficient allocation of resources. Hybrid finance allows for the engagement of **new classes of actors,** thus bringing more financial resources into the VP/SI space and valuable assets and capabilities.

- **Reduce the risks** associated with achieving the impact or financial goals for different actors. Hybrid finance can reduce the risks associated with achieving the impact goals for philanthropic and public capital providers, or the risks associated with achieving the financial goals for traditional investors, such as retail and commercial investors.

We provide plenty of examples of hybrid financing vehicles and mechanisms.

We conclude this report with a section that summarises the challenges, learnings and recommendations we collected thanks to the collaboration with a large group of experts, including practitioners, academics and consultants.

Figure 7: The main objectives of hybrid finance (*Source: EVPA Knowledge Centre*)



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Stephanie Petrick	*Phineo AG*

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Last but not least we would like to thank all the experts who provided us with the case studies that are presented in this report.

All errors and omissions remain the responsibility of the authors. We encourage you to submit comments and clarification questions to: knowledge.centre@evpa.eu.com

METHODOLOGY

This report is the result of one year of intensive work (Figure 8), trying to unravel all the options that VP/SI organisations have to finance SPOs in the most effective way.

We started by scanning the literature on access to funding for social purpose organisations, analysing the financial instruments available in the VP/SI market, with a specific focus on hybrid finance and on financing mechanisms, from a vast number of sources. We then developed a framework including the main themes identified through our desk research. In the meantime, we reached out to the EVPA network and established an expert group to solidly ground the research in practice, by coupling our theoretical modelling with direct experience of VP/SI practitioners.

Our objectives in terms of the collaboration with the expert group were:

- to verify whether our framework included the key themes;
- to work on the definitions around hybrid finance;
- to look in-depth at how tailored financing is implemented in practice;
- to collect a series of cases on tailored financing and on hybrid financing vehicles and mechanisms to explain these practices to the broader VP/SI community.

The 28 members of the expert group – listed on pages 11 and 12 – include VP/SI practitioners, academics, representatives of the European institutions and consultants, providing a key contribution to the development of this report.

During the kick-off meeting at EVPA's premises in Brussels in March 2017, the members of the expert group were divided into working groups, reflecting the thematic areas originally envisaged.

After the kick-off, the experts in their groups worked on their thematic area and then they reported back the findings of their discussions to the wider expert group during a series of webinars. The webinars were organised with the purpose of stimulating discussion among practitioners on issues related to tailored financing and hybrid finance, and were also the occasion for the experts to present their cases.

Due to the many dimensions that play a role in finding the right combinations of financial instruments and actors to support SPOs in a suitable way, we believe that the examples presented throughout the report make a key contribution in summarising the main findings of this research project, highlighting both best practices and challenges.

After finalising the first draft of the report, we asked for feedback and input from the experts, conducted additional interviews and then implemented the comments we received from the group to come to the final version of this report.

Figure 8: EVPA research project timeline

HOW TO NAVIGATE THIS REPORT

This report is structured as follows. After an **introduction** to venture philanthropy (VP) and an explanation of the reasons why we decided to conduct this research in ***Part 1***, in ***Part 2*** we focus on **tailored financing** by unpacking the financial relationship between the venture philanthropy organisation/social investor and its investee/grantee, the social purpose organisation. Specifically, in *Chapter 1* we look at the pre-conditions linked to the VP/SI organisation that can influence the financial instrument(s) available, and in *Chapter 2* we look at the characteristics of the SPO that help determine the most suitable financial instruments to use. Then, in *Chapter 3*, we match the goals of the VPO/SI and the needs of the SPO, and we provide an overview of the different financial instruments a VPO/SI can use to finance a SPO. Lastly, in *Chapter 4*, we briefly discuss how the tailored financing process fits into the investment process of the VPO/SI.

In ***Part 3***, we then focus on **hybrid finance,** by explaining why it is needed in the VP/SI space, and by providing definitions and descriptions of the structures developed so far in this field (i.e. hybrid financing vehicles and hybrid financing mechanisms).

In ***Part 4***, we provide an overview of the current **challenges,** the **learnings** and **recommendations** linked to these practices – and we draw some conclusions. We also propose alleys for further research in this field.

The whole report is filled with cases and practical examples that make the theory and the frameworks come to life.

PART 1. INTRODUCTION

Inka © NESsT

PART 1. INTRODUCTION

WHAT IS VENTURE PHILANTHROPY (VP)?

Venture philanthropy (VP) is a **high engagement** and **long term approach** to generating societal impact[3] and financing solutions to pressing social challenges adopted by **venture philanthropy organisations and social investors**[4]**.** Three core practices are typically implemented[5] (Figure 9):

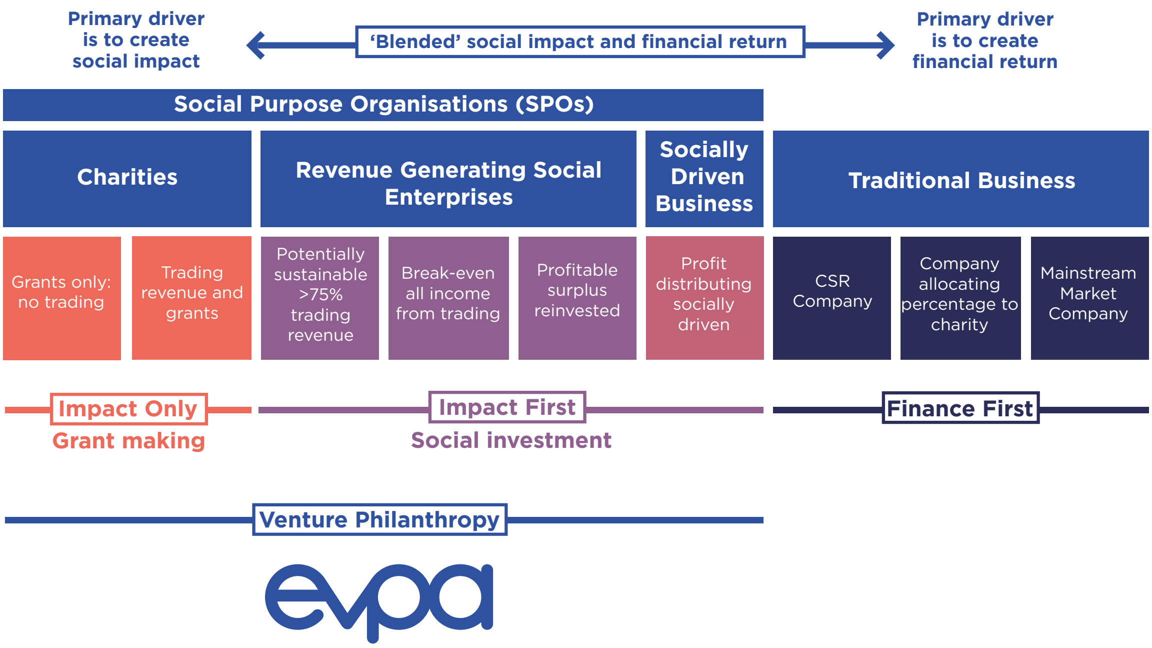
- **Tailored Financing**: the process through which a VP/SI organisation finds the most suitable financial instrument(s) to support a social purpose organisation (SPO) choosing from the range of financial instruments available (grant, debt, equity, and hybrid financial instruments).
- **Organisational Support:** the provision from VP/SI organisations of added-value support services to investees (SPOs) to strengthen the SPO's organisational resilience and financial sustainability by developing skills or improving structures and processes.
- **Impact Measurement and Management**: the measurement and management of the process of creating social impact in order to maximise and optimise it.

Venture philanthropy works to build stronger investee organisations (SPOs) by providing them with both financial and non-financial support (including organisational support and impact management) in order to increase their social impact. As shown in Figure 10, the venture philanthropy approach includes the use of the entire spectrum of financial instruments (grants, equity, debt and hybrid financial instruments), and pays particular attention to the ultimate objective of achieving social impact and financing solutions to old and emerging societal challenges.

Figure 9: The venture philanthropy approach
(*Source: EVPA*)

3 EVPA purposely uses the term "societal" because the impact may be social, environmental, medical or cultural. However, throughout this report we refer to "social impact" to indicate the same concept.
4 Throughout this report we indistinctly use both the terms "VPO/SI" or "VP/SI organisation" to refer to venture philanthropy organisations and social investors.
5 For more info: http://evpa.eu.com/about-us/what-is-venture-philanthropy

Figure 10: The EVPA Spectrum (*Source: EVPA*)

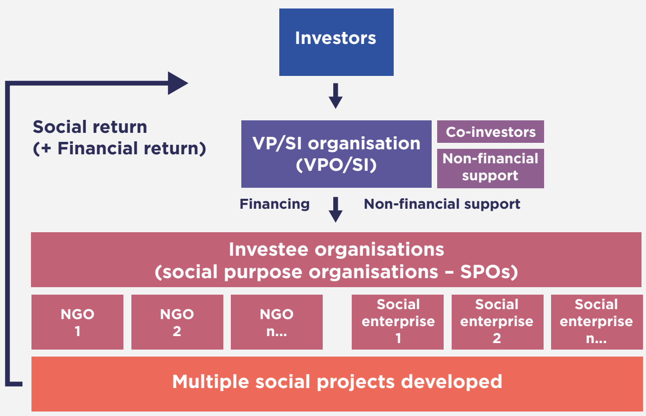


EVPA DEFINITIONS[6]

Venture philanthropy organisations and social investors (VP/SI organisations or VPO/SIs) are organisations that fund social purpose organisations through grant, debt, equity or hybrid financial instruments. VP/SI organisations act as vehicles, channelling funding from investors and co-investors, providing a range of non-financial support to various investee organisations (SPOs) and measuring and managing social impact. VP/SI organisations are either focused on the social return of their investment rather than on the financial return, or they consider the social return as important as the financial one.

Social purpose organisations (SPOs) – the investee/grantee organisations – are organisations that operate with the primary aim of achieving measurable social and environmental impact. The type of SPOs can range from charities, NGOs without trading revenues to NGOs with trading revenues, as well as from social enterprises and social businesses to socially-driven commercial businesses, with diverse organisational forms subject to country-specific legal and cultural norms.

Figure 11: The Venture Philanthropy model (*Source: EVPA*)



6 Throughout this report, we use these definitions.

WHY RESEARCH TAILORED FINANCING AND HYBRID FINANCE?

SPOs are organisations that operate with the primary aim of achieving a **measurable social impact**. In order to grow at each stage of their development, SPOs need both financial and non-financial resources, which are adapted to their needs and the cash-flow characteristics in each specific moment of their life cycle.

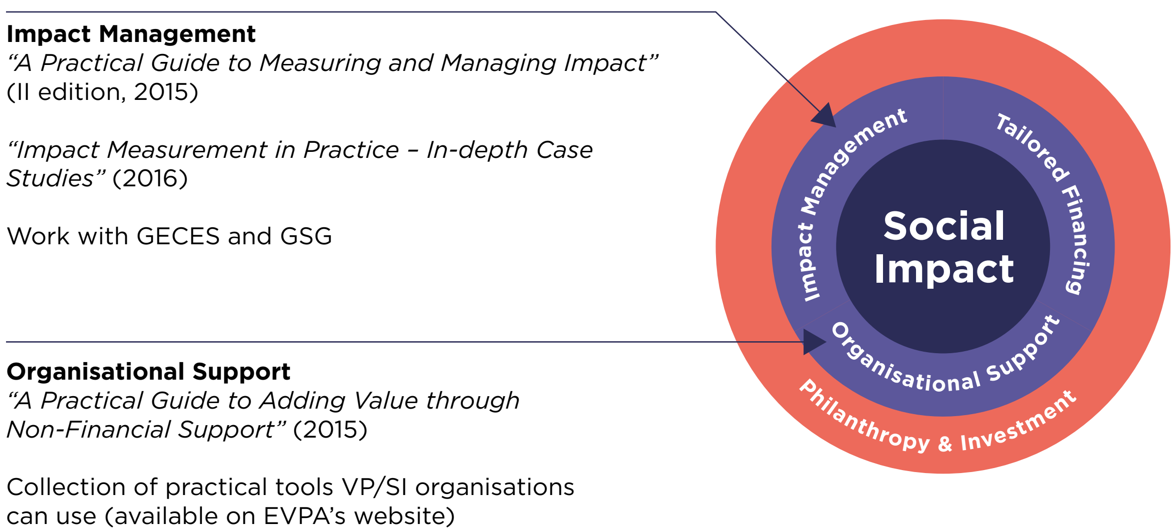
As the association of venture philanthropy organisations and social investors, EVPA is committed to help VP/SI practitioners improve their VP/SI practices and the way they support SPOs in developing, growing and scaling.

As part of this effort, the Knowledge Centre of EVPA has, for a number of years, been conducting research on the key practices of the venture philanthropy approach (Figure 12).

Back in 2013, EVPA published its report "A Practical Guide to Measuring and Managing Impact"[7], followed by two in-depth case studies[8].

In 2015, EVPA conducted an in-depth research on non-financial support[9], looking at how VP/SI organisations support SPOs in the three main areas of development: social impact, financial sustainability and organisational resilience.

Figure 12: EVPA research on how to practice venture philanthropy (*Source: EVPA*)



7 **Hehenberger, L.**, **Harling A.**, and **Scholten, P.**, (2015), *"A Practical Guide to Measuring and Managing Impact"*.
8 **Boiardi, P., Hehenberger, L.**, **Gianoncelli, A.,** (2016), *"Impact Measurement in Practice - In-depth Case Studies"*, EVPA.
9 **Boiardi, P.,** and **Hehenberger, L.**, (2015), *"A Practical Guide to Adding Value through Non-Financial Support"*, EVPA.

TAILORED FINANCING

As **tailored financing** is the third core element of the venture philanthropy approach, we decided it was time for EVPA to look into this practice.

Tailored financing is becoming a reality, with VP/SI organisations moving in this direction, as shown in Figure 13. About 60% of the organisations that replied to the fifth EVPA Industry Survey[10] declared they customised the financial instruments (FIs) used to the needs of their investees.

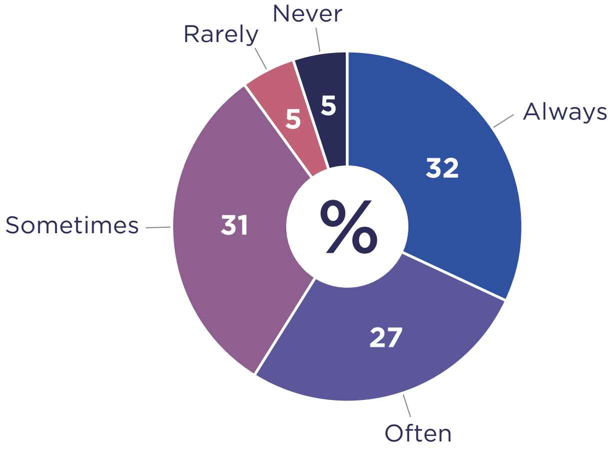
From the **point of view of the VPO/SI**, finding better ways to finance SPOs and to attract more resources into the VP/SI space is crucial to strengthening the social impact their investees can achieve.

From the **point of view of the SPO,** tailored financing can represent a way to solve the existing funding gap that prevents them from gaining access to the capital needed for achieving financial sustainability and for scaling. SPOs might need different types of financial support at different stages of their development but, since the diverse actors in the VP/SI space and other potential traditional funders operate in isolation, there are many difficulties for SPOs to find the appropriate financing mix to scale their social impact (European Commission, 2016).

Despite the importance of the choice of the most appropriate financial instrument for each specific investment, in-depth knowledge on how to maximise impact by using the right financing mix is still anecdotal, based on the practical experience of the actors investing in the VP/SI space. Furthermore, a holistic view on how to match investors' goals and investees' needs is still missing.

What are the specific conditions to use a financial instrument instead of another? Which financial instruments are best suited to finance a specific type of SPO at different stages of its development? This report aims at providing answers to these and more questions.

Figure 13: VP/SI organisations adapting their financing model to the needs of their investees (*Source: "The EVPA Industry Survey 2015/2016"*)



10 **Boiardi, P.** and **Gianoncelli, A.** (2016), "*The State of Venture Philanthropy and Social Investment in Europe | The EVPA Survey 2015/2016*", EVPA.

HYBRID FINANCE

As EVPA's vision is to create a world where philanthropy and investment combine to drive sustainable social impact, we strongly believe in the **collaboration of philanthropic capital and investment capital**, but we also see that for the moment they are more often than not still two separate worlds, even if the last years have seen an increase in interest for impact investment and more debate around the need for a more sustainable and meaningful economy among traditional fund managers.

Looking in-depth at **hybrid finance** is the way to explore how different actors, with different risk/return/impact profiles can collaborate in an efficient way in the VP/SI sector, by bringing together their capital, expertise and perspectives.

Furthermore, even though numerous reports have been published on different aspects of hybrid finance, each study focuses on a particular type of hybrid financing vehicle or mechanism, so that a comprehensive overview of hybrid finance is still lacking. Additionally, a summary of the reasoning behind the use of these different financing vehicles/mechanisms, the added value of this type of collaborations, and the common challenges and shared learnings of these practices is still missing.

Lastly, there seems to be quite some confusion around the concept of hybrid finance. It is still a vague notion, even in existing literature: does it entail mixing different financial instruments to have social impact? Is it about mixing public and private funds? How can different capital providers with different risk appetites, financial return expectations and impact objectives work together to sustain SPOs?

This report aims at answering all these questions and at clarifying each of these concepts.

It is important to underline that this research project is not a technical report on finance or financial instruments. It is not aimed at analysing in-depth all the different financing vehicles and mechanisms used and built up to support SPOs. This report is about **social impact.** It is about how funding can be shaped in such a way that it is aligned with the purpose of the investee, and how it thus can help both the VP/SI organisation and the SPO maximise their impact. This report is also about how different actors with different risk/return/impact profiles can cooperate in the VP/SI space to leverage each other's resources and expertise.

PART 2.
TAILORED FINANCING
Choosing the most suitable financial instrument(s) to support a SPO

3V Vets © Anne Holm Rannaleet

PART 2. TAILORED FINANCING
Choosing the most suitable financial instrument(s) to support a SPO

Tailored financing is the process through which a venture philanthropy organisation or a social investor (VPO/SI) finds the most suitable financial instrument(s) to support a social purpose organisation (SPO), choosing from the range of financial instruments available (grant, debt, equity, and hybrid financial instruments).

The choice of the financial instrument(s) will depend on the risk/return/impact profile of the VPO/SI and on the needs and characteristics of the SPO.

Tailored financing is one of the three characteristics of the VP approach, together with impact management and organisational support.

In order to guarantee the success of an investment, it is extremely important for the VP/SI organisation to select in advance the right financial instrument to deploy (Balbo et al. 2016; Varga and Hayday, 2016) or, in case the VP/SI organisation does not have the possibility to choose from a wide range of FIs, to screen in-depth the potential investees to see whether the FI available is the most suitable one vis-à-vis the characteristics of the investee.

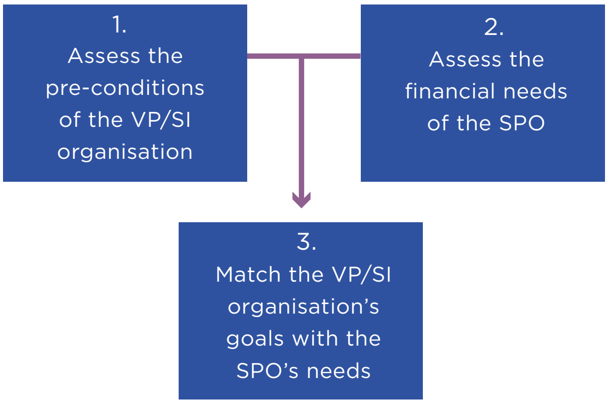
When a SPO is not financed with the most suitable FI, its risk of failure is higher (Hehenberger and Boiardi, 2014), both in terms of impact generation and, from a business perspective, because the risk of going out of business and closing shop is higher. For a SPO it is particularly relevant to find the appropriate financial instruments and the right social investor (Achleitner et al., 2011) to avoid the risk of misalignment in goals that can lead to conflict and confusion on objectives and strategy, or to a bad fit of the financing with the cash flows of the activities.

Hence, tailored financing is crucial in order to **use the capital available in an efficient and effective way**, to **reduce the risk of failure**, and to **offer the best option of funding to SPOs** to achieve an even greater impact.

Looking at tailored financing as a process, we can identify **three steps**. Following the order represented in the Figure 14, the first step for the VPO/SI is to reflect on its own investment strategy and its own constraints, to assess which financial instruments it will be able to use. In *Chapter 1* we provide guidance on assessing the risk/return/impact profile of VP/SI organisations (under existing legal and contextual constraints). Then, for the second step, in *Chapter 2* we provide guidance on a process to follow to analyse in-depth the financial needs of the SPO. Such analysis can be performed by the VPO/SI or by the SPO itself, depending on the circumstances. Once the characteristics of the potential SPO to be funded together with its own strategy and constraints are clear, the VP/SI organisation will be able to assess whether there is a match and to choose and structure the appropriate financial instrument(s) to use – or to decide not to invest. We go through this final step in *Chapter 3.*

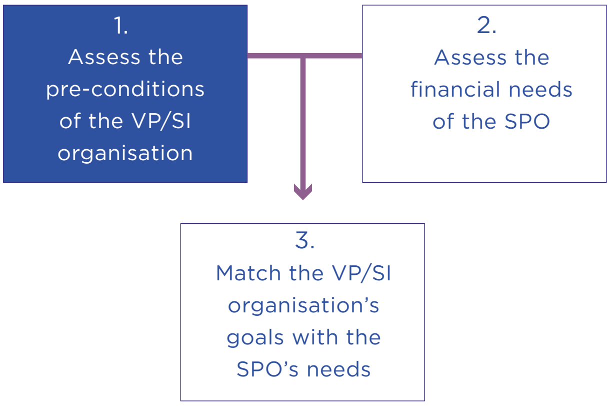
The selection of the financial instrument(s) to deploy is a key practice for VP/SI organisations and has to be integrated as a crucial part of the investment strategy and investment process, as shown in *Chapter 4*.

Figure 14: : Tailored financing as a three-step process (*Source: EVPA Knowledge Centre*)



1. ASSESS THE PRE-CONDITIONS OF THE VP/SI ORGANISATION

Figure 15: The first step of tailored financing (*Source: EVPA Knowledge Centre)*



Each VP/SI organisation has an **investment strategy**, which guides it when deciding which investments to make, and which to leave. The VPO/SI's investment strategy defines, among other things, which social sector and which geography it will target, which SPOs it will support, the financial and non-financial support it will provide and its exit strategy. VP/SI organisations need to make a thorough assessment of how the elements of their investment strategy will impact the choice of financial instrument(s).

In particular, two elements of the VP/SI organisation's investment strategy that influence the choice of which financial instrument to use are:

- the VP/SI organisation's **legal structure;**
- the VP/SI organisation's **impact/financial return expectations** and **risk profile**.

Next to the two core elements, other factors play a role:

- the VP/SI organisation's **investors/funders;**
- the VP/SI organisation's **life cycle**;
- the VP/SI organisation's **duration of commitment**;
- the VP/SI organisation's **non-financial support (NFS)**;
- the VP/SI organisation's **team.**

1.1. The VP/SI organisation's legal structure

An aspect of the VP/SI organisation that is extremely relevant for any consideration about which FIs to deploy is the **legal structure**. This factor determines a series of possibilities, but also limits and constraints, which have consequences on the financial instruments a VPO/SI can use.

For example, in many EU countries, a VP/SI organisation legally set up as a foundation cannot generate financial returns on its investments, which implies that it can only use grants. Due to these potential restrictions, if VPO/SIs could freely chose the legal structure of their organisation, they would probably prefer not to limit themselves and choose a more flexible type of structure, which also allows them to deploy loans and equity instruments.

Thus, the **domicile** of the VP/SI organisation, meaning where it will operate and where it expects to support a large portion of its SPOs, is a condition to be well evaluated, in case the VPO/SI can freely take a decision in this sense.

IK Investment Partners, a Northern European focussed Private Equity Firm, "stumbled into" the Stamp Out Sleeping sickness emergency initiative in Uganda. IK had been involved in philanthropic activities since its inception in 1989. However these were mostly of an un-strategic ad-hoc nature. So when attention was brought to IK by one of its PE portfolio companies to the Ugandan emergency situation, it was for IK the opportunity to focus its engagement and contribute more than just passive funding. To separate these activities from the traditional PE investments, **IK looked at different options.** Specifically: a **Swedish Foundation** (due to IK's Swedish roots) and a **UK company limited by guarantee which could also obtain charitable status.** IK screened pros and cons of the two possible choices and, in 2006, it ended up incorporating **IKARE Ltd**[11] as a UK company limited by guarantee which could also be registered as a UK charity. First, this allowed IK Investment Partners Ltd, the main donor, to receive tax deductibility on its donations in a simpler way than in the case of a Swedish Foundation, which would have also required a larger amount of initial capital to justify its running costs. Additionally, IK wanted to be able in the future, if this "experiment" supported by grants turned out well, **to also provide loans or make equity investments**.

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1.2. The VP/SI organisation's impact/financial return expectations and its risk profile – towards a categorisation of impact strategies

Although we consider the legal structure as a relevant condition for any reflection about which FI(s) to deploy, we prefer not to categorise VP/SI organisations based on their legal structure.

In this report we prefer to look at VPO/SIs from the point of view of their **risk/return/impact profile**. We do so because we observed that VPO/SIs with the same legal structure might have very different risk/return/impact profiles. For example, foundations are not all alike. An endowed foundation uses only the returns on its endowment to provide grants, which implies it has a very different risk profile than a foundation that needs to raise funds from external donors, to which it is accountable for the impact achieved.

Often VP/SI organisations are categorised looking – (exclusively) – at their **risk** and **financial return expectations** – without including impact considerations. In such case VP/SI organisations are placed in a matrix combining the two dimensions of risk and financial return. As a result, we can have two types of VP/SI funds placed in different quadrants of such matrix: the first one accepting more risk so probably expecting a positive financial return, the latter being risk-averse but only seeking capital repayment. However, such a matrix has two fundamental limits.

First, it does not consider the **social impact objectives** of the VP/SI organisation as a dimension that should be combined into its risk/financial return considerations.

Second, it puts **too much emphasis on the expected financial returns**, with the risk of distorting the discussion about social investment. In fact, a discussion on social investment which only focuses on financial returns without considering the social impact contributes to create **unrealistic expectations among VP/SI organisations** (Bolis et al., 2017). Often VPO/SIs have to consider how much of their financial returns they are ready to "sacrifice" to achieve higher social impact. The risk/ financial return matrix does not make this tension explicit.

11 For more info: http://www.ikinvest.com/IKare/

We thus avoid just considering the correlation between risk and return, preferring instead to link the impact expectations with the financial return expectations and risk profile of the VPO/SI. In fact, in the VP/SI space, the more relevant dimension is the **trade-off between the expected financial returns and the expected social impact**. And both impact and financial return expectations have an element of risk – which is to be dealt with in a second phase.

We thus move from a categorisation of VPO/SIs based on their legal structures or on their risk/financial return expectations to a **categorisation of impact strategies**, remembering that each VP/SI organisation can apply different strategies.

The starting point to develop a taxonomy of the impact strategies adopted by VP/SI organisations is to look at their **social impact expectations**. Social impact considerations should be the first driver of a VP/SI organisation. In fact, often VPO/SIs are willing to give up some financial return and/or take on more risk if the social impact objectives are overachieved. Social investors sometimes accept the risk of "losing" their capital (e.g. not receiving any capital back, or not realising any financial return) when they see that the social impact generated by the SPO has exceeded the expectations. Therefore a VP/SI organisation starts defining its strategy by designing its social impact expectations, and then looks at the financial return expectations.

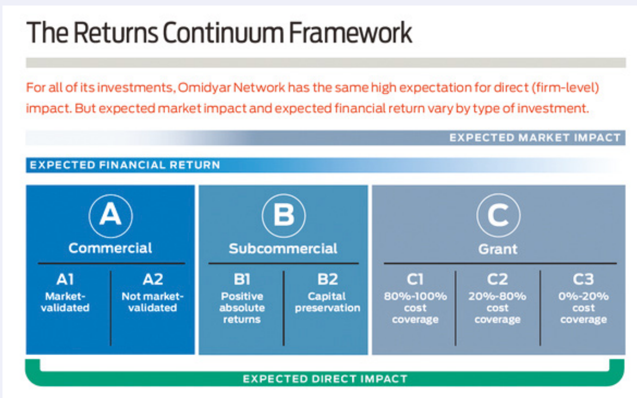
Once the expectations both on impact and financial returns have been evaluated, the VP/SI organisation moves to consider the **risk** dimension, **both on the impact and on the financial side**. Since in the VP/SI space the achievement of social impact is the key driver, also the **risk of not generating it** needs to be evaluated.

The risk that a VP/SI organisation is willing to accept will then have an immediate consequence on the financial instrument it will opt for.

The focus on social impact risks and returns has been embedded in the framework recently developed by Omidyar Network (Figure 16). The "Returns Continuum" helps give some answers to the debate on the trade-off between social and financial return within the VP/SI community: is there a positive or a negative correlation between the two dimensions? The framework looks at investment strategies by combining expectations on financial returns and impact. It extends from fully commercial investments (A) to philanthropic grants (C), passing by sub-commercial investments (B).

Omidyar has developed this framework for assessing the **market-level impact** whose creation is the only condition in which below-market returns are accepted (i.e. Omidyar uses grant instruments only when its investment in a SPO is generating a positive market-level impact – category C in the scheme above). In the framework both financial returns and expected impact are taken into account for deciding whether or not to invest. In this continuum, for investments that have been assessed to be in categories B and C, the expectations on the market impact increase as the financial returns expectations decrease (Bannick et al., 2017).

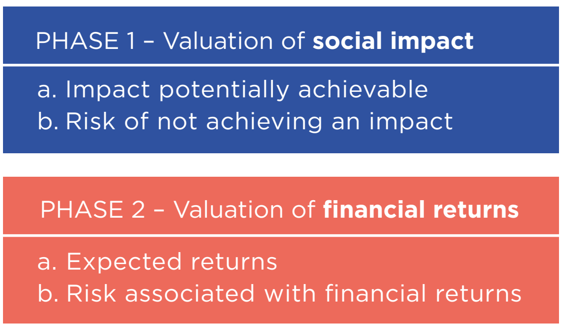
Figure 16: The Omidyar Network's Returns Continuum Framework (*Source: Omidyar, 2016*)



To summarise, we see a **two-phase process that combines all the three elements** discussed above: social impact, expected financial return and risk (Figure 17). When the VP/SI organisation needs to assess whether to invest or not, it would be useful to start looking at the potential social impact (Phase 1), considering also the risk associated to not achieving it. Then, the VPO/SI should consider the financial returns expected, taking into account the risks associated with them (as part of Phase 2 of the valuation process).

We take this two-phase approach to underline that in the VP/SI space funders have as a primary target the achievement of social impact (which is what differentiates them from commercial funders), so that is where they start from. However, many of them also have to comply with financial return/risk considerations, which is what makes them different from traditional philanthropists.

Figure 17: The valuation process (*Source: EVPA Knowledge Centre*)



As a complete mapping of the impact strategies of the VPO/SI does not yet exist, for the purpose of this report we consider three main groups of strategies:

a. The VPO/SI only aims to achieve a social impact, with no financial returns;
b. The VPO/SI wants to achieve primarily a social impact – but accepts a financial return;
c. The VPO/SI wants both to achieve a social impact and to obtain financial returns.

1.3. Other relevant factors

Alongside the legal structure and the impact strategy, there are other factors linked to the VP/SI organisation that can have implications on the FI(s) chosen:

- The VP/SI organisation's **investors/funders;**
- The VP/SI organisation's **life cycle**;
- The VP/SI organisation's **duration of commitment**;
- The VP/SI organisation's **non-financial support**;
- The VP/SI organisation's **team.**

1.3.1. The VP/SI organisation's investors/funders

We identify **different types of funders/investors** that make capital available for VP/SI organisations: foundations, corporates, banks, high net worth individuals (HNWIs), retail impact funds, governments, supranational funders (e.g. the European Commission), institutional investors (e.g. the European Investment Fund, the European Investment Bank, and the International Finance Corporation) and family offices.

A VP/SI organisation can offer its funders/investors:
- The achievement of a certain level of social impact, but no financial returns.
- The achievement of a certain level of social impact alongside the provision of a potential financial return.
- A financial return together with a social impact.

Depending on which of the three above options it chooses, the VP/SI organisation will need to align with its funders'/investors' wishes. The **promises** that the VP/SI organisation makes to its own **funders/investors** determine its choices in terms of impact and financial return expectations. The option selected will also affect the type of financial support provided by the VPO/SI to the SPO. For example, if the VP/SI organisation does not need to generate a positive financial return for its funders, it can focus on generating only a social return without asking the SPO for any repayment of the capital or any financial surplus. In such case, giving a grant is a viable option.

1.3.2. The VP/SI organisation's life cycle

The **life cycle** of the VP/SI organisation, which is closely linked to its legal structure, determines the number of years the organisation will run its activities. There can be VP/SI organisations:

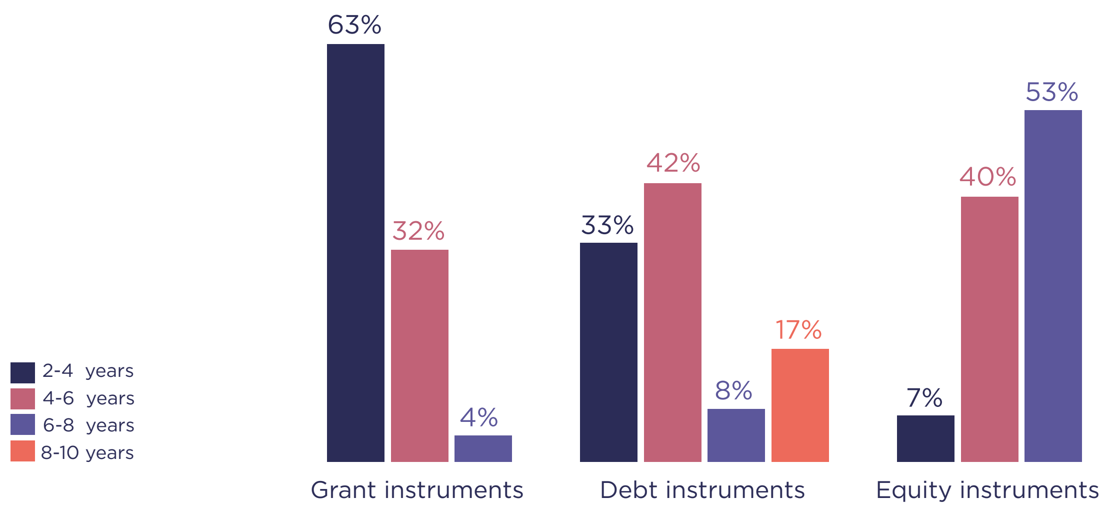
(i) established with a self-liquidating structure, implying they will be funding SPOs over a fixed period of time (see for example Atlantic Philanthropies[12], which was set up to invest all its fund in a ten year period of time),
(ii) established with a perpetual life cycle (typically endowed foundations),
(iii) continuously fundraising – this is the case, for example, of VP/SI funds, which go through a cycle of fundraising and deployment of capital.

Thus, this factor can have an effect on the possibilities for the VP/SI organisation in terms of the duration of the investment and consequently on the financial instruments deployed. In fact, if the VP/SI organisation has an extended life cycle, it can use more patient FIs (such as debt or equity instruments).

1.3.3 The VP/SI organisation's duration of commitment

Any consideration about the life cycle is also linked to the **duration of commitment**, which is defined as the length of time during which the VP/SI organisation is willing to support an investee. Looking at the data collected through the EVPA Industry Survey[13] we see a correlation between the average duration of the investment and the FI used (Figure 18). Considering only the organisations that use a single category of financial instruments, we can see that VP/SI organisations that use grant instruments have a shorter duration of commitment, committing themselves in a large majority (64%) for two to four years. The opposite situation can be observed for VP/SI organisations that use equity instruments. In fact, most of them are investing for a period of six to eight years, with only a minor percentage investing for a shorter term. The duration of commitment for VP/SI organisations using debt instruments is much more varied. However, three quarters of the respondents provide loans within a period between two and six years.

Figure 18: VP/SI organisations using different financial instruments per average duration of the commitment
(*Source: analysis of data collected by EVPA for "The EVPA Survey 2015/2016"*).



12 http://www.atlanticphilanthropies.org/
13 **Boiardi, P.** and **Gianoncelli, A.** (2016), "*The State of Venture Philanthropy and Social Investment in Europe / The EVPA Survey 2015/2016*", EVPA.

1.3.4. The VP/SI organisation's non-financial support

An additional component is the **non-financial support (NFS)** that the VP/SI organisation commits to give its SPOs.[14]

The NFS can have some implications on the way the VP/SI organisation works with the investees and, accordingly, on the financial instruments selected.

The VP/SI organisation needs to assess which forms of NFS it can provide to its investees, because this will be strongly interlinked with the success of the SPO in deploying a specific financial instrument. For example, when the VPO/SI provides complex financial instruments to the SPO it is advisable to foresee NFS in the form of ad-hoc advice on how to use it. Similarly, when a SPO is in the very early pre-seed stage, NFS can prepare it to receive the investment. In such case NFS has a role in **de-risking the investments**.

1.3.5. The VP/SI organisation's team

The composition of the team of the VP/SI organisation has an impact on the capability of the VPO in managing different types of financial instruments. Different types of teams are needed to be a debt investor versus being an equity investor, as the skill sets and knowledge are different. If the VPO/SI decides to deploy equity, for example, it will need to have an investment team with a very strong business sense. Equity usually involves valuation negotiations, complex equity sales discussions with other co-investors or follow-on funders, and, if all goes bad, there is no collateral can be recuperated, so there is an incentive to really drive the company to increase its value.

1.4. Conclusion

All the elements analysed in this chapter have an impact on the choice of the FIs a VPO/SI can use.

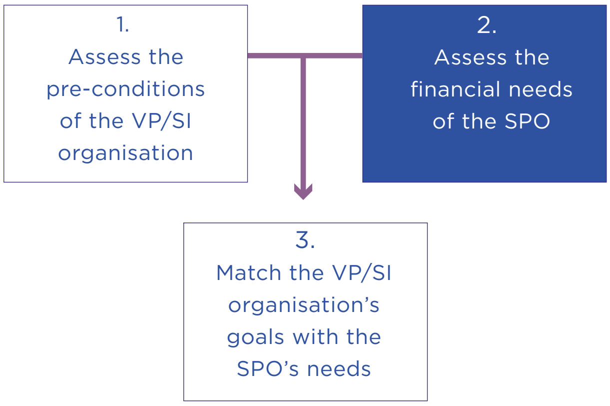
However, even though these elements can encourage a VP/SI organisation to use specific FIs, or can limit it in the use of other FIs, they do not tell when it is most suitable to use one FI rather than another from the point of view of the SPO.

This is the reason why it is particularly important to match all these considerations with the assessment of the SPO and its specific needs, which we outline in the next chapter.

14 To have a complete overview on how VP/SI organisations provide non-financial support to the SPOs they finance, please download the EVPA report: **Boiardi, P.,** and **Hehenberger, L.**, (2015), "*A Practical Guide to Adding Value through Non-Financial Support*", EVPA.

2. ASSESS THE FINANCIAL NEEDS OF THE SOCIAL PURPOSE ORGANISATION

Figure 19: The second step of tailored financing (*Source: EVPA Knowledge Centre*)



In this research we take a **SPO-centred approach**, since we believe it is important to focus on the needs of each investee. Every SPO requires financial and non-financial support[15] tailored to its needs to run its activities, to support its beneficiaries and – ultimately – to finance innovative and effective solutions that can solve specific societal challenges and generate social impact.

The following factors have an impact on the financial instrument(s) that can be used to finance a SPO:

Internal factors:
- the SPO's **business model**;
- the SPO's **organisational structure**;
- the SPO's **stage in the life cycle.**

External factors:
- the **macro-environment;**
- the SPO's **stakeholders.**

2.1. The SPO's business model

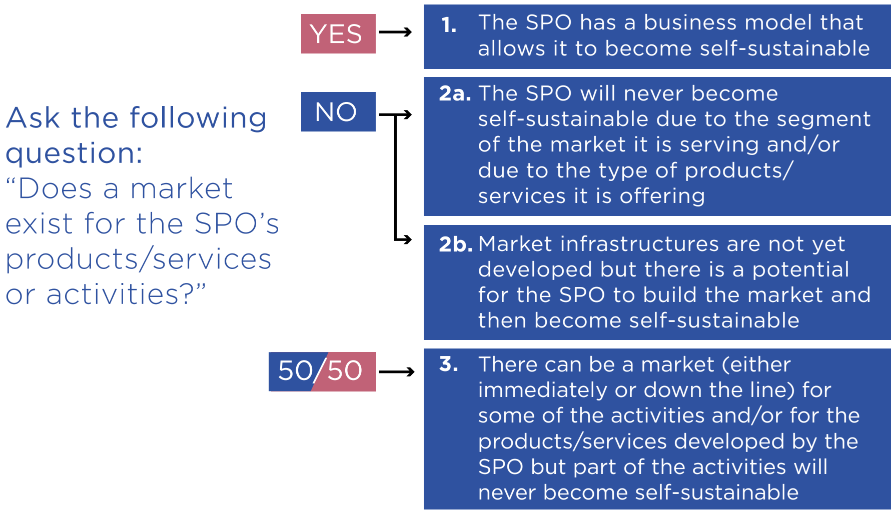
Similarly to VPO/SIs, SPOs need to think about their strategy – in the form of a business model. Defining a business model implies making decisions about the product and/or service to develop, the potential clients, the type of activities, the final beneficiaries, etc. All the elements of the SPO's business model have an implication on the FIs needed.

The first question a SPO asks itself is: "**Does a market exist for my products/services or my activity?**"

To put it simply, a SPO can answer this question in four ways, as shown in Figure 20: (1) yes, there is a market; (2a) no, there is no market and there will never be; (2b) no, there is no market, but there might be one if the market infrastructure is correctly developed; (3) yes, there can be a market (either immediately or down the line) for some of the activities and/or for the products/services developed by the SPO but part of the activities will never become self-sustainable.

15 To have a complete overview on how VP/SI organisations support through non-financial activities the SPOs they finance, please download the EVPA report: **Boiardi, P.,** and **Hehenberger, L.**, (2015), *"A Practical Guide to Adding Value through Non-Financial Support"*, EVPA.

Figure 20: Path for the SPO – Define the SPO's business model (*Source: EVPA Knowledge Centre*)



Recognising the existence of a market for the product/service (1) implies recognising that the SPO has a potential for becoming self-sustainable – if provided with the right type of patient capital and non-financial support. The market can either be purely commercial, i.e. the customer buying and paying for the product/service which is for their own use, or public. In the case of the public market, the buyer/procurer may also buy the service for use of others (such as in health and elderly care, education, social services etc.).

Many SPOs develop products and services for the public market and, as such, tend to develop an "over-reliance" on the public market "stepping in". This over-reliance is one of the main challenges of the VP/SI sector because it prevents SPOs from giving sufficient thought to their business models, to the market's/purchaser's price sensitivity and to the true added value, as well as ease of adaption to the end-user. The discipline of taking on equity investment can be very beneficial for start-up SPOs that have the potential to achieve self-sustainability. Raising equity requires SPOs to present to investors, from the beginning, a pathway towards financial sustainability and a commitment to achieve this within a specified time-frame. Whenever the SPO sees a market for its products and it can make reliable forecasts for it – there should be equity investors available. Social business angels, in particular, can match commercial angels for duration of investment, while, in many cases, having much lower return expectations – exactly the form of capital that start-up SPOs need. This discipline may be lacking if funding is raised solely from grants and donations. Indeed there is a danger in relying solely on philanthropy since in practice grants have fixed time duration and are often not renewable.

In the scenario in which the SPO realises there is no market for its products and services, there are two options. Either (2a) the SPO is developing activities that will never become sustainable (think for example of a SPO active in advocacy), or (2b) the SPO is developing a product/service in a market (sector or geography) that is so innovative that market infrastructures are not yet developed. In the latter case, there is a potential for the activities of the SPO to become sustainable, but only if first an investment is made in developing the market infrastructure. However, the VPO/SI needs to make sure the SPO has a very strong plan for financial sustainability to make sure that when the VPO/SI exits the SPO will have access to follow-on funding.

The last option is that (3) there can be a market (either immediately or down the line) for some of the activities and/or for the products/services developed by the SPO but part of its activities will never become self-sustainable. This case implies that the SPO has a **hybrid business** model, which combines marketable products and services with activities for which there is no market and never will be.

2.2. The SPO's organisational structure

From a legal perspective, the range of SPOs' **organisational structures** can range from charities, NGOs without trading revenues to NGOs with trading revenues, as well as from social enterprises and social businesses to socially driven commercial businesses, with diverse organisational forms subject to country-specific legal and cultural norms (as shown in Figure 10 in the *Introduction*).

The SPO's business model has an impact on the organisational structure the SPO will choose. In particular:

1. If the SPO recognises that there is a market available for all its activities, it should adopt an organisational structure that helps it raise social investment in the form of equity and debt instruments;

2a. If the SPO recognises that there is **no** market available for any of its activities, it should adopt an organisational structure that will exclusively rely on grants, such as a charity or NGO;

2b If the SPO recognises that there will be a market available for all its activities down the line, but the market is not developed yet, the SPO should consider a business model that lets it take grant but also potentially take on equity and debt (as in scenario 1);

3. If the SPO recognises that there is a market available for some of its activities, while others will never have a market, it might choose a hybrid structure that fits with its hybrid business model.

Focussing on the last scenario, we see that recently more and more SPOs are not structured as *pure businesses* (i.e. for-profit **or** not-for-profit), but as ***hybrid structures*** (i.e. a combination of a for-profit entity **and** a not-for-profit one). This split enables SPOs to attract both philanthropic capital in the form of grants, and social investments and other investments in the form of debt and equity, to be channelled accordingly into the right entity.

Consequently, SPOs that have a **hybrid structure** require a **combination of multiple actors** that can invest using different financial instruments, and that bring into the investment different ways to assess risks, different financial return expectations and different impact requirements. Despite being more complex, the hybrid structure of many SPOs can be an asset in terms of their capacity to seek funding from diverse sources, such as VPO/SIs, public funds, foundations, impact investing, mainstream finance.

Linked to the SPO's organisational structure, there is its **legal structure,** an element that is also strongly connected to the geography where the SPO is incorporated and to the legal jurisdiction in which it operates. There is wide variation between countries on the legal powers that SPOs have to raise capital, especially if they are incorporated as non-profits. Non-profits cannot issue equity, and in many jurisdictions cannot conduct commercial activity (at least, not without jeopardising their tax exempt status). In some countries, taking on debt is also problematic for SPOs. In Belgium, for example, it can be difficult to constitute a hybrid structure for a SPO because doing so may threaten its tax exempt status, whereas in the UK even non-profits can take on debt without too much legal difficulty. In Germany, some non-profits are not permitted to hold large levels of cash reserves, which can be problematic for taking on longer term financing. All these legal considerations have to be taken into account when setting up the structure of the SPO.

2.3. The SPO's stage in the life cycle

During its life, a SPO goes through **four sequential stages** – which constitute its **life cycle:** (i) pre-seed/seed, (ii) start-up/early stage, (iii) validation, (iv) preparation to scale and scaling.

Depending on their business model, throughout these different phases, SPOs may change their funding needs and develop, in some cases, an appetite for more sophisticated FIs (Figure 21).

For SPOs that develop products and services that have a potential market, this sequence of phases is similar to the one experienced by ventures acting in traditional commercial markets, and funded through Venture Capital and Private Equity, despite the fact that SPOs mainly focus on obtaining a social impact rather than financial returns.

As in venture capital/private equity, also in the VP/SI market, for each stage of development there is a different funding need that grows over time and SPOs can benefit from different type of financial instruments at different stages of development. In particular:

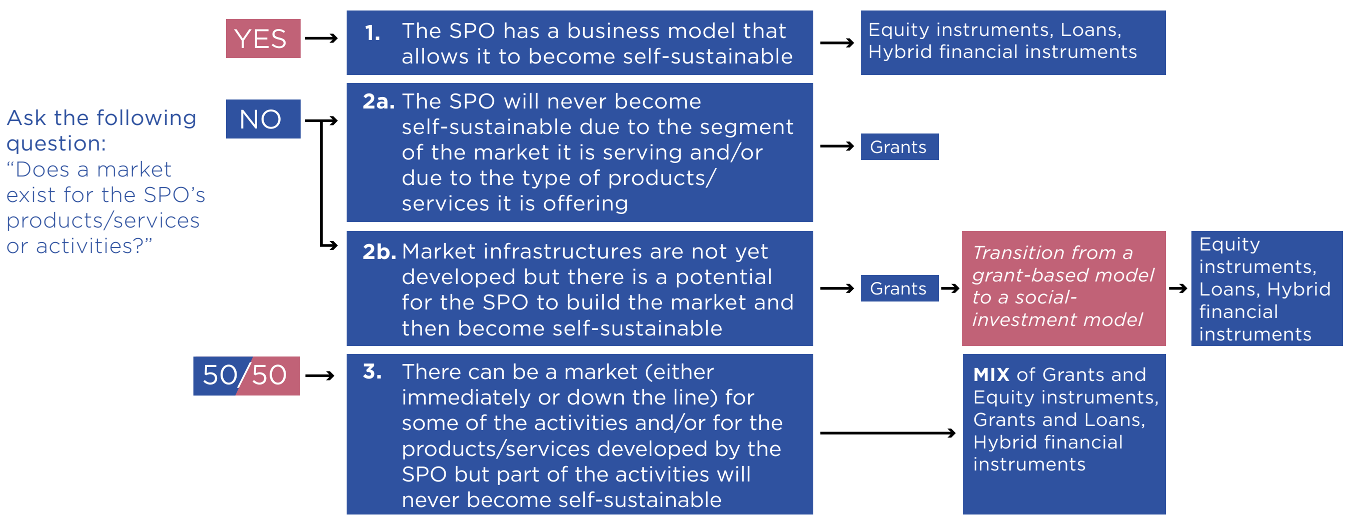
In the (i) **pre-seed** and **seed stage** all SPOs normally struggle to find the capital they need to develop their social entrepreneurial idea. Hence, regardless of their business model, SPOs in this phase typically have to rely on grants.

In the (ii) **start-up/early stage**, SPOs, like any other company, need to support all the costs related to the initial phase of their activity. In case of a SPO with products or services that have a potential market, as the services or products are not yet marketable and since the SPO is not generating any revenues yet, the financial resources normally come from families, friends and philanthropic funders, often in the form of donations/grants.

As argued in 2.1, SPOs offering goods and services that have a potential commercial market would be better off with patient social investment even if in reality they are often relying mostly on grants, and not on equity. However, grants are not always the most suitable form of financing for a SPO in the start-up phase. Since at inception a SPO needs more patient capital, longer time frames and continued support, equity instruments can be adequate sources of capital, just like the situation for a fully market-oriented start-up at the beginning of its activities. However, SPOs face a lack of appropriate patient investment capital, due to the lack of actors active in the social investment space willing to take the risk to invest in early stage SPOs, with relatively low financial return upside.

SPOs that have a potential market down the line, but are active in markets that are under-developed will have to rely on grants funding during this phase.

Figure 21: Path for the SPO – Assess the SPO's financial needs (*Source: EVPA Knowledge Centre*)



In the (iii) **validation phase**, when the SPO's business model starts to be tested and proven, we see a differentiation of paths among SPOs with different business models:

1. In case the **SPO has a market for its products and services** the funding typically starts to change. Families, friends and philanthropic funders' grants and donations are substituted with social investment from VPO/SIs and impact investors that start seeing the opportunity to invest equity into the SPO. As mentioned earlier, in an ideal world SPOs would have access to patient equity capital already in an earlier stage – but in reality equity and debt investors only come in when they see a proven business model. At this stage **grants can be used in a strategic way**, as guarantees or as pure leverage to mobilise other funding such as loans (e.g. from banks) to increase the working capital.

2a. If the **SPO has a business model that will never become self-sustainable**, it will take a charity/NGO status and will need to be financed through grants throughout its existence (eventually with different amounts, depending on the decision or not to scale). Here we are thinking of SPOs that are, for example, active in advocacy, and that are the primary target for our members that do highly-engaged grant-making and for the public sector in the phase of scaling.

2b. If market infrastructures are not yet developed but there is a potential for the SPO to build the market and then become self-sustainable, we argue that the VP/SI organisation will need to provide first grants, and then social investment (in the form of patient equity, loans and hybrid financial instruments). This is one of those cases in which the SPO will need to change its organisational structure while it evolves, moving from a grant-based model to a social-investment model.

3. If there can be a market (either immediately or down the line) for some of the activities and/or for the products/services developed by the SPO but part of the activities will never become self-sustainable, the SPO will take a hybrid structure and will need to have access to a mix of grants and social finance, provided often by different actors. In *Chapter 3,* we will present two cases about financing SPOs with a hybrid structure.

In the (iv) **preparation to scale and scaling** phase, the funding needs of SPOs – which either (1) develop products and services that have a market, or (2a) develop products and services that will never have a market – do not change in type, but only eventually in size.

SPOs that (2b) have products or services that did not have a market until proven will need to reassess their business model. If the market has not yet been created, the SPO will need to reassess its business model and, if necessary, continue to be funded through grants. In case the market now exists, the SPO can access social investment. If the products and services of the SPO have a market, the SPO can attract FIs such as convertible loans or other forms of equity. At this stage grants can be substituted by recoverable grants. The capital raised during the preparation to scale is used to professionalise the SPO's processes and functions. It is at this point that, usually, this type of SPOs completes the transition from a grant-based model to a social-investment model, since they need to be prepared to also raise capital in a different form compared to traditional charitable funding, and they need to be able to repay, and hence **be profitable or cash flow positive**. Hybrid financial instruments can be extremely helpful in this evolution, since these FIs combine features of financial instruments such as debt and equity, with features of grants and donations. Often, by the end of this phase, the SPO transitions completely from a grant-based model to a social-investment model represented in a large majority by equity.

It is important to note that for all SPOs – regardless of their business model – in this phase, there is a substantial difference from venture capital/private equity because SPOs face a very different challenge compared to commercial ventures. For SPOs scaling means not necessarily continuing to grow (nor for the investor helping the investee in growing further its size), but instead **scaling the social impact they generate**. Indeed, in the VP/SI sector, scaling might even involve keeping the same size for the investee as scaling will take a different form such as, for examples, crafting a new public policy, creating codified practices that can be replicated by other SPOs, creating an open platform, or lowering the costs through franchising activities and replication models.

So, in the VP/SI space, it is important for a SPO not to concentrate on the growth in terms of its size (Gugelev and Stern, 2015) but, instead, on scaling the social impact it is generating and/or on the potential impact that its example can help to achieve. **Focusing on scaling the social impact – instead of the size of the SPO – may affect the motivation of the investor and the type of financial support that it is willing to provide the investee with in order to help it to scale the social impact**. Thus philanthropic capital might come alongside the social investment even in this phase for SPOs with products and services that have a commercial market, if the SPO needs to start over in a new location, serving new groups of beneficiaries. A proven impact model, which is ready to scale into other geographic regions would be hugely interesting to a philanthropic funder, particularly if it only has to fund the scaling part and the model itself will be able to break-even and become self-sustainable (as it has been proven by the SPO). Another example is for a SPO, which has grown and is break-even, that now wishes to expand its social impact through scaling (in a non-revenue generating way such as open sourcing) and might want to go back to philanthropy for that particular piece.

It is also important to flag at this point that the sequence of phases is not necessarily always linear: it can be the case that a SPO with a very volatile structure is able to reach break-even during the first year of activity, being able to attract capital that foresees a re-payment of capital or the generation of a financial return (e.g. debt and equity). Then, in the following year, due to its volatile structure the SPO might not be able to achieve the same result, and would thus need to go back to philanthropic capital as a source of funding.

NESsT[16] is a financial intermediary investing in SPOs and providing them with capacity building. In its experience, we see a development in their approach over 20 years of activity. They operate in Central Eastern Europe (CEE) and Latin America (LA), considered still emerging markets where there are not many patient capital investors and there is not a sizeable pipeline of investibles. In its first decade of activity, NESsT supported investees in the **blueprint phase** (i.e. social entrepreneurs having an innovative idea) and in the early **start-up phase**, helping them develop and test their business model, using an engaged investor approach. Currently, NESsT focuses on investees in their **validation and prepare to scale phases**, in two impact areas: dignified jobs and sustainable income for marginalised groups. It provides them with larger amounts of money, in the appropriate form and structure, and capacity building to multiply the social impact generated. This evolution in the targeted SPOs and in the overall ecosystem and NESsT's achievements and learnings to date, had an important effect/influence on the strategy implemented and the financial instruments used. In fact, at the beginning NESsT primarily deployed grants, because this FI perfectly responded to the targeted SPOs' needs at that time (mostly start-ups, not breaking even, non-profits that needed philanthropic capital to launch their businesses). With time, as the sector has evolved and many more accelerators and incubators focusing on this phase emerged, NESsT has moved to work with social enterprises that are more advanced, have increasing sales and are creating impact, but are still not scaling. This is the **missing middle**, experience in the validation and prepare to scale stages, where other instruments are needed, albeit still with philanthropic support. In these stages, NESsT offers more flexibility and opportunities **to tailor the FIs to the needs of its investees**, deploying also recoverable grants, patient loans, guarantees and (potentially) equity.

16 For more info: http://www.nesst.org/. For more info about NESsT, read their complete case featured in OECD/EU, (2017), "*Boosting Social Enterprise Development: Good Practice Compendium*", OECD Publishing, Paris, pages 235–244.

2.4. The macro-environment

As mentioned in the previous paragraph, SPOs have to take decisions regarding their **business model,** depending on the stage of development of the market itself.

While asking itself if a market exists, the SPO should look at the **macro-environment** which is composed of two elements: geography and sector.

There are **geographies** where the venture philanthropy and social investment ecosystem is developed thanks to, for example, the presence of social business angels, incubators, VP/SI funds, social investment intermediaries and other market service providers. Therefore, for SPOs active in these markets, it is easier to have access to a wider spectrum of FIs, and learn how to use them, which implies that these markets are attractive for SPOs with a potentially sustainable business model. Conversely, in geographies where the social investment infrastructure is not developed, SPOs struggle to find appropriate financial instruments, to effectively run their activities. In particular, a lack of social business angels funding seed and early stage SPOs can be a bottleneck preventing SPOs from surviving the early years and making the leap to the growth stage.

In terms of **sectors,** some industries are more appealing – also across geographies – because they are growing, so the financial returns can be potentially higher (e.g. in many African countries, notably Kenya for example, this has been the case of digital and mobile enabled platforms such as M-PESA which have achieved substantial scale and funding).

Consequently, SPOs active in these sectors can easily attract social investment, whereas investees operating in sectors that offer low return expectations and/or no exit options for equity investors, patient loans and grants may be the only financing option.

Additionally, a sector can have different levels of maturity depending on geographies and this can have an implication on the financial instrument needed by the SPO and then chosen by the VPO/SI. For example, in immature markets where SPOs find it difficult to access follow-on funding, the VP/SI organisation needs to design its financial (and non-financial) support in a way that moves the SPO towards financial sustainability.

2.5. The SPO's stakeholders

SPO's stakeholders are an external factor to be considered in case of **transition of the SPO's business model** from a grant-based model into a social-investment model or a hybrid model. We have identified the following ones, which are particularly relevant during a transition: the SPO's board, the management team, the staff, the existing funders and available funders.

While making the aforementioned transition, the SPO usually goes through a major cultural shift. The SPO's **board** and the **management** team need to have the appropriate risk appetite to lead this change. They need to be willing to go through this transition from a philanthropic-funded model to a social-investment model, in which, in case of equity, they will have to give up part of their ownership and to share some control. For the VPO/SI, it is important to perform a thorough due diligence on the SPO's board and management team in order to understand the potential risk aversion of these stakeholders and to see if the organisation is ready and able to receive other forms of funding. At the same time, it is necessary to analyse if the SPO's **existing funders** are fine with this switch from philanthropy to social investment, by evaluating if they have the culture needed to accommodate this change and if they are comfortable with the SPO taking on certain other forms of investment. Additionally, as described for the board and the management of the SPO, if the existing funders are, for instance, risk averse, in the future the SPO might be limited in taking on FIs linked to a higher risk, or there is a risk that existing donors may pull away at a time when the SPO needs to continue relying on some donations as it makes the transition.

In reality, there are often cultural barriers and a lack of understanding from existing donors towards the cooperation with other investors that have different risk/return/impact profiles. Just consider the two – legitimate – concerns that existing grant-giving donors could raise concerning the possibility for social investors to earn money building on their grants, and the risk for the SPO of dilution of its impact when going through the transition period. Given that, sometimes, even if the impact achievable could be much greater, existing funders might not support any transition for the SPO.

2.6. Tools available to help investees to better understand their needs

In this section we propose two tools that can help SPOs better understand their financial needs.

Social Investment Toolkit

For example, the "Social Investment Toolkit" is a set of online tools (Figure 23) produced by Mark Cheng, the Europe Director of **Ashoka**, based on his experience of guiding social entrepreneurs through the process of raising social investment. The Social Investment Toolkit comes with a Self-Assessment and it is written from a SPO's perspective and contains tools such as a template Financial Model which social entrepreneurs can use to model both their cash flows and their potential social impact, or Sample Term Sheets for the kind of hybrid FIs which social entrepreneurs may wish to use (Figure 22).

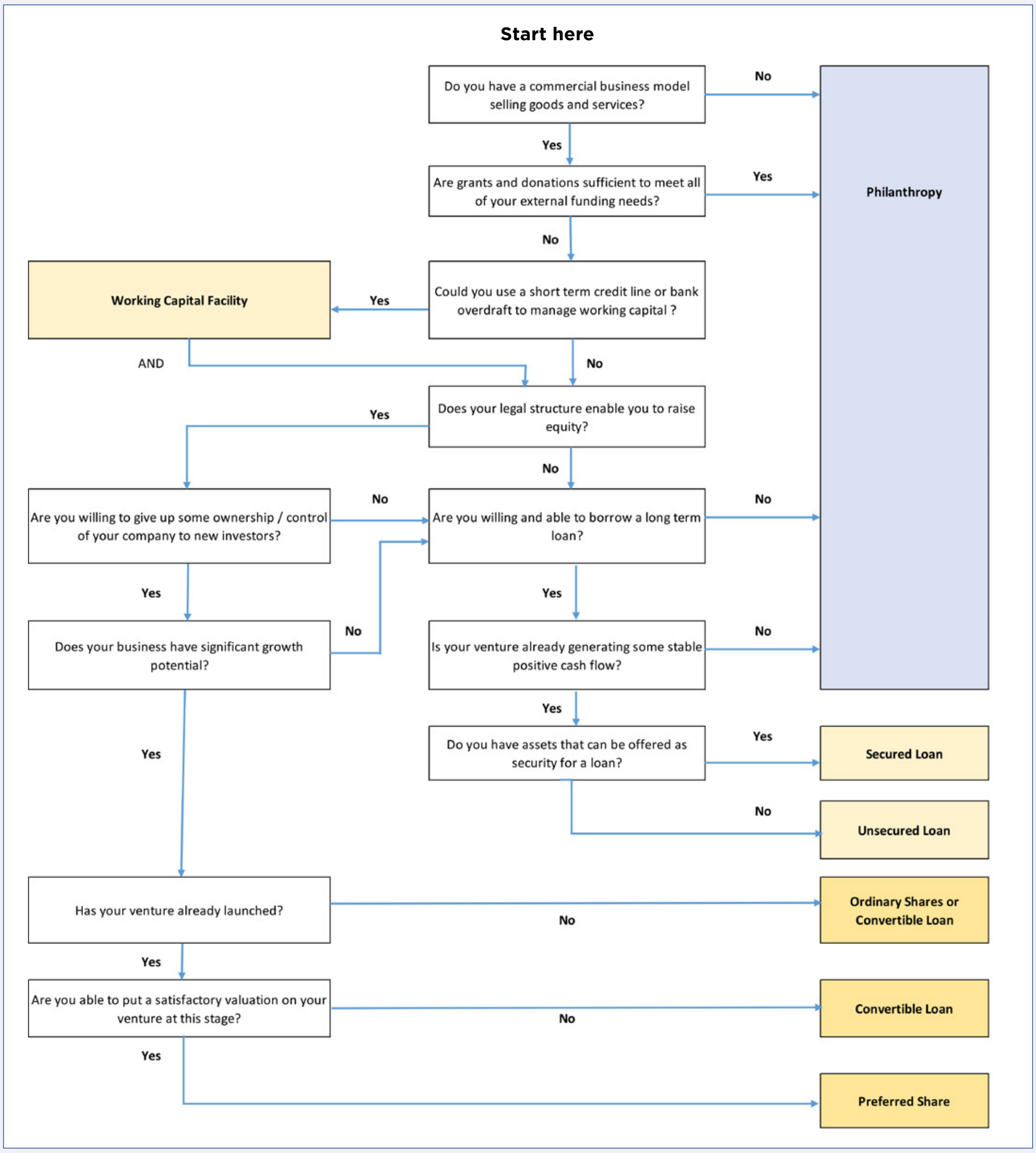


Figure 22: Social Investment Toolkit, Module 7: "Choosing a Financing Option" *(Source: M. Cheng, 2017)*[17]

17 Find out here www.socialinvestmenttoolkit.com how the Social Investment Toolkit is structured.

Figure 23: Overview of the 8 modules of the Social Investment Toolkit (*Source: M. Cheng, 2017*)

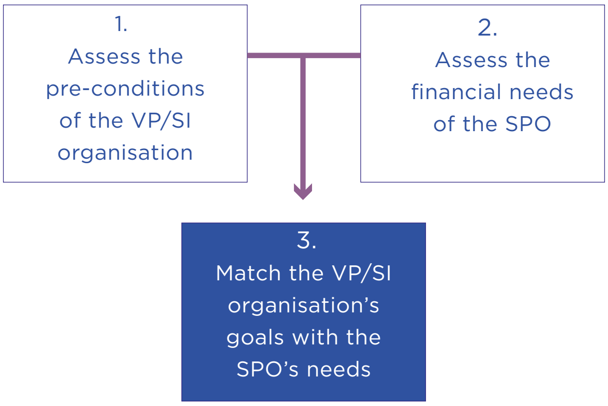
"Tools for Success" – a Social Investment guide for social purpose organisations

This tool has been conceived by the Centre for Charity Effectiveness at Cass Business School and funded by City Bridge Trust. "Tools for Success" can be used by SPOs wishing to invest in their long-term sustainability. It consists in a Social Investment guide aimed at helping SPOs to understand social investment and how they can use it in their funding mix. It also includes a diagnostic tool that SPOs can use to think about social investment. The package is divided into twelve guides[18]: Introduction, Self-assessment, Compliance, Governance, Direction, Finance, People, Operations, Connect, Step change, Impact assessment and Social investment.

18 To have an overview of all that is included in the twelve guides and to download them: http://www.cass.city.ac.uk/faculty-and-research/centres/cce/knowledge-sharing/tools-for-success

3. MATCH THE VP/SI ORGANISATION'S GOALS WITH THE SOCIAL PURPOSE ORGANISATION'S NEEDS

Figure 24: The third step of tailored financing
(*Source: EVPA Knowledge Centre*)



In this chapter we look at how VPO/SIs use different financial instruments to support SPOs with different business models and organisational structures at different stages of their development, by matching their goals with the SPOs' needs.

We also briefly discuss each financial instrument (grant, debt, equity and hybrid instruments). However, this is not a technical report, so we do not go into the details, but just provide definitions and pros/cons of each instrument.

The last part of this chapter briefly discusses the role of social investment intermediaries in supporting the matching between the VP/SI organisation's interests and the SPO's needs.

3.1. Matching

In the third step the VPO/SI matches its impact strategy with the financial needs of the SPO. As already pointed out in *Chapter 1*, since a complete mapping of the impact strategies of the VPO/SI does not yet exist, for the purpose of this report we consider three main groups of strategies:

a. The VPO/SI only aims to achieve a social impact, with no financial returns;
b. The VPO/SI wants to achieve primarily a social impact – but accepts a financial return;
c. The VPO/SI wants both to achieve a social impact and to obtain financial returns.

Combining these three broad impact strategies with the four business models outlined in *Chapter 2,* it is possible to identify which VPO/SI is most suited to support a specific SPO for each deal and which financial instrument(s) is/are the most appropriate.

Table 1. Matching the expectations of the VPO/SI with the financial needs of the SPO[19] (*Source: EVPA Knowledge Centre*)

	No market			**Market**
SPO's business model / VPO/SI's impact/financial return expectations	2a. There is no market for the products and services of the SPO	2b. There will be a market for the products and services of the SPO	3. There can be a market for some of the products/services of the SPO but part of the activities will never become self-sustainable	1. There is a market for the products and services of the SPO
A. Only social impact	Grants	Grants (seed/market building)	Grants (for the non-profit part)	Grants (seed)
B. Social impact primarily, financial return accepted		• Grants (seed/market building) • Hybrid financial instruments • Social Investment (validation and scaling)	• Grants (for the non-profit part) • Social investment (for the income-generating part)	• Grants and social investment • Hybrid financial instruments
C. Social impact and financial return on the same level		• Hybrid financial instruments • Social investment (scaling)	Social investment (for the income-generating part)	• Hybrid financial instruments • Social investment (scaling)

Table 1 summarises the options that, in a perfect market, are the most advisable to choose to support each category of SPO. For example, SPOs that offer products and services that will never have a market should be supported by VP/SI organisations that seek exclusively to generate a social impact. On the other hand, VP/SI organisations that want to generate a social impact but also look for a financial return should finance SPOs that are or will be able to generate returns through their business model.

This table has two limitations. First, as mentioned, it does not take into consideration the full spectrum of impact strategies of VPO/SIs, but only three broad groups based on the investors' motivations.

Second, it does not take into consideration the risk that the VPO/SI is willing to take, and the risk that each investment will bring. One main reason for not factoring in the risk in this table is that it will depend on a number of factors (i.e. the sector and geography of each investment, the legal constraints, etc.) which will need to be evaluated on a deal-by-deal basis. A more complete assessment of the VP/SI organisations' impact strategies, also factoring in the risk considerations, will need to be developed.

Looking specifically at those SPOs that have a hybrid business model, an innovative way to address the issue of access to finance, from the point of view of the SPO itself, is to set up a **hybrid structure:** a combination of **a for-profit entity and a not-for-profit one.** By creating these two separate entities, the SPO can attract grants through its non-profit part and social investment through its for-profit part. For the SPO, the advantage of such hybrid structures is to channel in a more effective way the resources available, directing the right form of capital into the most appropriate entity.

The two cases below illustrate this innovative way conceived by SPOs to be able to attract more resources from different actors.

19 Please note that with "social investment" in the table we mean both debt and equity instruments.

Fair Finance[20] (FF) is a microfinance lender operating in the UK, specifically in London, where more than four million people do not have access to finance and many do not even have a bank account.[21] FF supports financially-excluded communities through affordable credit, lending small personal loans (£ 500 average size) for up to 18 months on average. They also help their clients re-schedule debts and re-build a credit score, so that they can eventually access mainstream finance. FF also often helps their clients set up a bank account[22] for the first time and negotiate with their creditors.

FF operated through a **combined model** with a business (making personal and business loans to appropriately vetted customers) and a charity (giving debt advice for free). But this combined model was costly. Prior to raising social investment, FF was not operating at a profitable scale and generated overall negative financial returns, even though the lending activities were profitable by themselves. Additionally, funds from philanthropy alone were insufficient to enable FF to reach break-even, as they needed a 5x increase in size to become financially sustainable.

FF resolved this challenge by developing a **hybrid model**, **splitting itself into 3 entities**, all under the FF brand: a **personal loans** business (for-profit), a **business loans** unit (for-profit), and a **debt advice charity** that continued to raise donations (Figure 25). By doing this, FF was able to direct all of its philanthropic fundraising towards its charity which provided free advice to over-indebted clients. Meanwhile the business units were able to raise social investment in the form of a flexible 7 year loan from social business angels. This helped leverage a further £ 5m credit line from commercial banks, enabling FF to reach the scale it needed on its lending activities to be fully financially sustainable.

Figure 25: The hybrid model of Fair Finance (*Source: Fair Finance's Annual Report 2017*)[23]

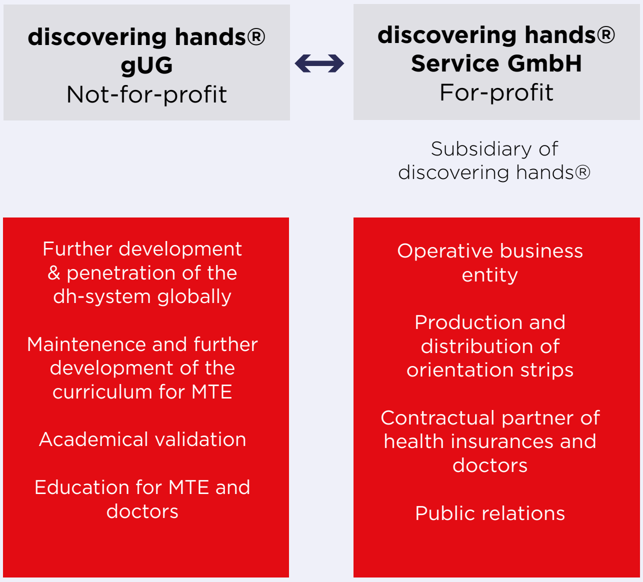
fair FINANCE		
fair PERSONAL LOANS	fair BUSINESS LOANS	fair MONEY ADVICE
FPL PROVIDES AFFORDABLE PERSONAL LOANS TO INDIVIDUALS WHO DON'T HAVE ANY OR HAVE ONLY LIMITED ACCESS TO MAINSTREAM FINANCE.	FBL HAS DESIGNED A FUNDING PRODUCT AND SERVICE FOR SMALL AND MICRO-BUSINESS OWNERS / THE SELF EMPLOYED TO RESPONSIBLY SUPPORT FINANCIALLY EXCLUDED BUSINESSES.	FMA IS A REGISTERED CHARITY PROVIDING DEBT ADVICE AND FINANCIAL CAPABILITY SERVICES, HELPING INDIVIDUALS REGAIN CONTROL OF THEIR MONEY.

20 For more info: https://www.fairfinance.org.uk/about-us/history/
21 The only solution for those millions of financially-excluded people was the recourse to "loan sharks" who would have charged interest rates of about 3000%.
22 The only way to receive State benefits.
23 For more info: https://www.fairfinance.org.uk/wp-content/uploads/2017/07/Fair-Finance-Annual-Report-2017-low-res.pdf

Discovering Hands[24] (DH) aims at solving a dual social problem: the increase of breast cancer rates[25] and the high unemployment rate among blind women.[26] The solution developed by DH was a method of **superior early breast cancer detection through visually impaired women (Medical Tactile Examiners**, MTEs).[27] The business model of DH is: direct fee generation in Germany and social franchise fees abroad. DH currently builds on **two different revenue streams** (Figure 26): (1) a fee per examination generated by selling patented orientation stripes (a consumable used by the MTE) to physicians in the core market and (2) revenues from franchises in other countries (one-off payments and on-going revenue share). The examinations itself are paid either by insurance companies or by patients out-of-pocket. DH is **split into two separate entities**: one non-profit and one for-profit. Due to its hybrid nature, DH manages to keep on having an initial grant, plus **on-going support through grants** to finance the non-profit arm. To support the for-profit entity, which has the potential to grow, in 2013, **FASE**[28] raised, together with BonVenture and KfW, a mezzanine facility (€ 500k) and in 2016, it leveraged and raised € 800k to be invested in **mezzanine (quasi-equity)** with business angels and foundations.

© Discovering Hands

Figure 26: The hybrid nature of Discovering Hands' business model (*Source: FASE*)[29]



24 Frank Hoffmann, the funder of Discovering Hands, is an Ashoka fellow and Discovery Hands is one of the first transactions of FASE. For more info: http://www.discovering-hands.de/en/

25 More than 1.5 million women worldwide are diagnosed with breast cancer annually, with death rates at more than 500,000 women per year.

26 Around 80% of visually impaired women are unemployed and/or extremely poor. Although often highly qualified, their potential due to hypersensitive skills is completely left untouched.

27 DH trains and deploys visually impaired women to use their proven superior sense of touch to detect breast cancer and in certifying them as MTEs. Preliminary qualitative results show that MTEs detect about 30% more and approximately 50% smaller tissue alterations in the breast than doctors do.

28 For more info: http://fa-se.de/en/

29 For more info: http://fa-se.de/wp-content/uploads/2015/11/141006_Case_Study_Discovering_Hands_English.pdf. To access more case studies produced by FASE about their hybrid investments: http://fa-se.de/en/case-studies/

3.2. Main financial instruments – Pros and Cons[30]

Financial instruments are *contracts involving monetary transfers* through which, in the VP/SI space, venture philanthropy organisations and social investors financially support social purpose organisations.

The three main groups of financial instruments are **grants**, **debt instruments** and **equity instruments**.[31]

3.2.1. Grants

***Grants* are a type of funding in the form of a cash allocation that establishes neither rights to repayments nor any other financial returns or any form of ownership rights on the donor.**

When is it suitable to use grants?
A share of social investors and, more in general, of the practitioners active in the impact investing sector, do not consider grants as financial instruments, but as a way to disburse funds, thus not pertaining to the space. However, grants are fundamental for the VP/SI sector, for a number of reasons:

- Grants are fundamental to **creating a market or a public good** that no private investor would support at any point in time and that has no business model.
- Grants help build **proof of concept in the seed stage.** Grants create a potentially commercial solution that no commercial or public body would risk so much on at that stage. Thus grants can be used to finance a start-up that potentially has a market for its product or service, but which is in such an early stage of development (most often the seed stage) that it is too risky for other types of funding.

However, it is important to remember that **providing grants to for-profit companies might disrupt markets** – so it should be avoided.

Pros and Cons of using grants
From the point of view of the **VP/SI organisation,** grants have the advantage of giving the freedom to determine the use of funds, so that the VP/SI organisation can determine that a certain amount of money will be used for a specific project, or be invested in specific activities, such as strengthening the management team or the financial systems. However, grants have the potential to create a situation of dependency of the SPO, if not provided with adequate non-financial support to strengthen the financial sustainability and organisational resilience. Grants give SPOs little incentives to maximise efficiency of funds, scale operations, and reach sustainability. Additionally, grants do not provide a financial return, which means that in the case the SPO starts to generating revenues, the VPO/SI – that made the first-loss investment – will not be able to recover any of it.

From the point of view of the **SPO**, grants have the advantage of being free money that comes with no strings attached. This implies that the donor has no influence on the overall organisation except that on how the specific fund is used. However, if the grant is given to cover the costs associated with a specific project, the SPO might end up in a situation of unbalance, with a certain part of its activities receiving more funding than others.

In general it is important to consider that ensuring sustainable growth of impact through grants is difficult, as SPOs might become dependent. Grants are less efficient at incentivising capital efficiency and driving organisational growth. When deploying grants, it is better to focus on fewer organisations and provide deeper support, as prescribed by the VP approach.

30 This paragraph is based on the presentation "Structuring deals to maximise impact" by Fabio Segura, head of International Programs at Jacobs Foundation, during the EVPA Fundamental Course on Venture Philanthropy and Impact Investing, Barcelona, 14th September 2017.

31 For an overview of the FIs available to social enterprises: **fi-compass,** (2016), "*Financial instruments working with social entrepreneurship*", European Commission and European Investment Bank. Available here: https://www.fi-compass.eu/sites/default/files/publications/Factsheet_Financial_instruments_working_with_social_entrepreneurship.pdf

3.2.2 Debt instruments

***Debt instruments* are loans that the VP/SI organisation can provide to the SPO, charging interest at a certain rate. The interest charged can vary depending on the risk profile of the investee and on the securitisation and repayment priority of the loan (senior vs subordinated loan).**

When is it suitable to use debt instruments?
Debt instruments are considered when the VP/SI organisation is looking at a **fixed term** (which can be either short or long) and **fixed return** (the interest rate). Risk on the debt can be reduced by working with SPOs that are cash flow positive and/or have predictable revenue streams and can lower the risk on the investment by securing the debt against some form of collateral.

Pros and Cons of using debt instruments
From the point of view of the **VP/SI organisation,** debt instruments are "safer" than equity, as they provide a predictable return, with a clear time horizon for the exit. When secured[32], debt instruments provide the VPO/SI with limited exposure, and – in case the amount is significant – the VPO/SI can provide the SPOs with loans that have specific terms and conditions. However, debt instruments do not allow the VPO/SI to have any control over the decisions of the SPO. Additionally, SPOs in the very early stage of development might not have any collateral to offer, which implies that the exposure of the VPO/SI might end up being the same as if it was investing equity.

From the point of view of the **SPO,** debt instruments allow not to give a share of profit or even of the company to the VP/SI organisation. Debt instruments have a predictable financial behaviour which depends on the amortisation plan and, differently from equity, are not repayable on-demand. However, loans are not very flexible and thus might not fit the cash-flow needs of the SPO. In case of default on payments, the SPO might lose its collaterals, which might imply going out of business. Last, lenders might require demanding terms and conditions for larger loans, which would be difficult to fulfil.

If revenues and cash flows are irregular or subject to shocks (because of weather, seasonality, or because a high amount of revenues comes from clients that pay irregularly), then the SPO should be careful about not taking too much debt since this involves fixed and regular repayments. In case debt is the only form of financing available, the SPO should try to obtain very flexible debt terms.

3.2.3 Equity instruments

***Equity instruments* are contracts through which a VP/SI organisation provides funding to SPOs and in return acquires ownership rights on part of the SPO's business. This can be appropriate when the prospect of a loan repayment is low or non-existent. If the SPO is successful, the equity share holds the possibility of a financial return in the form of dividend payments. In addition, it allows for the possibility of a transfer of ownership to other funders in the future.**

When is it suitable to use equity instruments?
Equity instruments should be considered when there is, or is likely to be, a **market available** for the SPOs products/services so that strong growth can be expected and a potential exit is available and the SPO assumes a for-profit legal form that can pay dividends and sell equity. However the return on investment may take place over a **very long time period** and may require significant amounts of other sources of (grant) capital to achieve it.

Pros and Cons of using equity instruments
From the point of view of the **VP/SI organisation,** equity instruments are interesting because they guarantee a participation in the financial upside of the

32 Secured debt is debt backed or secured by collateral to reduce the risk associated with lending, such as a mortgage. If the borrower defaults on repayment, the bank seizes the house, sells it and uses the proceeds to pay back the debt. Assets backing debt or a debt instrument are considered security, which is why unsecured debt is considered a riskier investment. (Source: http://www.investopedia.com/terms/s/secureddebt.asp#ixzz4tVkkOLFY).

business. Thus, if a SPO starts making a profit after the business model has been validated, the VPO/SI will be able to participate in the profit-sharing. Additionally, through equity the VPO/SI can gain control over the strategic direction of the business, thus being able to steer the use of resources in a specific direction. However, equity instruments imply having to share risks and liabilities with the SPO, also implying that the ability of the VPO/SI to exit will be subject to the company's performance. In case of bankruptcy, the providers of equity are the last ones to be repaid, after the employees and the providers of debt. Differently from other instruments, equity is more complex, so more work will be needed to structure and manage the investment throughout the investment process.

From the point of view of the **SPO,** equity instruments are interesting because they come with no need to pay back the investor in case of bankruptcy. Additionally, in VP/SI equity is more patient than in venture capital/private equity, so the cash out will be paced by the performance of the business. However, the reverse of the coin is that the SPO will need to share the financial upside with the VP/SI organisation. VPO/SIs bring business and industry know-how and networks. However, they demand control over the strategic direction of the business, so the SPO will have to accept losing its complete independence.

3.3. Hybrid financial instruments

In addition to grants, debt and equity, a VP/SI organisation can use **hybrid financial instruments** (HFIs) to support its investees.

> ***Hybrid financial instruments*** **(HFIs) are monetary contracts that combine features of the traditional FIs (grants, debt instruments and equity instruments) in order to achieve the best possible alignment of risk and impact/financial return for particular investments.**

HFIs are financial instruments seeking to reconcile some of the basic tensions between the financial requirements of the investors and the impact motivation of the social entrepreneurs (Varga and Hayday, 2016). HFIs are well suited for the funding of SPOs that are developing products and services for which there is potentially a market (Spiess-Knafl and Struewer, 2015) to respond to their diverse financing needs (Damaschin-Țecu and Etchart, 2016). Even though hybrid financial instruments can be very useful to better finance SPOs, not all VP/SI organisations may be aware of the possibility to also use them, and may not know how to structure and deploy them. It could also be that it is complex and hence it risks being lengthy to implement, also because it requires financially literate businesses to invest in, so that they understand the mechanism. Or VP/SI organisations might simply not be aware of the term "hybrid financial instruments" and what it entails, demonstrating that HFIs are still not easily understood and used, both by VPO/SI and their investees (Varga and Hayday, 2016).

Some examples of hybrid financial instruments are mezzanines, convertible loans/debts, and recoverable grants.

3.3.1. Mezzanine finance (also known as quasi-equity)

> ***Mezzanine finance*** **is a hybrid of debt and equity financing, usually used to fund the scaling of an organisation. Although it is similar to debt capital, it is normally treated like equity on the organisation's balance sheet. Mezzanine finance involves the provision of a high-risk loan, repayment of which depends on the financial success of the SPO. This hybrid financial instrument bridges the gap between debt and equity/grant through some form of revenue participation. Examples include a loan that is only repayable through royalties based on the future sales of a product or service; or a royalty-sharing agreement that can be activated once an agreed profitability threshold has been reached. These hybrid financial instruments can offer an appropriate balance of risk and return (Balbo et al., 2016).**

3.3.2. Convertible loans and convertible debts

> ***Convertible loans*** **and** ***convertible debts*** **are "*two different circumstances in which the loan may be converted into equity.*" In both cases we are looking at "*a loan that has to be repaid. However, in one circumstance, because the lender***

is willing to vary the loan terms in the borrower's favour, the borrower gives the lender rights to exchange its creditor position for an ownership in the enterprise at a later date. In another, more challenging circumstance, a loan is converted into equity either because the borrower's regulator requires the intermediary to bolster its capital or upon the occurrence of a future funding round. It is particularly useful where the enterprise is so young that a valuation is not possible and an equity price cannot be set" (Varga and Hayday, 2016).

Pros and Cons of using convertible debts

From the point of view of the **VP/SI organisation,** convertible financial instruments offer the combination of limited exposure and the possibility to exit independently from the SPO's performance with the opportunity to participate in the upside of the business. However, this freedom comes at a price: convertible debts are expensive to structure and to manage, so an intensive amount of work is required at all stages of the investment process. If not enough attention is paid when structuring these hybrid financial instruments, the VPO/SI may face undesired outcomes, such as automatic or mandatory conversion, high valuations, etc.

From the point of view of the **SPO**, convertible instruments are less advantageous. However, they bring in investors who are likely to bring business and industry knowhow and networks. In some cases, the SPO might be able to convert instruments at its convenience. Additionally, the debt portion is likely to fit the cash-flow needs of the SPO (although it's not guaranteed). However, convertible debts come at the price that once converted, the SPO will need to share profits and control with the VPO/SI, as in traditional equity.

3.3.3. Recoverable grants

***Recoverable grants* are grants that can be returned to the VPO/SI, under certain terms and conditions agreed in advance by the VPO/SI and the SPO. Recoverable grants are "*designed to focus the recipient on sustainability and reduced risk of grant dependence*". (Varga and Hayday, 2016).**

Note that some VP/SI organisations do use recoverable grants from time to time. This may involve the return of all or part of a grant, contingent upon an agreed event. For example, a grant might be given to enable fundraising but if the fundraising is successful or exceeds agreed levels, a portion of the grant may be returned.

Inka Moss[33] is a Peruvian social enterprise that collects and processes sphagnum moss known for its hydrating and filtration qualities.[34] The company trains small farmers to collect the moss from their lands in a sustainable manner, and then buys it from them for a fair price. It also provides the suppliers with technology, materials and tools needed to collect and transport the moss, as well as infrastructure development in their communities.[35] In 2014, **NESsT**[36] invited Inka Moss into its portfolio investing in the enterprise with both financial and non-financial support[37]. At that point, **Inka Moss needed to prototype and test new technologies**

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Inka © NESsT

33 For more info: http://inkamoss.com/
34 Sphagnum moss is a natural product that is highly demanded by international orchid growers.
35 Social challenge tackled by Inka Moss: few opportunities for employment and reliable income in the Andean Highlands, where villages are small and remote, and farmers are poor.
36 For more info: http://www.nesst.org/
37 The non-financial support includes business services and mentoring provided by NESsT from 2014 to 2017 valued at $ 32,000.

to improve its collection processes and validate its business model. NESsT supported the **development and validation** of the technologies (*Phase I*) through a **grant**.[38] As the investment was successful, Inka Moss needed further financing support to implement an **expansion plan** (Phase II). A first **tailored hybrid financing package** was strategically structured using different FIs. The enterprise was in a position to take on debt but also needed philanthropic capital to strengthen and grow its business and ensure its social and environmental impact. NESsT invested with a low interest **loan**[39] for infrastructure and equipment needed to expand production capacity; a **recoverable grant**[40] to grow sales in new markets (i.e. the US and Asia); and provided a **grant**[41] directly to the communities to support the production process. In 2017, once revenues increased and projections were met, Inka Moss decided to expand by working with new communities. NESsT started to partner with **co-investors** (*Phase III*), **leveraging additional funding** in the form of a loan for further production capacity expansion and a grant to develop land management plans.[42]

3.4. The role of social investment intermediaries in matching VP/SI organisations' goals and SPOs' needs

In the VP/SI space, a fundamental role in matching VP/SI organisations' goals and SPOs' needs is played by social investment intermediaries.

These organisations are referred to with different terms – intermediaries, facilitators or advisors – and some of them are context specific. Entities like Social Finance in the UK, Social Investment Lab in Portugal, FASE in Germany, Impact Investing Australia or SITAWI in Brazil are some examples.

Social investment intermediaries aim at increasing the pool of financial resources available for SPOs to reach and scale their social impact by bridging the demand and the supply side of capital, channelling funds towards SPOs in a more efficient way and bringing more resources into the VP/SI space.

Social investment intermediaries share some common characteristics:

- **Multi-stakeholder approach:** they partner with different stakeholders from different sectors, such as governments, VP/SI organisations, SPOs.
- **Range of activities and services:** they often start operating on an ad-hoc basis, being multifaceted and not much specialised. Then, over time, they focus on specific streams: market building (e.g. contributing to building National Advisory Boards on Impact Investing[43]), capacity building for SPOs, advocacy and advisory to the public sector in the way they commission social outcomes. Thus, they are engaged in the creation of an efficient and healthy ecosystem and usually seek to act where no one is or where returns are difficult to get.
- **Focus on additionality:** they are usually flexible to accommodate their services to the market needs at a given point in time. They aim at solving issues that have not been solved by the market yet thus addressing existing gap and neglected problems.

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38 $ 8,000 grant to prototype and test solar moss drying, and processing press technology.
39 NESsT provided a loan through its KIVA credit line for $ 50,000 (4%, 3 years, 1 year grace period). For more info about KIVA: https://www.kiva.org/
40 $ 45,000 provided by NESsT as a recoverable grant, to be repaid, after a two years grace period, over five years,
41 $ 27,500 grant directly invested in the communities for tools, ropes and mules.
42 NESsT leveraged a grant of $ 190,000 from Genesis Investment Management, which was foreseen and turned out to have a catalytic function (for more info about Genesis: https://www.giml.co.uk/). Additionally, NESsT leveraged a loan of $ 59,000 provided by Peru Opportunity Fund (for more info about this fund: http://www.peruopportunity.org/)
43 National Advisory Boards are made up of individuals representing the financial and social sector which have played an important role in the development of the social impact investment market in their country. For example, the UK National Advisory Board to the Social Impact Investment Taskforce was convened in June 2013. Its membership is made up of individuals representing the financial and social sectors in the UK all of whom have played an important role in the development of the social impact investment market in the UK.

We can summarise the relevance of the activities of these entities in:

- Contributing to the general understanding of VP/SI: they disseminate good practices and try to adapt them to their local content.
- Articulating the efforts of all actors within their national context.
- Triggering a broad national strategy for promoting VP/SI in their countries (e.g. creation of National Advisory Boards on Impact Investing, building the national agendas for their national VP/SI ecosystems).
- Promoting a well-functioning VP/SI ecosystem through the building of robust market infrastructures and help match demand and supply of capital.

Laboratório de Investimento Social (Social Investment Lab – LIS)[44] represents a good example of an intermediary acting in the VP/SI space. Created in 2013 in Lisbon, it was founded by the Calouste Gulbenkian Foundation, incubated within IES – Institute for Social Entrepreneurship – and benefited from the technical support of Social Finance UK. At that time, the market in Portugal was incipient and, through its role of advisor, LIS had a mandate to test the viability of using some innovative financial instruments to help SEs to scale their interventions. Since then LIS works to improve social enterprises' access to capital and skills that enable them to fulfil their impact potential. What is remarkable is how **the Lab's focus** has **evolved over the years**, **adapting to the Portuguese VP/SI market's needs**.

When the Social Investment Lab was set up, the focus was to become a market catalyst by developing knowledge, setting up the Portuguese Task force for Social Investment, building impact accelerator programs and helping shape public policy in the funding of social innovation. Only in the third year they structured their first investment transactions, thus **developing a track record as a financial intermediary**.

In 2017, the Lab works on three streams: **public sector commissioning advisory** by helping the government and local municipalities to better commission social services[46]; **capacity-building and investment readiness support** through two accelerators, which offer fourteen weeks of intensive hands-on support to eight enterprises at a time; and **capital raising support** by helping social enterprises find the best investors' match and structure a win-win investment proposition. The focus of the last stream is specifically the **assessment of the most suitable** financial instruments **to be used.**

Year	Focus	Outputs
Year 1	Conducting feasibility studies and disseminating concepts and best practices	8 research notes on topics such as: SI, VP, promoting a social impact investment market ecosystem, getting investment ready, SIBs.
Year 2	Building market infrastructures	• Support to the government to design the national € 150 million wholesaler fund.[45] • Creation of Portuguese Task Force for Social Investment.
Year 3	Launching pilot projects and taking deals off the ground	• Social Impact Investment accelerator programme. • Launch of 3 new SIBs. • Structuring the first Social Impact Investment transactions (€ 1M).

44 For more info: https://gulbenkian.pt/en/

45 Portugal Social Innovation is the € 150 million wholesale fund and is structured in 4 different funds/programs: 1) outcomes/SIBs fund, 2) VP fund, 3) capacity-building vouchers program and 4) Social innovation fund which will be endowed with € 110 million and will be a fund of funds. Portugal Social Innovation was created in 2014. All programs (1), (2) and (3) have started operations, except the social innovation fund (4). See: https://evpa.eu.com/uploads/documents/Portugal-Inova%C3%A7%C3%A3o-Social.pdf

46 Activities carried out by Social Investment Lab within this stream: launch of new SIBs; creation of a Unit Cost Database that will help to figure out how much social issues cost to the State; design of outcomes based commissioning training.

4. THE VP/SI ORGANISATION'S INVESTMENT STRATEGY AND INVESTMENT PROCESS

During the definition of its investment strategy, the VP/SI organisation decides which financial instruments to use. At the same time the SPO reflects about its financial needs when defining its business model.

As shown in Figure 27, Step 1 "Assess the pre-conditions of the VPO/SI" and Step 2 "Assess the financial needs of the SPO" of the tailored financing process have to be performed when defining the **investment strategy,** from both the VP/SI's organisation and the SPO's sides.

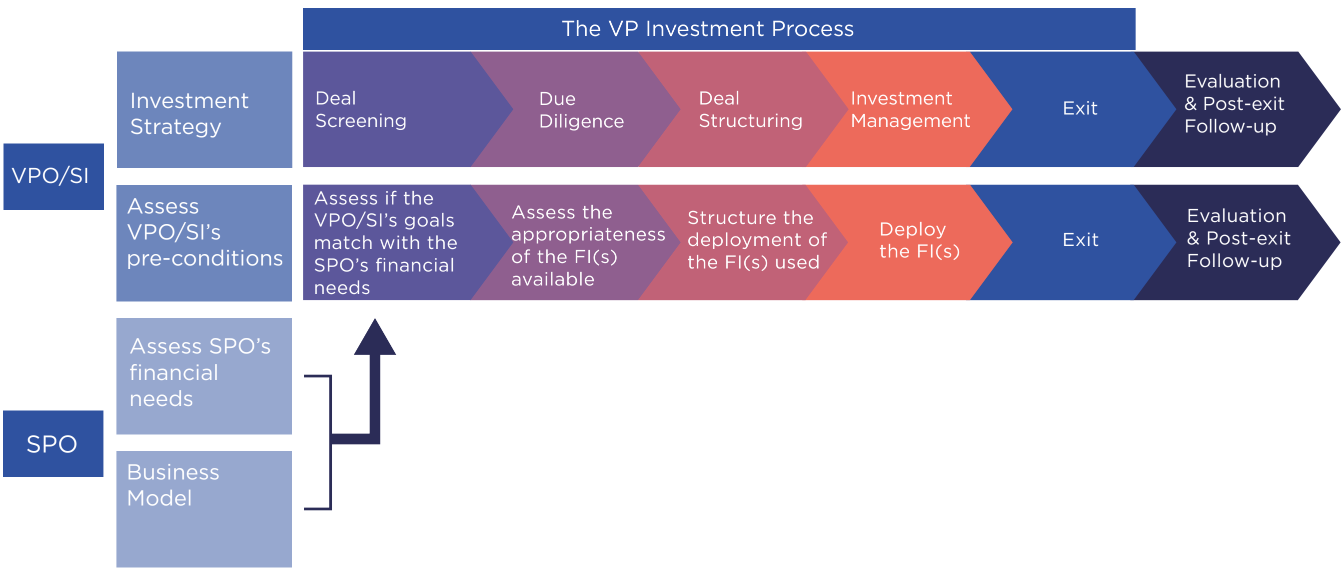
During the **deal screening,** the first phase of the VP investment process, the VP/SI organisation should assess whether the characteristics and needs of the SPO match with its proper goals, as already defined during the delineation of the investment strategy. Concretely, the VP/SI organisation needs to make sure that its own impact and financial return expectations are in line with the needs of the specific SPO.[47]

Then, during **due diligence,** having a clear idea of those SPOs matching its proper expectations, the VP/SI organisation has to select the SPOs that will receive the financial support. At this stage, there can be two different scenarios: (i) the VPO/SI has the possibility to pick among a wider range of FIs; (ii) the VPO/SI can only use a single type of financial instrument, e.g. due to its legal structure.

In the first case, the VPO/SI should assess what is the best FI to use, among the different possibilities available, which can be successful in terms of the VPO/SI's expectations, SPO's needs and impact achieved.

In the second case, the VP/SI organisation needs to assess whether the only FI it can deploy is really the most appropriate to effectively finance the SPO and

Figure 27: Tailored financing within the VP investment strategy and investment process
(*Source: EVPA Knowledge Centre*)



47 For more details, see Part 2, Chapter 2.

to match its own goals with the needs of the SPO. Or whether, for the VPO/SI, it would be more convenient to find other SPOs to support and for the SPO to look for other types of financing[48].

After choosing the SPO to support, the VP/SI organisation structures its financial offer in the phase of the **deal structuring**[49].

Looking at the **exit,** there are several questions that the VPO/SI should ask itself (possibly already **during the due-diligence phase,** as they will have an implication on the decision whether or not to invest): what is the exit potential? Does the SPO even offer the potential for an exit from the investment? Can the VPO/SI sell its shares in due course? If the answer is no, the VP/SI organisation does not have any possibility to exit even at a later time, so deploying equity can be challenging. In the same way, if the SPO operates in markets where a positive financial return is very difficult to achieve, the investee will not be attractive for trade-buyers or for strategic partners, so the VP/SI organisation may struggle to find a way to exit and equity may not be the most adequate financial instrument to use.

IKARE Ltd[50], a UK registered charity legally structured as a company limited by guarantee, started its VP activities supporting the Stamp Out Sleeping sickness (SOS) emergency intervention[51] in Uganda SOS Uganda **purely through grants**. The next challenge for IKARE Ltd was to build a (commercially viable) veterinary services infrastructure from scratch to also help deliver the public good/services needed to achieve the target impact. In order to help each of the SPOs to get used to good business practices and financial discipline, it was decided **to turn part of the grant** (purpose was to purchase vehicles) **into loans** (where the vehicles served as collateral). The vets (called "3V Vets")[52] needed to amortise the loans given to finance the purchase of their motorbikes (critical for extending their reach across large districts), as it was also expected that they would take better care of the motorbikes if they owned them and had worked hard to procure them.

It is important to highlight that, technically, **equity instruments** could have been used as well, as the objective was the financial sustainability of each veterinary's start-up. However, due to the amounts involved being rather small and IKARE having to set up a special subsidiary to take on equity, coupled with uncertainty of rules on foreign ownership in Uganda as well as whether dividends/profits could be expatriated from Uganda, they ended up choosing a mix of grants and loans.

3V Vets © Anne Holm Rannaleet

48 The reality of the field is that most actors prefer or are used to deploying certain types of instrument and choose SPOs that align with them.
49 For reference, see Part 2, Chapter 3.
50 For more info: http://www.ikinvest.com/IKare/
51 For more info: http://www.ikinvest.com/IKare/The-SOS-Initiative/
52 For more info: http://www.ikinvest.com/globalassets/newsletter/ikare_news_3_2104.pdf and http://www.ikinvest.com/globalassets/newsletter/ik_ikare_4_final.pdf

PART 3. HYBRID FINANCE
A way for VP/SI organisations to tailor financing

PART 3. HYBRID FINANCE
A way for VP/SI organisations to tailor financing

Hybrid finance is the allocation of financial resources to impact-oriented investments combining **different types** of **financial instruments** and different types of **risk/return/impact profiles of capital providers.**

There are two elements in hybrid finance developed on the **VPO/SI's side** (Figure 28):

a. **Hybrid financing vehicles** are funds set up to provide finance to the SPOs in a more efficient way, while satisfying different risk/return/impact profiles of investors. These vehicles are typically managed by *VP/SI organisations acting as financial intermediaries.*
b. **Hybrid financing mechanisms** are financing schemes developed, on a deal-by-deal basis, to increase the resources brought to impact-oriented investments by reducing the risks associated with achieving impact or financial goals.

Hybrid finance arrangements combine different impact strategies of actors using different financial instruments (hybrid or not) to achieve a degree of leverage and impact alignment that could not be achieved through a single financial instrument or by a single actor.

When multiple actors with different impact strategies join forces, they have several options. For example, different investors/capital providers can set up a new **hybrid financing vehicle,** with its own impact strategy, which differs from the ones of the actors that set up the hybrid fund. Or they can stipulate contracts to set up a **hybrid financing mechanism** through which a VP/SI organisation can collaborate with other actors interested in supporting the same investment (e.g. Social Impact Bonds). In the first example a new independent structure is created by two parties, while in the second one a contractual agreement is signed.

If the VP/SI organisation can only use a single type of FI, it can use hybrid finance to pull in other investors that use alternative financial instruments, in order to find an appropriate combination of FIs to efficiently support the investee. Hybrid finance is also used when the VP/SI organisation sees the additionality brought in by the collaboration between different actors that put together not only diverse sources of capital, but also diverse skills, perspectives, knowledge and expertise in deploying alternative financing tools, in order to maximise the support given to investees.

Figure 28: Hybrid finance (*Source: EVPA's Knowledge Centre*)

HYBRID FINANCE
Allocation of financial resources to impact-oriented investments combining different types of **financial instruments** and different types of **risk/return/impact profiles of capital providers**

HYBRID FINANCING VEHICLES
→ *at fund level*
Funds developed to provide finance to SPOs in a more efficient way, while satisfying different risk/return/impact profiles of investors

HYBRID FINANCING MECHANISMS
→ *deal-by-deal*
Financing schemes developed to increase the resources brought to impact-oriented investments by de-risking traditional capital (i.e. retail, commercial or public)

So, why is hybrid finance important, why does it matter? In this report we argue that hybrid finance has three main objectives, which constitute the added value of hybrid finance (Figure 29):

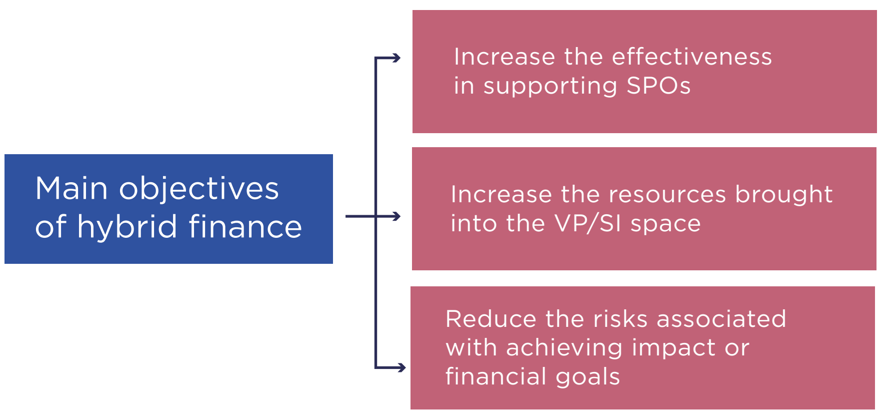
- **Increase the effectiveness** in supporting SPOs by providing them with the right support in the right form at the right time. This is particularly true for those SPOs that have the potential to become self-sustainable by generating revenues at a certain point in time in their life cycle, which might develop an appetite for diverse or even more sophisticated FIs as their business moves towards self-sustainability.

  Hybrid finance promotes the **sustainability and the capacity of investees.** Thanks to the combination of philanthropic capital and social investment (e.g. grants combined with loans), it is possible to sustain specific capacity building elements through grants that could not be easily financed by the loan because they do not generate revenues. Moreover, in some cases, looking at structuring a new hybrid vehicle, this can complement the financial deficit in the business model of the social purpose organisation. By financing that gap, the remaining part of the investment becomes amenable to commercially-oriented investors, thereby unlocking new capital encouraging commercial investments and making the SPO more sustainable over the long-term, promoting its economic viability.

- **Increase the resources** brought into VP/SI space – and the efficient allocation of them. Hybrid finance allows for the engagement of **new classes of actors,** thus bringing more financial resources into the VP/SI space and valuable assets and capabilities. Hybrid financing models align the interests of actors in a transaction around impact goals. Concretely, by plugging in traditional investors (e.g. the public, retail investors, commercial investors) with investors that have a strong focus on social impact in hybrid investments, impact-oriented goals are brought in. And that will shape the transaction by deploying traditional finance into the VP/SI space that normally would not be linked to impact in impact-oriented deals and making the impact goals clearer, more visible and better managed across the transaction.

- **Reduce the risks** associated with achieving impact or financial goals for different actors. Hybrid finance can reduce the risks associated with achieving the impact goals for philanthropic and public capital providers, or the risks associated with achieving the financial goals for traditional investors, such as retail and commercial investors.

Figure 29: The main objectives of hybrid finance (*Source: EVPA Knowledge Centre*)



Considering these aspects, a valuable advantage of the emergence of hybrid financing vehicles is the **specialisation of capital**. For example, often, investors with specific expertise in deploying loans are forced to provide also grants to cover a specific need of an investee. This solution is sub-optimal for both the VP/SI organisation and the SPO, as the former is using a financial instrument it has no strong expertise in, and the latter does not receive the best support available. By combining multiple actors' capital and expertise in the same deal, SPOs will benefit from the most suitable mix of financial and non-financial support, while all the investors deepen their capabilities in deploying a specific FI, which is known as specialisation of capital.

Specifically, considering hybrid financing vehicles, **the attraction to the SPO** is that it only has one (rather than multiple) counterparty and that ideally it only has to judge one type of financing. It is at the fund level (i.e. the vehicle) that the incoming funds (with different return requirements) are pooled and then one type of funding with a certain financial servicing and return requirement is granted to the SPO. As the SPO then amortises or pays interest or dividends, the split happens at the fund level so that the grant providers get nothing while those with non-subordinated debt instruments or special fund interests have a first right to (pre-determined) returns.

On the other hand, specifically considering hybrid outcome-based mechanisms, thanks to them, programming can become smart and effective as a result of **increased flexibility and autonomy of service providers**. There can be an increased transparency and accountability for outcome delivery through the **direct link between outcomes and investor returns**. Moreover, there will be an increased attention to the achievement of an even greater impact due to **performance incentives that reward the service provider** in the case of over-performance. Furthermore, there will be an **increased clarity of the value of outcomes** that will enable better understanding of investment opportunities and prevailing market prices. Lastly, these mechanisms ensure that **donors get the full value for their money** and **do not pay for programmes that do not perform**.

It is important to distinguish between hybrid finance and **blended finance**. "Blended finance" is a term that started to become internationally used and further recognised after the adoption of the Addis Ababa Action Agenda as outcome document of the Third International Conference on Financing for Development organised by the UN (United Nations, 2015).[53] With the AAAA, the UN underlined **the potential of new investment vehicles within development finance**, such as blended finance, which combines concessional public finance with non-concessional private finance (ibid.). For the UN, blended finance instruments serve to **lower investment-specific risks and incentivise additional private sector finance** across key development sectors led by regional, national and subnational government policies and priorities for sustainable development.

Additionally, still in 2015, in the context of the **ReDesigning Development Finance Initiative** (RDFI), the **World Economic Forum** and the **OECD** defined blended finance as "*the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets*" (OECD, 2016; OECD/WEF, 2016; OECD/WEF, 2015a; OECD/WEF 2015b).

Thus, blended finance is often used as a term that refers to a development cooperation context, in which development finance (incl. both Official Development Assistance, ODA, as well as private funds governed by a development mandate) is used to mobilise additional commercial capital. So, even though in our definition of hybrid finance we also include examples that follow a similar rationale of blended finance,[54] we look at a much broader space where diverse types of →

53 Conference held in Addis Ababa in July 2015.
54 However, in this report, while we refer, for example, to hybrid financing mechanisms, we are also talking about de-risking the public through the private. That is the opposite of what we see in blended finance as described by the OECD and widely known.

collaborations with different logics take place. So, we can consider blended finance as part of the whole hybrid finance concept (specifically, under hybrid mechanisms) that has specific characteristics and declinations.

However, it is relevant to add that some VP/SI organisations, especially in the UK, such as Access Foundation[55] and Social and Sustainable Capital,[56] use the term "blended finance"[57] to refer to a practice that we describe as hybrid finance and, specifically, as the set-up of hybrid structures (i.e. the use of different type of financial instruments deployed through the same investment fund).

As mentioned above, for the purpose of this research, in Part 3 of the report, we specifically focus on SPOs that have the potential to become self-sustainable by generating revenues at a certain point in time.

In the following paragraphs, we provide practical cases of hybrid finance investments. The list is not exhaustive but it well represents the variety of examples of hybrid finance developed so far in the VP/SI space.

55 For more info: https://access-socialinvestment.org.uk/
56 For more info: http://socialandsustainable.com/
57 For more info: https://www.civilsociety.co.uk/voices/blended-finance-is-transforming-social-investment.html

1. HYBRID FINANCING VEHICLES – SETTING UP FUNDS TO COMBINE FINANCIAL INSTRUMENTS IN A MORE EFFECTIVE WAY

In the VP/SI space there is a compelling need for hybrid models that use a **combination of financial instruments** (Wilson, 2014) in order to better finance SPOs, since most deals require a mix of different types of FIs and actors. Moreover, if we look at how the most complex projects are financed, we can see that they do not rely on only one source of money, but piece together **capital from several sources,** with different risk-return profiles (Oldenburg, 2014). For example, foundations are co-investing with social investment funds to combine their experience in grant-giving with the experience and knowledge of more commercial investors (OECD, 2015).

As anticipated, **hybrid financing vehicles** are developed, at fund level, to provide finance to the SPOs in a more efficient way, while satisfying different risk/return/impact profiles of investors. They are structured to respond directly to the SPOs' need of diverse specific FIs due to their evolution through consequential stages of development. This type of vehicles combines in a new, independent, hybrid fund the impact strategies of different types of actors, such as public funders, philanthropic funders and social investors so that the new vehicle has its own impact strategy, which might differ from those of the actors that set it up.

Often these hybrid financing vehicles aim at supporting SPOs that have the potential to become self-sustainable (often referred to as **social enterprises**[58]), during their **early stage phase.** At this stage, these SPOs have difficulties accessing both philanthropic capital and social investments, for different reasons. Since grant-giving VPOs are not seeking financial returns, they are better fitted to support non-profit organisations that do not generate revenues, thus leaving out early stage social enterprises. On the other hand social investors, who are interested in financial returns alongside social impact, normally support social enterprises that have a high chance of generating revenues, thanks to already proven business models, and that have reached a later stage of development. In fact, more mature social enterprises allow for larger ticket sizes and can offer higher profitability (Freiburg et al., 2016). When it comes to debt, SPOs cannot access relatively small scale unsecured simple loans as they **do not have any security or track records** to borrow from mainstream lenders. In addition most social investment funds are reluctant to lend small amounts of finance because the transaction would be too risky and costly.[59] Moreover, many of the SPOs that could benefit from social investment need a lot of support to develop business models and put in place systems and processes for managing enterprise operations and repayable finance.

As a result, early stage SPOs have difficulties finding a suitable source of capital with the risk of not being supported at all or not being served in the most appropriate way.

Evidence supports the theory that there is a need to find new ways to fill the financing gap for SPOs in the stage of development that follows the very seed/early stage and precedes the growth/scaling stage.

The Financing Agency for Social Entrepreneurship (FASE) identifies a strategic financing gap in the early growth stage when, as explained before, SPOs are generally "too big for donations/philanthropists, too small (and risky) for institutional (social) investors".

58 The European Commission developed the following definition for social enterprises: A social enterprise is an operator in the social economy whose main objective is to have a social impact rather than make a profit for their owners or shareholders. It operates by providing goods and services for the market in an entrepreneurial and innovative fashion and uses its profits primarily to achieve social objectives. It is managed in an open and responsible manner and, in particular, involves employees, consumers and stakeholders affected by its commercial activities. For more: http://ec.europa.eu/growth/sectors/social-economy/enterprises_en

59 Normally these funds are not willing to invest in deals lower than £ 150k-200k. However, social funds previously subsidised by the European Structural Fund or by other public funds, are inclined to invest such as small amounts of capital (Seb Elsworth, Chief Executive of Access Foundation).

In this phase, SPOs generally need between € 50k and € 500k and a combination of financial instruments can be the best solution to fill the gap (Figure 30).

However, other research shows that the "Valley of Death" – also called the "Missing middle" – is in the expansion stage (Figure 31), where small social enterprises are often too big for microfinance and informal sources of finance, but too small or risky for commercial banks and private equity investors (Bolis et al., 2017). In this phase, VP/SI organisations can play a critical role before the SPOs can reasonably take on traditional commercial finance.

Figure 30: The strategic financing gap (*Source: FASE*)

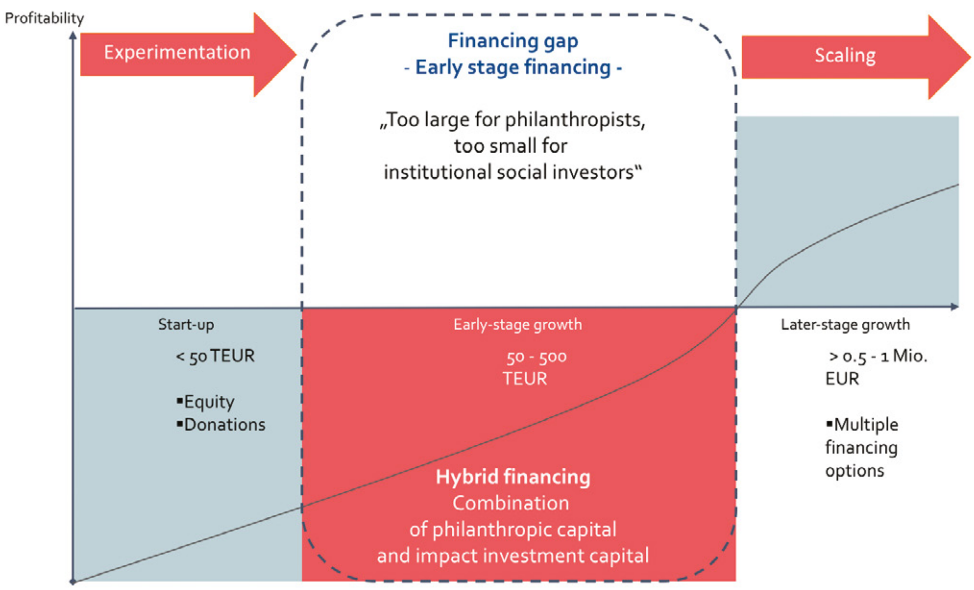
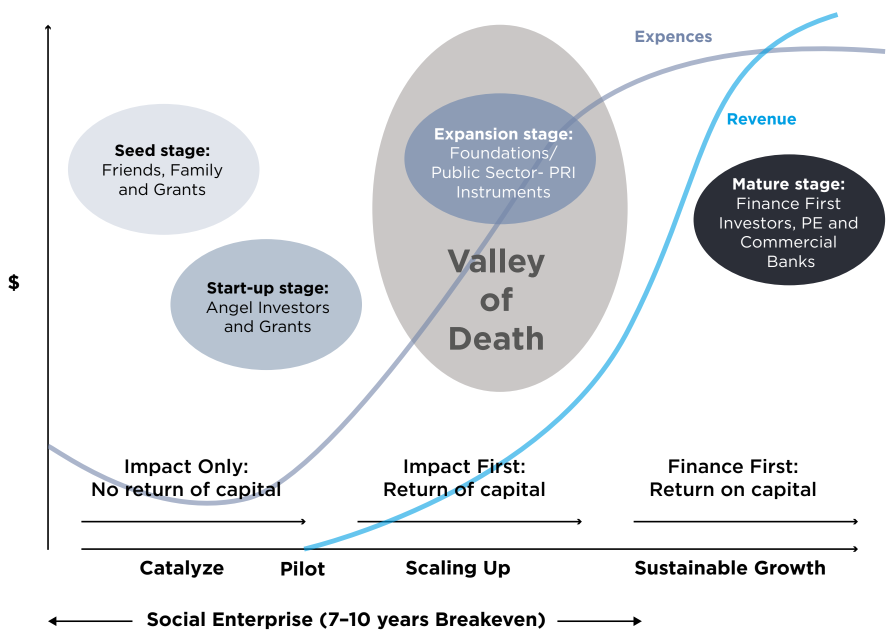


Figure 31: Growth stages of enterprises, from start-up to sustainable growth (*Source: Bolis et al. 2017*)



In Germany, the **Financing Agency for Social Entrepreneurship** (FASE)[60] is setting up a hybrid co-investment fund to serve a specific segment of the VP/SI market: **early stage social enterprises**. The fund would provide moderate financial returns (i.e. 2% to 5% across different investment tranches). The volume foreseen for the fund is € 20 million to support about 80 social start-ups over a five-year investment period. **Mezzanine capital** and/or **equity** over duration from 5 to 6 years will be the financial instruments deployed through the fund (Freiburg et al., 2016). The fund will have a multi-layered structure, which will combine hybrid capital: bringing philanthropic, public and social investment actors together. One important characteristic of the SEs that the fund also takes into account is the **maturity or development stage**. Young start-ups with an initial proof of concept of both the business and the impact models, which have to scale their product or service to gain a foothold in the market, need between € 100k and € 500k in capital. Mature start-ups already successfully persisted in the market in both the business and impact dimensions, typically require above € 1 million to continue growing (ibid.).

Phineo[61], a non-profit corporation based in Berlin that is active as an intermediary in the German impact investment market, plans to set up a pilot hybrid fund. The so-called "**hybrid donor fund**" will invest in 6-8 impact deals, bringing together foundations as donors and social investors. The aim is to leverage social investments through the philanthropic capital with an average ratio of 1:2. The hybrid fund is targeting around € 700,000 philanthropic capital from foundations and € 1.4 million from social investors. The returns for social investors are capped.

The aim of the pilot is also to test the feasibility and prove the sustainability of such hybrid finance initiatives and promote market development. However, German foundations have so far been hesitant to provide philanthropic funding through this type of new financing vehicle, which may require a strategic repositioning of the pilot.

Phineo is fundraising the donor fund and screening the SPOs to be supported through the fund. One of those has already passed the due-diligence and three more are in the pipeline. The selection criteria are linked to social impact, governance, and business model. **FASE** is involved as a project partner in the pilot and is supporting the search for social investors to match the donations.

Access Foundation – The foundation of Social Investment[62] was established in 2015 to make it easier for SPOs in England **to access the capital they need to grow and increase their social impact**. Access's funding comes from 10-year spend-down endowment given by the UK Government, and a blended capital facility supported by the Big Lottery Fund and Big Society Capital.

To address the dual challenge described above, Access runs two main programmes. Firstly by combining grants and loans in a £45m blended finance facility, the **Growth Fund**[63], which is made available to organisations who lend to SPOs. The grant subsidy allows for those lenders to take greater risk and helps subsidise the transaction costs of managing lots of small loans. The finance offered by

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60 For more info about FASE, read their complete case featured in OECD/EU, (2017), "Boosting Social Enterprise Development: Good Practice Compendium", OECD Publishing, Paris, pages 111–119.
61 For more info: https://www.phineo.org/english. For more info about Phineo, read their complete case featured in OECD/EU, (2017), "Boosting Social Enterprise Development: Good Practice Compendium", OECD Publishing, Paris, pages 121–129.
62 For more info: https://access-socialinvestment.org.uk/
63 The Growth Fund, which combines £ 22.5m of grant from the Big Lottery Fund with at least £ 22.5m in loan funds from Big Society Capital, helps social investors make investments of up to £150,000 in SPOs. For more info: https://access-socialinvestment.org.uk/growth-fund/what-is-the-growth-fund/

those loan funds is **small, flexible, unsecured,** and **affordable**. Two examples of investees supported by the Growth Fund are **Hollywell Housing Trust**[64] and **Intraquest**.[65]

Secondly Access provides grant funding for **capacity building** and **investment readiness programmes from the £60m endowment.** Current programmes include the **Reach Fund**[66], which provides SPOs with grants[67] to help them become able to take on a loan, and the **Impact Management Programme,** which specifically helps SPOs with skills to embed impact performance in their management information.

© Hollywell Housing Trust

Hybrid funds are also set up within the **development cooperation** context. In Germany, since 2005 the German Government and KfW Development Bank[68] have established several **structured funds**[69] **to finance target investments** in developing countries via financial institutions. Target investments are Micro- and SME-Finance, green investments, or for example education finance. These funds **divide the overall risk of a portfolio into tranches**, each with a different degree of risk, and those are then passed on to investors with varied risk appetites. Concretely, a loan portfolio is divided into – for instance – three tranches. The junior tranche (the equity-like risk tranche, taken on by the German Government); a mezzanine tranche (often passed on to **development finance institutions**); and a senior tranche (associated to a lower risk, passed on to the **capital market** and **traditional private investors**).

Another example is the **DEG**[70] **"Up-Scaling" Programme** through which DEG provides € 500k that must be repaid in case of success of the investment. 50% of the total investment volume is provided through the programme. So that the SEs supported – selected based on both their **financial and development impact performances** – have to bring in the remaining 50% from private and/or public investors, mobilising **additional resources and actors**.

Thus, these vehicles channel funding into **new sectors and geographies**, and apply **high environmental and social standards** to all the investments.

64 For more info: http://www.reachfund.org.uk/news/hollywell-housing-first-reach-investment
65 For more info: https://www.pioneerspost.com/news-views/20170116/first-access-funding-reaches-frontline
66 For more info: https://access-socialinvestment.org.uk/access-social-investment-business-announce-launch-reach-fund/
67 The grant component (up to £ 15,000) is designed to test a new model of investment readiness support.
68 For more info: https://www.kfw-entwicklungsbank.de/International-financing/KfW-Entwicklungsbank/
69 An example of structured fund is the European Fund for Southeast Europe (EFSE) set up in 2005. For more info about this fund: https://www.efse.lu/
70 For more info: https://www.deginvest.de/International-financing/DEG/

2. HYBRID FINANCING MECHANISMS – COMBINING DIFFERENT ACTORS TO FINANCE SOCIETAL SOLUTIONS

Hybrid financing mechanisms are schemes developed, on a deal-by-deal basis, to increase the resources brought to impact-oriented investments by reducing the risks associated with achieving the impact goals (for philanthropic and public capital providers) or the financial goals (for traditional investors, such as retail and commercial investors).

Hybrid financing mechanisms differ in terms of actors involved and ways of functioning, as we will see in the paragraphs below.

2.1. Outcome-based mechanisms

Outcome-based mechanisms are contracts through which societal challenges are tackled in an innovative way, by stimulating the efficiency of social investors to generate a greater social impact. Outcome-based mechanisms are contracts financed by a risk-taking social investor to de-risk (from an impact risk perspective) the investment for other types of actors, such as public entities (see below the examples of SIBs), philanthropic donors (see below the example of DIBs) and commercial investors (see below the example of the Social Success Note).

The focus is on impact: governments/public entities and philanthropic actors repay the investment made by the risk-taking investor, including a surplus, only once the innovative intervention has achieved the pre-defined social impact results. Concretely, this practice avoids outcomes-payers taking risks in case the interventions do not work or do not achieve the social impact expected.

Looking at specific type of outcome-based mechanisms, we see that **Social Impact Bonds** (SIBs) are a typical example of results-based contracts between governments/public entities and social investors.

Social Impact Bonds enable federal state, and local governments to partner with high-performing service providers by using private investment to develop, coordinate, or expand effective programs (Dear et al., 2016).

Social Finance UK[71] is a not-for-profit organisation that partners with the government, the social sector and the financial community to find **better ways of tackling social problems** in the UK and beyond. In September 2010, Social Finance UK conceived and launched the first **Social Impact Bond** (SIB): a six-year SIB pilot scheme in **Peterborough** that aims to reduce reoffending, providing short-term prisoners from Peterborough prison with intensive interventions both in prison and in the community.

In 2017, the final results have been measured, showing that the world's first SIB has been successful. In fact, The independent evaluation determined that the Peterborough Social Impact Bond **reduced reoffending of short-sentenced offenders by 9%** and **investors were fully repaid**.[72]

By linking a social target to financial success, the Peterborough pilot generated worldwide interest in whether innovative finance can make an impact on the world's most difficult challenges (Dear et al, 2016). Since Social Finance pioneered Social Impact Bonds in 2010, this type of financing mechanisms has experienced a rapid growth in the global market. As of today, there are **89 Social Impact Bonds in 19 countries**,[73] mobilising more than £300m of investment into tackling complex social issues such as refugee employment support, loneliness among the elderly, rehousing and reskilling homeless youth, and diabetes prevention.

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71 For more info: http://www.socialfinance.org.uk/

72 To read the extensive study about SIBs: **Dear**, **A., Helbitz, A., Khare, R., Lotan, R., Newman, J., Crosby Sims, G.,** and **Zaroulis, A.,** (2016), "*Social Impact Bonds. The early years*", Social Finance: http://www.socialfinance.org.uk/sib-white-paper/

73 To access the press release published in July 2017: http://www.socialfinance.org.uk/wp-content/uploads/2017/07/Final-press-release-PB-July-2017.pdf

Duo for a Job[74] is a Belgian SPO that provides young migrants with mentorship from experienced workers. At the beginning of its activities, Duo for a Job was lacking a strong track record and did therefore not qualify for funding from the Belgian government agencies. In 2014, **KOIS Invest**[75] structured the first-ever SIB in Belgium (Figure 32). Social investors provided upfront financing to Duo for a Job (the service provider), thereby taking the social impact risk away from the government (represented in this case by Actiris – the public agency for professional reintegration in the job market of the Brussels Capital Region). At the end of the project, Actiris will reimburse social investors their investment, plus an interest according to the social impact achieved and assessed by an independent evaluator (the Observatoire Bruxellois de l'Emploi). Thanks to the SIB, Duo for a Job is able to develop and scale its mentoring programme through increased financing, and to focus more on its social programmes through the outsourcing of their quest for financing. Additionally, the social issue linked to integration and access to the job market for migrants has been tackled by an innovative social programme in a more efficient way.

DUO for a JOB © KOIS Invest

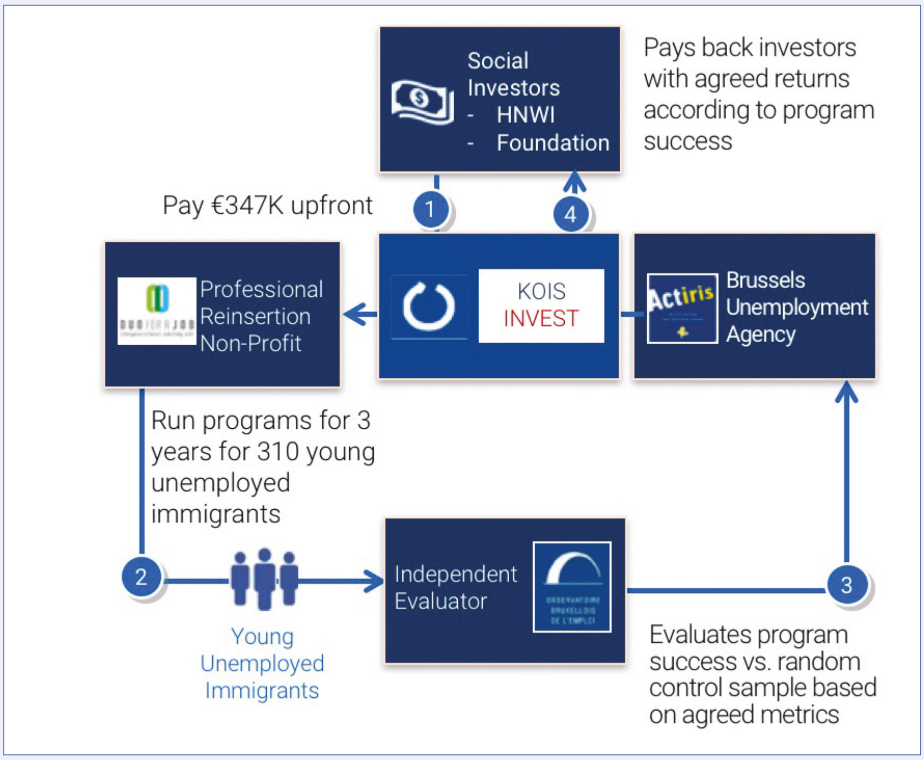


Figure 32: Mechanism of Duo for a Job's SIB (*Source: KOIS Invest*)

74 For more info: http://www.duoforajob.be/en/home/
75 For more info: https://www.koisinvest.com/

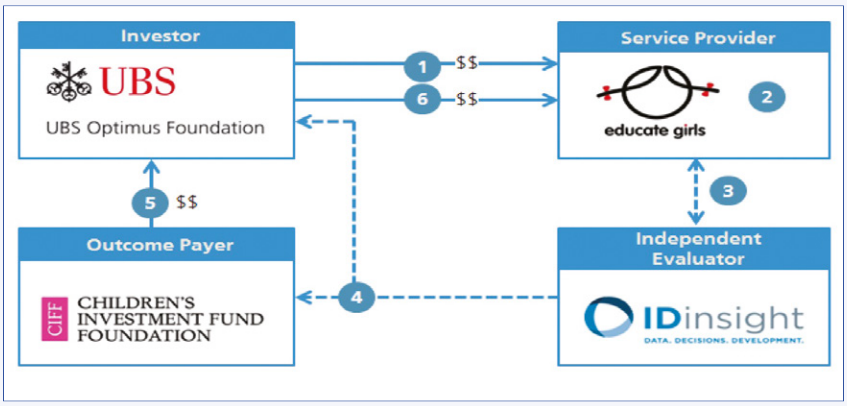
Another type of outcomes-based contracts is **Development Impact Bonds** (DIBs). These contracts work following the same logic of SIBs, but in this case, the outcome-payer is a philanthropic organisation or a development aid provider like the Department for International Development in the UK. Hence, the difference between SIBs and DIBs comes from who ultimately pays for the social outcomes.[76] A DIB aims to prove the concept of outcome-based financing and create systemic change in the **financing of development interventions** over time. This hybrid mechanism is a way to move **from conventional aid,** where an external donor addresses immediate needs and pilots innovative models, to a **sustainable public sector** ownership, where public sector commits long-term funding and fully integrates the project into the national system. Thus, DIBs tap into market-based incentives and private sector funding to demonstrate the value of outcome-based financing.

In order to improve the quality of girls' education and attract new investments for social outcomes, UBS Optimus Foundation, the social investor, the Children's Investment Fund Foundation (CIFF), the outcome payer, IDinsight, the independent evaluator and Instiglio, the intermediary, launched the first Development Impact Bond[77] (Figure 33). Over three years (mid-2015 to mid-2018), Educate Girls is aiming at closing the gender gap in enrolment and improving children's learning levels. Year two results show that **Educate Girls[78]** has achieved 87.7% of the 3-year enrolment target and 50.3% of the 3-year learning target. UBS Optimus Foundation, which provided the upfront DIB working capital, remains on track to recoup its initial funding.

© Educate Girls

At the end of the DIB program, if both the enrolment and learning targets are met, the initial investment will be paid back to UBS Optimus Foundation by the outcome payer, in this case CIFF. CIFF will pay interest of up to 15%, depending on how far the children's learning targets are reached. Educate Girls will also receive part of this payment if it achieves its targets.

Figure 33: Educate Girls DIB (*Source: UBS Optimus Foundation*)



Information Flow
Money Flow

1. Payment of grant
2. Delivery of social intervention
3. Monitoring and evaluation by third party
4. Report on KPIs such as enrollment, attendance and learning
5. Reimbursement of grant plus interest if outcomes are met
6. Incentive fee to Educate Girls if targets met (Bonus)

76 For more info: http://www.instiglio.org/en/impact-bonds/
77 For more info about this DIB: http://instiglio.org/educategirlsdib/ and https://evpa.eu.com/blog/development-impact-bonds-a-new-finance-model-for-international-development
78 For more info: http://www.educategirls.in/

Why use impact bonds rather than traditional funding?

1. It makes money more effective. By tying funding to measurable results, Impact Bonds reduce the risk of funding programmes that do not work.
2. It allows providers to adapt to change. By shifting focus from activity to impact – that is, by reimbursing results rather than receipts – Impact Bonds give service providers more flexibility to do what they need to do to get results.
3. It incentives better programmes. By tying funding to results, Impact Bonds make it attractive and profitable for service providers to improve their programmes.
4. It focuses the private sector on social issues. By creating an investment opportunity that includes a financial return, Impact Bonds invite the private sector to participate in improving social programmes.

(Source: http://www.instiglio.org/en/impact-bonds/)

A third type of outcomes-based contracts is **Social Success Notes** (SSN)[79]. SSN is a new financing innovation that allows capital to flow into underfunded sectors (e.g. low income geographies) deemed traditionally too risky or unprofitable for mainstream capital. These mechanisms have been created to address the investment gap for social enterprises and social businesses by crowding in commercial investors. The donor makes the transaction more viable for commercially-oriented investors, thereby unlocking additional capital to be channelled towards the VP/SI market. Social Success Notes involves commercial investors that provide the social business with concessionary loans (i.e. loans bearing no interest or at below market interest rates). If the social outcomes are reached, the commercial investors receive a premium from the donor, which amounts to a competitive market rate return which amounts to a competitive market rate return, and the SPO also receives a premium from the donor, effectively lowering its cost of borrowing. The donor gets significant leverage as the investor still provides the majority of financing for the social business, the donor pays only for the outcome and the social business provides long term sustainable impact.

Impact Water Uganda (IWU)[80] is a social business (supported by Yunus Social Business through concessionary loans) dedicated to scaling safe drinking water solutions for schools and health facilities in Uganda. The key barrier to the installation of clean water systems at schools is the need for financing, especially because IWU provides the final beneficiaries with the systems on credit. IWU typically provides financing over a period of 1-2 years with 5 payment terms aligned with school terms, allowing schools to offer clean water while paying off their loan when they receive school fees.

Yunus Social Business and Rockefeller Foundation have developed a **Social Success Note**[81] whereby

© Impact Water

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79 For more info: http://www.yunussb.com/blog/social-success-note/ and https://www.youtube.com/watch?v=nJ91CE0i1Jw
80 For more info: http://impactwater.org/
81 For a complete overview of the mechanism: http://www.yunussb.com/wp-content/uploads/2015/12/Yunus-Social-Business-Social-Success-Note-Handout-2.pdf

UBS Optimus Foundation (UBS OF) as lender and Rockefeller Foundation as outcome funder aim to support the accelerated roll-out of IWU's water systems (Figure 34). UBS OF will provide this Social Success Note structured as a $ 500k five-year loan with a 60-month grace period.

UBS OF will receive a return on its borrowing to IWU that could rise up to [~8%] if all targets are met. Rockefeller Foundation will make an outcome payment depending on IWU's ability to meet impact targets, assessed by an independent evaluator. Importantly the structure encourages IWU to achieve the impact targets and effectively achieve lower funding costs. For the investors, achieving impact targets correspondingly results in a higher return. The Social Success Note will see IWU provide over 2 million children with clean drinking water in a sustainable way.

Table 2: Possible outcome scenarios[82]

Scenario	Impact	Investor return	Outcome payment	Interest rate IWU
Success	100%	8%	$ 200k	0%
Partial success	50%-100%	6-8%	$ 100-200k	0%-3%
Failure (but able to service loan)	0%-50%	5%	Nil	5%
Failure (not able to service loan)	0%-50%	Loss of principal	Nil	Administration

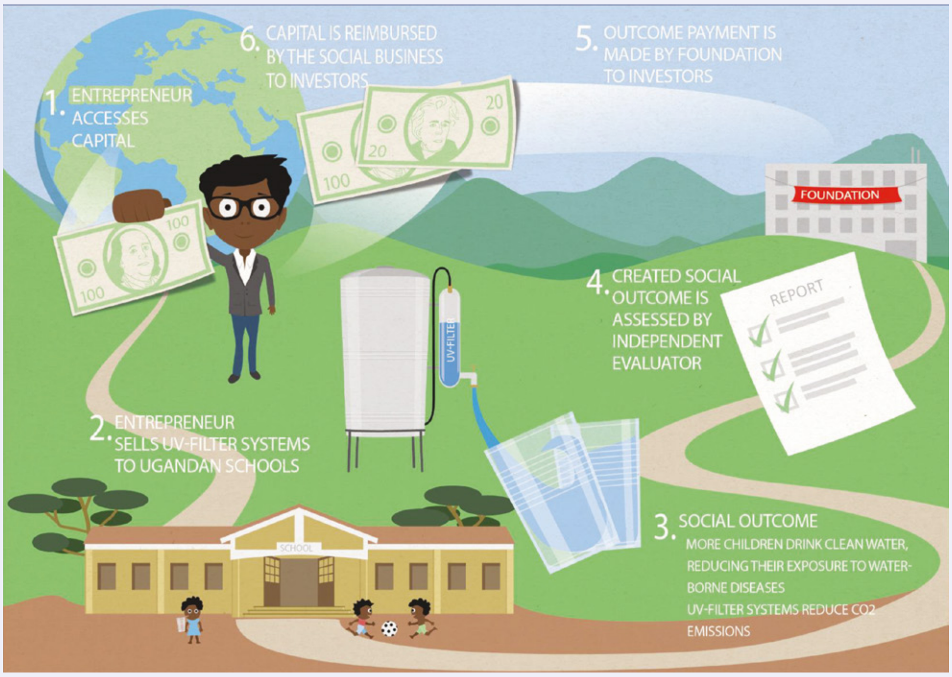


Figure 34: Social Success Note developed to finance Impact Water (*Source: Yunus Social Business*)

82 Source: Finansol's Solidarity Finance Barometer 2017, figures at 01/08/2017.

In the VP/SI space new ways to provide more efficient financial support to SPOs are continuously conceived. With the **same logic of an outcome-based mechanism,** but with the social outcome payed directly to the social enterprise, **Social Impact Incentives** (SIINC)[83] have recently been developed by the Swiss Agency for Development and Cooperation and Roots of Impact in partnership with the Inter-American Development Bank (IDB), New Ventures and Ashoka. SIINC are premium payments to high-impact social enterprises based on verified social outcomes that enable them to improve profitability and reach scale. Through this mechanism impact is incentivised very directly: it becomes linked to the social enterprise's profitability and automatically makes the organisation more attractive to investors, including traditional commercial investors. With SIINC, social enterprises are empowered to raise large amounts of investment and to grow sustainably while creating positive social impact at scale. The first two successful transactions with SIINC have been made at the beginning of 2017. The pioneers applying SIINC to raise investment and scale are Clínicas del Azúcar[84] in Mexico and Village Infrastructure Angels[85] in Honduras.

2.2. Guarantee scheme

Another mechanism to de-risk investments used also in the VP/SI space is the guarantee. It can be considered a hybrid mechanism since it involves different actors and is set up with the intention to bring more resources into the VP/SI space.

> **A *guarantee*[86] is a promise by one party (the guarantor) to assume the debt obligation of a borrower if that borrower defaults. A guarantee can be limited or unlimited, making the guarantor liable for only a portion or all of the debt. In the VP context, guarantees are one of the financial instruments available for VP/SI organisations to support SPOs. The VP/SI organisation in this case does not need to supply cash up-front, but it opens up access to bank funding by taking on some or all of the risk that the lender would otherwise incur.**

For example, a SPO can be supported with **bank loans that can be guaranteed either by a VP/SI organisation or by an institutional investor,** such as for example the European Investment Fund (EIF). The guarantor does not need to supply cash up front, but it opens up access to regular funding sources by taking on some or all of the risk that the lender would otherwise incur.

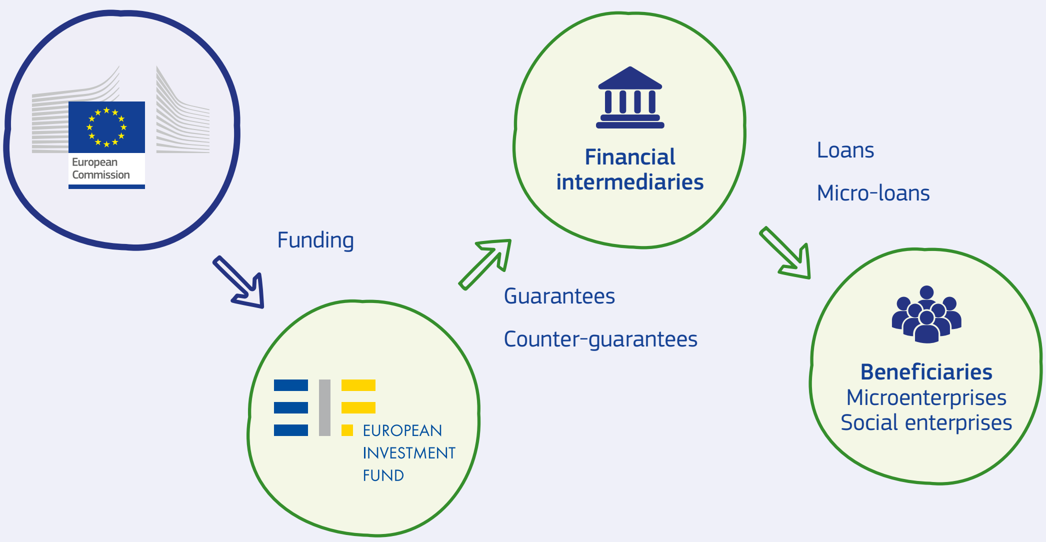
Below the example of the EaSI guarantee is presented, a mechanism where the European Investment Fund is the guarantor vis-à-vis a financial intermediary. Looking then at the second example provided in this section of the report, we have the case of **Social Banking at Erste Bank in Austria (EBOe),** being the financial intermediary that benefitted from the EaSI guarantee.

> "*Well-structured Credit Guarantee Schemes, for example, can help closing the financing gap by replacing the need for collateral with credit protection provided by an external guarantor. A credit guarantee is a […] triangular relationship between a lender, a borrower and a guarantor. The guarantor, typically in return for a fee, commits himself to repay the loan to the lender, in case of the borrower's default. While CGSs do not address the root of the market failure directly, they can increase the incentives of lenders to supply credit to Social Enterprises by providing a substitute for collateral*" (Torfs and Lupoli, 2017).

83 To know more about this mechanism: http://www.roots-of-impact.org/wp-content/uploads/2017/05/Social-Impact-Incentives-SIINC-White-Paper-2016.pdf and http://www.roots-of-impact.org/siinc/
84 To access to complete case: http://www.roots-of-impact.org/wp-content/uploads/2017/06/SIINC-Case-Studies-CdA-FINAL.pdf
85 To access to complete case: http://www.roots-of-impact.org/wp-content/uploads/2017/06/SIINC-Case-Studies-VIA-FINAL.pdf
86 Source: https://en.wikipedia.org/wiki/Loan_guarantee

The EaSI Guarantee Instrument[87] is funded by the European Commission (EC) under the EU Programme for Employment and Social Innovation – EaSI (Figure 35). The general objective is to increase the availability of and access to finance for social enterprises and microenterprises. The specific objective is **to offer guarantees and counter-guarantees to financial intermediaries**, thereby providing them with a partial credit risk protection for newly originated loans to eligible beneficiaries. The **potential intermediaries** are financial institutions, micro-finance institutions, guarantee schemes, guarantee institutions, foundations, family offices, social investment funds or other institutions duly authorised to provide loans/guarantees or risk-sharing structures according to the applicable legislation. Specifically, the form of financing consists in an EIF segregated account from which the financial intermediary **can call the guarantee quarterly to cover defaulted loans**. It is free of charge for those financial intermediaries that are able to transfer this added valued to the final recipients applying more favourable financial conditions compared to their standard conditions (so-called "transfer of benefit"). As regards the SEs, the coverage for SEs loans is **up to 10 years** and up to **80%[88] of loss is covered**. Lastly, this instrument is complementary to direct financing facilities and other guarantee schemes (as far as the intermediary retains 20% credit risk and there is no overlap with other EC funds on the same portfolio).

Figure 35: How the EaSI Guarantee works
(*Source: European Commission*) [89]



87 For more info on how the EaSI Guarantee Instrument works: http://www.eif.org/what_we_do/microfinance/easi/easi-guarantee-instrument/index.htm and European Investment Fund, (2016), "EaSI Guarantee Financial Instrument – leaflet for intermediaries". Available here: http://www.eif.org/news_centre/publications/eif_flyer_easi_en.pdf
88 With a guarantee cap rate of up to 30%.
89 For more info: http://ec.europa.eu/social/BlobServlet?docId=16913&langId=en

Social Banking at Erste Group[90] focuses on making an impact via: (i) improving financial stability and inclusion for low-income people; (ii) enabling job creation and self-employment via financing starting entrepreneurs; and (iii) fostering development and enlarging impact of social businesses. Through its network of local banks in the Central and Eastern European (CEE)[91] region and also in partnership with other organisations and NGOs, Erste Social Banking provides not only **tailored financial products**, but also financial literacy and money advice, business training and mentoring to support all client Social Banking clients to grow and to make wise financial decisions in the future.

In order to be able to finance more social purpose organisations, in 2016 **Social Banking at Erste Bank in Austria (EBOe)** signed a **guarantee agreement with the European Investment Fund**, being then required to invest in SEs a total volume of € 5 million.

A first example of an investment made within the EaSI Guarantee is the **"Sustainable energy company"**, an energy provider that makes smart use of green energy, reducing costs for consumers. This company was already receiving **grants from the Austrian State**. The prospect of potential market growth and the **EaSI Guarantee** led EBOe to **provide a loan of € 50,000 termed for 5 years**. A second example is **"Sign Language"**, a company aiming at providing news and media to deaf people, via an animated avatar, which translates text partially automated into sign language. From 2008 until 2016, they were **self-financed** and receiving **grants from the Austrian State** and **the EU**. In 2017, **FASE** was instructed to find € 750,000. Independent of FASE but aware of its search, **EBOe provided a bank loan of € 200,000 with the EaSI guarantee**. Being backed by the EIF and prospecting a possible growth in the market, as well as the ongoing search of FASE for additional capital led EBOe to provide the loan.

Even though both outcome-based mechanisms and the guarantee scheme are conceived to de-risk actors involved in specific impact investments, a relevant difference exists between the two. In the first example, the outcome-payer will disburse money in case of success of the SPO involved in the investment, whereas in the second example, the guarantor will disburse money in case of the SPO's default.

2.3. Solidarity-saving Schemes

We believe that it is reductive to exclusively mention outcome-based mechanisms and guarantee schemes while describing the different possibilities that capital providers have to channel more resources into the VP/SI space following the logic of hybrid finance.

Solidarity-saving schemes, for example, are companies-specific employees' savings plans, such as retirement plans, or internal corporate saving plans for employees. They represent the main mechanism to collect solidarity savings and have been successfully developed in France, counting nowadays over 1 million solidarity savers.[92] These schemes aim at increasing the resources going into the social investment market, engaging new actors (e.g. retail investors) into a space in which they were not present before.

One example of solidarity schemes are the French **90/10 Solidarity Funds.** The first 90/10 fund, "Insertion Emplois Dynamique", representing a unique fund aiming at supporting jobs creation in France has been created in 1994 by the Caisse des Dépôts and France Active. Since then, enterprises, institutions and associations but also employees and retail investors can

90 Erste Group Bank: Social Banking – for more info: https://www.erstegroup.com/en/about-us/social-banking
91 Up till today more than 200 Social Organisations and Social Enterprises were financed and EUR 17 million disbursed by Erste Banks in CEE.
92 Source: Finansol's Solidarity Finance Barometer 2017, figures at 01/08/2017.

invest their capital/savings in these funds. Then, from 2008, they act as **solidarity saving-schemes** obliging companies with more than 50 employees to offer their staff the possibility to choose to put their savings in a fund that dedicates a minimum of 5% and a maximum of 10% of its resources to eligible social enterprises, with the remaining resources being applied to traditional investments.

The 90/10 Solidarity Funds can largely contribute to the development of the social investment sector with almost "no effort" required from the investors as 90% of the fund remains invested in a "traditional" way, helping the investors to almost keep the same financial performance, the same liquidity, the same risk. The 90/10 Solidarity Funds are a win-win approach as they help social enterprises to get access to longer-term money to finance their development and to diversify their financing, and they also contribute to channel private money to the generation of social impact.

The 90/10 Solidarity Funds offer recognised advantages, such **as democratisation of social impact investment, access to patient capital for social enterprises, considerable sources of financial wealth held in employee savings**, etc. Its replication is currently being investigated for other types of retail placements, such as pension funds in France and the UK, as well as in other European countries.[93]

The final goal of Solidarity-saving Schemes is though to increase the capacity of social enterprises in developing their societal solutions thanks to a greater amount of financial resources deployed, by de-risking diverse actors, such as, in this specific case, retails investors. The logic is the same followed by, for example, the outcome-based mechanisms (described in Paragraph 2.1). However, there is a relevant difference to highlight since Solidarity-saving Schemes support a specific SPO, whereas the outcome-based mechanisms support a specific societal solution developed by a SPO.

BNP Paribas Asset Management[94] (BNPP AM) is an early adopter of 90/10 funds, which has helped the group to develop a solid offer of Solidarity Funds since 2003, that are accessible not only to its **own employees** and its **corporate clients** through the employee savings plans[95] (Plan d'Epargne Entreprise) but also to any **institutional investors**. Since 2015 the access to solidarity funds was extended to the **retail clients** of the bank with the launch of the fund **BNP Paribas Social Business France.** The range of BNPP AM's solidarity funds share in common a dedicated social performance reporting[96], issued and updated twice a year, describing the social enterprises that are invested in, their social impact by means of impact indicators per Social Cluster (Domaine d'Action Sociale) and an illustration of the remarkable capacity of one example of a social enterprise to find solutions to one of the societies' issues (unemployment, social and economic exclusion, homeless people…). As of the end of December 2016, the total assets under management in solidarity funds managed by BNPP AM exceeded € 1.3 billion, of which **€ 68 million are directly invested or lent into 22 social enterprises** (Figure 36).

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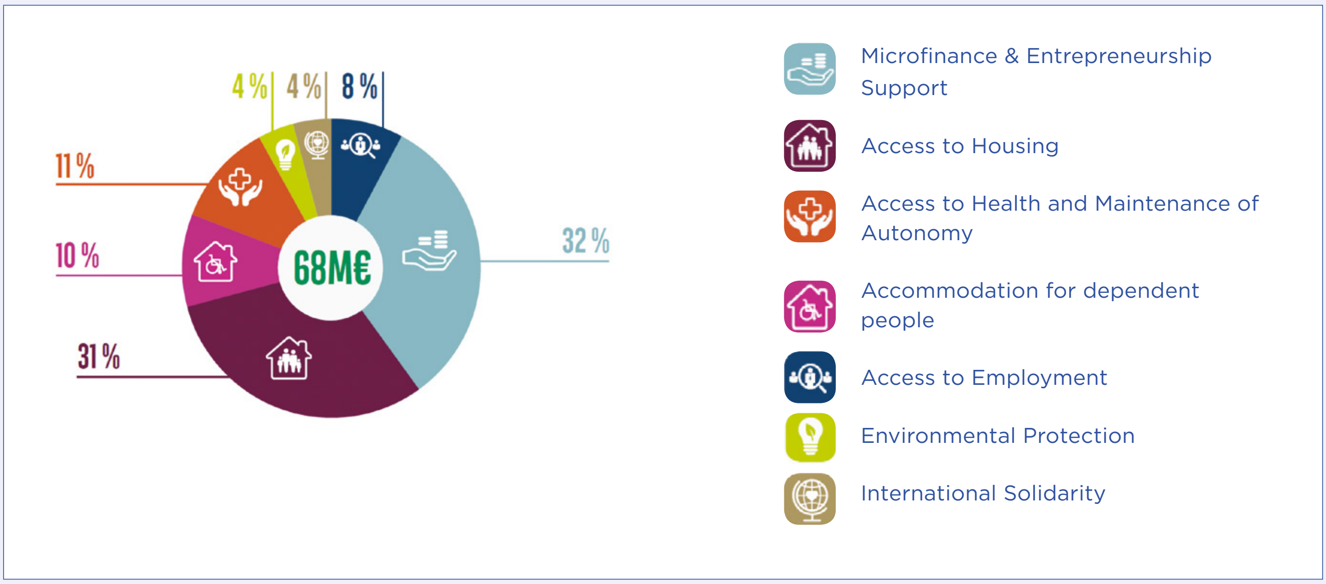
93 For more info: http://evpa.eu.com/uploads/documents/FR-Nugget-90-10-Funds.pdf
94 For more info: https://www.bnpparibas-am.com/en/
95 So far, 175,000 employees have saved their money in BNP Paribas solidarity funds.
96 For more info: http://docfinder.is.bnpparibas-ip.com/api/files/D86FACC4-5851-4153-9675-9048A3A3595C

Figure 36: Share invested into social enterprises
(*Source: BNP Paribas AM as of 31/12/2016*)



France Active[97] is a French non-profit Financial Network specialised in impact investment into mission-driven small and medium enterprises. Thanks to its network made of 42 affiliated local associations, France Active is acting locally.

Through **various financial instruments** such as grants, bank loans guarantees, middle term loans, and equity investment, France Active offers a **large panel of financial solutions to social entrepreneurs**. In addition to this, strategic advice services, solutions of networking to help the entrepreneurs in their search of money are available.

France Active has a long practice of **hybrid partnership** to achieve its social mission collecting private and public funds from various investors, such as the European Investment Fund, and the Caisse des Dépôts[98] in France.

Through its Investment Company (**Société d'Investissement France Active** – SIFA)[99], France Active collects each year an **important amount coming from 90/10 Funds**. They have partnerships with the main asset companies in France, such as Mirova[100], Humanis Gestion d'Actifs[101] and BNP Paribas, and they collect the "solidarity-based" part of the 90/10 Funds they managed. In 2016, through the SIFA, they invested **€ 18.8 million** in more than **320 SPOs.**

97 For more info: http://www.franceactive.org/
98 For more info: http://www.caissedesdepots.fr/
99 For more info: http://www.franceactive.org/default.asp?id=2790
100 For more info: http://www.mirova.com/en-BE/p
101 For more info: https://epargne.humanis.com/entreprise/mon-information/humanis-gestion-dactifs

Simplon.co[102] represents a specific example of a social enterprise receiving financial support from a 90/10 fund. Since 2013, Simplon.co offers free professional trainings from 6 to 12 months in the digital domain, based on the practice and mutual assistance and addressed to unemployed people and school dropouts. In the first four years, nearly 800 people have been trained of which 78% found a job less than 6 months after the training.

France Active has supported the growth of the business Simplon.co: after a first loan of € 75,000 in 2015, in 2016 SIFA led the first fundraising campaign for Simplon.co. SIFA contributed with € 750,000 and pooled other seven investors, including the Caisse des Dépôts, for a total amount of € 4.75 million. Additionally, Simplon.co benefits from an investment of € 250,000 from the 90/10 fund "Insertion Emplois Dynamique".

Simplon © Frédéric Bieth

102 For more info: https://simplon.co/

PART 4.
TAILORED FINANCING AND HYBRID FINANCE
What is next?

DUO for a JOB © KOIS Invest

PART 4. TAILORED FINANCING AND HYBRID FINANCE
What is next?

Tailored financing and hybrid finance can represent a way to solve the existing funding gap that prevents social purpose organisations from gaining access to the capital needed for achieving financial sustainability and for scaling. SPOs might need different types of financial support at different stages of their development but, since the diverse actors in the VP/SI space and other potential traditional funders operate in isolation, there are many difficulties for SPOs to find the appropriate financing mix to scale their social impact (European Commission, 2016).

Thanks to this research we have identified a number of challenges, learnings and recommendations for the VP/SI sector, which are summarised in this part of the report.

1. CHALLENGES

As main conclusion of this research, we see that **tailored financing** and **hybrid finance** promote a more efficient and effective deployment of resources in the VP/SI space.
However, there are some challenges while trying to benefit from these two practices.

On the social purpose organisation's side:

1. Even in case the SPO has the potential to grow quickly, it is ***not easy to move away from philanthropic financing sources towards more commercial capital***. In fact, the majority of investors are waiting at the end of the investment pipeline and commercial investors normally start to find a concrete interest in investing in social purpose organisations once social investors commit and the business model is sufficiently proven. With lower and delayed returns on offer, social purpose organisations have historically found it difficult to attract traditional investors. In the current, low-yield environment experienced since the financial crisis of 2007 there are some signs that this tendency may change.

2. The financial ecosystem for social purpose organisations is still dominated by two prevailing mentalities: either money given without expecting any positive financial return or any capital repayment (i.e. the provision of grants) or investments made to realise market-rate returns. However, ***SPOs that have the potential to also generate financial returns, such as social enterprises, challenge this traditional separation because they combine for-profit and non-profit elements***. Therefore, they often do not fit into the traditional "binary" funding models and face serious financing challenges. As a result, there is a lot of impact that could be leveraged by venture philanthropists and social impact investors with financing models that can fill in the space between -100% returns and the market-rate returns.

3. ***There is not sufficient patient investment capital available to finance the so-called "valley of death"***. It is hard for SPOs – especially in the early stages of development – to attract appropriate funding to grow and scale the social impact. In fact, without risk-adjusted rates of return, it is hard to raise investments from mainstream and even financial first impact investors. Furthermore, business models with high working capital needs are difficult to finance without a track record. Due to the difficulty to attract both commercial capital, and social investment capital from finance-first impact investors, early stage SPOs face a strategic financing gap that leads to a potential failure in their growth.

4. ***Legal constraints in certain countries make it difficult (if not impossible) for SPOs to accept social finance*** (i.e. loans, equity and hybrid financial instruments). The legal structure can be a blocking factor for the development of an SPO towards more sophisticated financial instruments and even towards self-sustainability. For example, if the organisation to support is a charity, meaning that its legal nature is not suitable for raising investments and it can collect just grants, it might not access the right type of capital needed to grow and scale.

5. ***Too few SPOs that have the potential to attract equity rely on it***. Many SPOs develop products and services for the public market and, as such, tend to develop "over-reliance" on the public market "stepping in". This over-reliance is one of the main challenges of the VP/SI sector as it prevents the SPO from sufficiently thinking about its business model and the market's/purchaser's price sensitivity and true added value, as well as ease of adaption to the end user. Taking on equity investment can help start-up SPOs that have the potential to achieve self-sustainability to grow. Raising equity requires SPOs to present from the beginning to its investor(s) a pathway towards financial sustainability and a commitment to achieve it within a specified time-frame.

6. More and more SPOs have a hybrid business model, which implies they can operate with a hybrid structure. The decision to split the legal structure into two separate legal entities (one for-profit that can generate revenues and take on FIs other than grants and the other one non-profit that can receive grants, ideally with favoured tax incentives for donors) can be a way to solve the issue of combining different sources of capital. However, ***for the SPO it might be extremely challenging to run these different entities in parallel and to take on different forms of investment***. Even if the SPO overcame this challenge, the investor relationship management might become more difficult as it has to manage different expectations. Hybrid solutions can be a way to solve the issue of combining different sources of capital. However, even if the SPO found a good financing solution which is a hybrid one, ***it might struggle to adapt its business structure*** in a way that can take on different forms of investment.

On the VP/SI organisation's side:

1. ***Traditional funders/donors from the charity world have little understanding of what a hybrid investment would entail***. When the SPO is likely to generate revenues but it needs time as it is in a start-up phase in which it has to test a new technology, the VP/SI organisation should take the risk to prototype it through the deployment of grants. As soon as the SPO is able to fully develop and commercialise the technology, follow-on investors (both private and public) will join the investment. Often the providers of start-up grants have concerns about accepting that social investors enter the investment and generate financial returns by leveraging the initial grant capital they provided. Additionally, looking exclusively at hybrid structures and mechanisms, from the VP/SI organisation's perspective, they present a number of challenges, as they function as contracts and agreements that involve multiple actors.

2. ***It can be time intensive to bring together multiple actors that have different processes, ways of working, return expectations and timeframes.*** The more actors involved, also means the higher the coordination and transaction costs and it takes commitment and effort to, for example, set up multiparty collaboration, to start a negotiation of terms.

3. ***Setting up a hybrid financing vehicle or mechanism implies the need to align objectives.*** However the private actor will often (but not always) seek to transfer its risk to the public or philanthropic actor to protect its risk-adjusted return. Furthermore, determining the appropriate use of each type of capital in this context and aligning it with social impact objectives can be challenging. In fact, it can be difficult to determine the right level of "hybrid" in a structure, both in terms of whether it is needed at all (so commercial capital is not crowded out) and, if it is the case, what each actor needs to do to balance the risk burden and promote the SPO's sustainability.

4. ***There is a need for more social investment intermediaries in the VP/SI space,*** capable of integrating and absorbing the different requirements of the investors, while offering the best solutions for the investees. Hybrid financing structures can be complex, thus unless they are integrated and absorbed at the intermediary level, accessing finance will be more challenging for the SPO.

5. ***The composition of the team of the VP/SI organisation has an impact on the capability of the VP/SI organisation in managing different types of financial instruments.*** In the case of hybrid finance, the ability of the investment team is even more relevant, as the VPO/SI needs a team that is also able to handle different actors, both public and private. Currently, not many VPO/SI are set up for this.

2. LEARNINGS

2.1. Tailored financing

The **social impact objectives** of the VP/SI organisation need to be added as a dimension that should be combined into its risk/financial return considerations. Putting **too much emphasis on the expected financial returns** increases the risk of distorting the discussion about social investment. In fact, a discussion on social investment which only focuses on financial returns, without considering the social impact, contributes to create **unrealistic expectations among VP/SI organisations** (Bolis et al., 2017). Often VPO/SIs have to consider how much of their financial returns they are ready to "sacrifice" to achieve higher social impact. A risk/financial return matrix does not make this tension between social impact and financial returns explicit.

Being financed through **social investment** (thus with debt and equity instruments or hybrid financial instruments) can help govern and steer the SPO for its own benefit, as it helps SPOs that have the potential to become sustainable **install good business practices**, such as a regular reports to investors, which can improve internal processes. Business practices may only be put in place when they become relevant, i.e. when the SPO needs to repay the source of capital, as it is the case when it is funded through social investment instead of grants or other types of philanthropic funds. For example, if a SPO is financed through a form of repayable investment (such as an amortised loan), it will have to report on both social and financial metrics. An increased reporting will steer the SPO towards a more responsible use of resources. Additionally, being financed through non-grant money can help provide SPOs with credit history, which can over time enable them to address traditional financial markets (e.g. banks). There is often a strong correlation between social impact and financial success, or looking at the risk side, if the business collapses there will probably not be any social impact.

Financial instruments should not provide cheap or free money in exchange for impact. They should provide high impact potential companies and organisations with an opportunity to thrive, where few traditional investors would be motivated to give adequate financing.

The risks inherent in investing in remote locations, pioneering innovative industries, and working with underserved populations often materialise. However, VPO/SIs should not be deterred by risk and focus on more secure sectors or SPOs. They should rather seek to understand and manage risk better than peer investors in traditional capital markets.

2.2. Hybrid Finance

The first generic learning is that **there are no purely market-based solutions** for early stage financing of SPOs, due to significant external effects and high transaction costs.

Starting from this premise, first, it is essential **to prove the viability of the business model of SPOs through the initial tranches of investment coming from philanthropic investors, venture philanthropy organisations and social investors**. Concretely, this kind of investors/funders can be used to prove the viability and scalability of the SPOs' business models. By de-risking the proposition through their early commitment, these investors/funders help SPOs to attract and establish relationships with traditional and commercial investors in order to secure their funding as well. Furthermore, SPOs need to understand that it is crucial to start considering early how to attract traditional investors as well, since specialised pools of capital are limited.

Specifically, philanthropic donors and VP/SI organisations can help SPOs provide other type of investors (i.e. the more traditional ones) with proof of concept and of validity of their business to secure commercial funding. Moreover, during the validation stage, market knowledge (i.e. reliable financial projections) and impact results can contribute to attracting additional funding for SPOs. Consequently, it is good practice to establish clear goals and indicators for both social and financial performances.

Second learning: for SPOs with **hybrid business models, hybrid legal structures facilitate the combination of various financial instruments** and allow for building a self-sustaining financial system. Having a hybrid structure lets SPOs look for different investors and increase the chances of getting more and diverse sources of capital. Thus, creating new legal structures, which splits the business of SPOs into a for-profit entity raising investments (social and/or commercial) and a non-profit one raising donations, is key to deal success, for example, in countries where the social enterprise form does not exist. It can also be a perfect compromise for being business-minded while keeping a social mandate. This translates into a suitable flexibility for mobilising and allocating hybrid financing.

However, there is also a number of downsides for SPOs having a hybrid structure, namely:

- There is additional complexity when running two legal entities with different legal frameworks and tax laws.
- There can still be tensions between the two entities, since they have different goals/targets (one to be profitable, other purely impact-oriented). So instead of having tensions between profit and social impact within the same entity, you can have them between two entities.

Third learning, it is consequently important that the **mind-set of the funders/donors is aligned** with the transition from a SPO's organisational structure that can receive just grants to a structure that allows other type of FIs. Funders/donors have to understand the relevance of this switch and the possibilities that they have by, for instance, using VP/SI money as catalyst. Thus, the original funders/donors have to learn how their donations and grants could be channelled in a better way. Additionally, the board and the management team have to be aligned as well and collaboration with valuable legal and financial advisors can be essential. Linked to those actors, there are other stakeholders that need to support the SPO in the transition (e.g. commercial banks, governments, corporates) by recognising the potential of these SPOs in becoming self-sustainable and supporting the collaboration between different investors.

As fourth learning, VP/SI organisations, commercial investors and all the other stakeholders need to understand that tailoring the financial offer and/or taking part in a hybrid financing vehicle and/or mechanism **takes time and a lot of effort** in order to develop an efficient VP/SI market. The results, both in terms of social impact achieved and of financial returns generated, will be achieved most probably in the mid-term or even in the long-term.

Lastly, hybrid finance opens up a highly divided market of pure philanthropy and pure commercial investment, in order to give space for the **true complexity of the market**, in which SPOs act at the intersection between both, and are particularly in need of funding that reflects their character of being neither purely philanthropic nor purely commercial. However, at present, there is very little demand from SPOs for hybrid finance. This is largely due to a lack of knowledge about available FIs, as well as a current lack of supply.

3. RECOMMENDATIONS

There is still the need in the VP/SI sector – on both the VPO/SI's and the SPO's sides – to **raise awareness on financial instruments** and how **they relate with stage of development, risk, social impact and financial returns**.

For **tailoring** to be successful, VP/SI organisations need to enter into a mind-set that puts the **SPO at the centre of the decision,** and adopt a deal-by-deal approach to build customised financing packages that fit with the needs of the investee, instead of offering a one-size-fits-all solution. VPO/SIs need to consider all the relevant aspects linked to both the VP/SI organisation and the SPO that can have implications on the financial instruments to use before deciding if and how to invest. VP/SI organisations need to adopt a more systematic approach to deal screening and due-diligence, which should include **considerations about the appropriateness of the financial instruments** that should be used, with particular attention to the revenue and cost profile of the SPO. **Social investment intermediaries** can help in this respect, as they have the capabilities to link potential investors and donors on the supply side with SPOs on the demand side.

On their side, before accepting social investment (in the form of debt and equity instruments or hybrid financial instruments), **SPOs** need to assess their own "**investment readiness**", and – if necessary – work on the gaps (making sure, for example, that the middle management team is ready and that a system to manage the new form of funding is in place).

One of the challenges highlighted in this report is the lack of **funding for the early stages of development of the SPO**.

As we have seen in this report, **grants are fundamental for the VP/SI sector**, for a number of reasons, including their role in creating a market or a public good and in helping build proof of concept in the seed stage.

Philanthropic capital is still extremely relevant in financing SPOs as it is a **crucial leverage to raise investment capital** (especially for developing social innovations to reach marketability). It is crucial to **raise awareness among philanthropists about the role they can play** in helping social businesses move to social-investment or hybrid models.

Hybrid financial instruments, such as mezzanine finance, can also be a very **flexible financial tool to finance those SPOs with a potential to become self-sustainable in their early stage** and can be customised to their individual needs.

Specifically, **hybrid financing vehicles** can also help fund early stage SPOs, as these innovative funds collect resources from a broad range of funders to develop tailored financing solutions.

However, VP/SI organisations need to be educated about both the **advantages and the challenges of hybrid financing structures (i.e. vehicles and mechanisms)**. In particular, VP/SI organisations need to assess in which case it is advisable to use a hybrid approach, rather than to use it just because it is the hype of the moment. In fact, the most effective way to attract resources into the VP/SI space is to clarify the connection between the social investment and its **social impact**. The VP/SI organisation should recognise the **centrality of the social impact** as the driver of the investment and understand that impact measurement allows the SPO to track impact from day one and mobilise social funders for the validation and scaling stages of the SPO. Focussing on the **effectiveness of social solutions to tackle specific social problems** is the most effective way to help the SPO attract more funders down the line. Additionally, the VP/SI organisation needs to take into consideration that not all SPOs will immediately buy in or understand the concept of hybrid. Thus, it is important that the VPO/SI structures hybrid financing packages that also foresee to **provide non-financial support to the SPO, through technical assistance and mentoring** for example.

For a VPO/SI, it can also be **difficult to sell the concept of "hybrid finance" internally**. For example, most VP/SI organisations are not set up with a cooperative mind-set, so for many of them the idea of being part of a hybrid financing vehicle or setting up a hybrid financing mechanism in cooperation with other actors can be difficult to accept. Thus, we recommend the management team of the **VPO/SI engages its board and own funders/investors early on**, also with the help of **specialised social investment intermediaries**, so they understand the implication of the VP/SI organisation being involved in a hybrid investment.

Similarly, SPOs that want to go towards building a hybrid structure (meaning two separate legal entities) need to think strategically and be aware of the pros and cons of such choice. More complex structures call for stronger leadership and more skilled management teams, capable of managing multiple sources of funding and multiple types of financial instruments.

It is important also to point out potential risks around hybrid financial instruments and hybrid financing vehicles and mechanisms. One of the risks is that VP/SI organisations are "repackaging" deals in nice new hybrid finance investments, but with underlying assets of a varying quality. Thus, even if the packaging is attractive enough to bring more money into the VP/SI sector, if the underlying SPOs are not solid (for example only few SPOs have really succeeded in scaling, and many fail) a wider range of stakeholders will end up being disappointed.

4. CONCLUSIONS AND NEXT STEPS

Tailoring the financial instrument(s) to the needs of each investee is important both to guarantee the success of the specific investment/SPO/project and to guarantee an **efficient and effective allocation of resources in the VP/SI space**. **Hybrid finance** can help in this respect, as it fosters the **collaboration of multiple capital providers** in the ecosystem and the use of **different financial instruments,** including the hybrid ones.

We believe that it is necessary to take a tailored financing approach and stimulate and promote the creation of more and better hybrid financing mechanisms and structures, which will contribute to a **more efficient allocation of the capital available in the sector**. Moreover, we believe it is important to inform venture philanthropy organisations and social investors on **how to use hybrid financial instruments in order to combine features of the main financial instruments** (i.e. grants, debts and equity instruments) to better match the needs of the SPOs, especially those that have the potential to generate revenues and become self-sustainable (e.g. social enterprises). It would also be useful to evaluate the efficiency of HFIs vis-à-vis traditional financial instruments (i.e. grants/debt and equity instruments).

Looking at hybrid finance, it is necessary to monitor its development over time and **evaluate the efficiency of hybrid financing vehicles and mechanisms**. It will also be necessary to see whether hybrid finance will have managed to attract more capital into the VP/SI space. If hybrid finance becomes mainstream, **the added value that it brings into the VP/SI space will need to be assessed**, looking in detail at if and how social purpose organisations have benefitted from it. Additionally, more research is needed to determine which financing structures and mechanisms are more effective.

As next steps, we will work on **disseminating the learnings and recommendations** in tailoring the financial instrument(s), including the use of hybrid financial instruments, and on how to set up hybrid financing vehicles and mechanisms in impact investment, focussing on the advantages and openly discussing the challenges.

We believe there are **many more examples of hybrid finance** and **potentially other elements to be taken into consideration while customising the FIs deployed**, than the ones discussed in this report. More needs to be done by researchers, who can give a clear contribution in this still underexplored area of development of venture philanthropy by, for example, collecting data on the impact that the different hybrid financing structures have on increasing the resources channelled towards the VP/SI sector.

At EVPA we will **keep on monitoring the best practices** developed in the VP/SI space, to understand what works and what does not. Additionally, we will work on developing more in-depth knowledge around **impact strategies** of VP/SI organisations and on collecting **data on the sector** and **case studies** that will allow us to understand how tailored financing and hybrid finance are evolving.

The European Commission Expert Group on Social Entrepreneurship (GECES) highlights some **barriers and deficiencies that prevent SPOs from accessing adequate funding** in its latest report [103].

Social enterprises often lack the internal capacity to become self-sustainable (as, for example, they may not be strong on financial management, marketing, communication, etc.) and they do not fit many predefined funding criteria for commercial investors. Furthermore, due to their size, the financing amounts that they normally need are relatively small, which means that financial intermediaries incur high transaction costs, which make social enterprises less attractive for traditional commercial lenders.

Externally, there is a general lack of understanding of the risk/returns, a lack of incentives, and regulatory hurdles associated with investing in social enterprises. Therefore, on the financing side, there is the need to grow the VP/SI community, including the broader mainstream funding community. In fact, there is an urgent need to bring in more actors from across the entire spectrum, in order to support social purpose organisations more efficiently. Thus, SPOs will benefit from the presence of various types of funders, in terms of additional skills provided, diverse experiences and points of view brought in, additional resources, etc. The role of hybrid finance becomes fundamental in this respect, as VP/SI organisations find new structures and mechanisms to accommodate the different needs and expectations of different types of funders.

On the other hand, on the market infrastructure side, it is important to ensure an alignment between public and private funding priorities. Moreover, there is a need to develop appropriate and sufficient financing vehicles and mechanisms to mobilise public resources leveraging existing private funding, to encourage the public participation in social investments together with philanthropic and social investment actors, in order to increase the support provided to SPOs.

103 To have access to the report **GECES (Commission Expert Group on Social Entrepreneurship),** (2016), "*Social enterprises and the social economy going forward – A call for action*", European Commission: http://ec.europa.eu/growth/tools-databases/newsroom/cf/itemdetail.cfm?item_id=9024

Glossary

Beneficiaries
The people, communities, broader society and environment that a SPO seeks to reach through its activities. Beneficiaries can be affected positively or negatively by the activities of the SPO.

Blended Finance
The OECD defines blended finance as "*the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets*" (OECD, 2016; OECD/WEF, 2016; OECD/WEF, 2015a; OECD/WEF 2015b).

Business model
A business model describes the rationale of how an organisation creates, delivers, and captures value, in economic, social, cultural or other contexts. The process of constructing a business model is part of the business strategy. In theory and practice, the term business model is used for a broad range of informal and formal descriptions to represent core aspects of a business, including purpose, business process, target customers, offerings, strategies, infrastructure, organisational structures, sourcing, trading practices, and operational processes and policies including culture.

Co-investment (also known as Co-funding)
In private equity, co-investment is the syndication of a financing round or investment by other funders alongside a private equity fund. In venture philanthropy, it involves the syndication of an investment into a social purpose organisation (SPO), by other funders (e.g. grant-makers or individuals) alongside a venture philanthropy organisation.

Convertible loans and convertible debts
Convertible loans and convertible debts are "*two different circumstances in which the loan may be converted into equity.*" In both cases we are looking at *"a loan that has to be repaid. However, in one circumstance, because the lender is willing to vary the loan terms in the borrower's favour, the borrower gives the lender rights to exchange its creditor position for an ownership in the enterprise at a later date. In another, more challenging circumstance, a loan is converted into equity either because the borrower's regulator requires the intermediary to bolster its capital or upon the occurrence of a future funding round. It is particularly useful where the enterprise is so young that a valuation is not possible and an equity price cannot be set*" (Varga and Hayday, 2016).

Deal flow
Deal flow refers to the number and/or rate of new proposals presented to the investor. This term is used with respect to venture capital/private equity funds, venture philanthropy funds, and has also been borrowed and used by philanthropists in reference to 'deals' or potential projects to be awarded grants.

Debt instruments
Debt instruments are loans that the VP/SI organisation can provide to the SPO, charging interest at a certain rate. The interest charged can vary depending on the risk profile of the investee and on the securitisation and repayment priority of the loan (senior vs subordinated loan).

Due diligence
Due Diligence is the process where an organisation or company's strengths and weaknesses are assessed in detail by a potential investor with a view to investment.

Equity instruments
Equity instruments are contracts through which a VP/SI organisation provides funding to SPOs and in return acquires ownership rights on part of the SPO's business. This can be appropriate when the prospect of a loan repayment is low or non-existent. If the SPO is successful, the equity share holds the possibility of a financial return in the form of dividend payments. In addition, it allows for the possibility of a transfer of ownership to other funders in the future.

Exit

The end of the relationship between the venture philanthropy investor and social purpose organisation (SPO). The nature of the exit will normally be agreed before the investment is completed. In the case of a charity, the venture philanthropy funder will ideally be replaced by a mix of other funders (see financial sustainability). The time scale for the exit can be agreed upon at the outset. In the case of a social enterprise, exit may require the repayment of a loan, for example, and the timing will depend on the commercial success of the enterprise. An exit strategy is the action plan to determine when the VP/SI organisation can no longer add value to the investee, and to end the relationship in such a way that the social impact is either maintained or amplified, or that the potential loss of social impact is minimised.

Financial instruments

Financial instruments are contracts involving monetary transfers through which, in the VP/SI space, venture philanthropy organisations and social investors financially support social purpose organisations.

Financial sustainability

Financial sustainability for a social enterprise is the degree to which it collects sufficient revenues from the sale of its services to cover the full costs of its activities. For charities, it involves achieving adequate and reliable financial resources, normally through a mix of income types.

Foundation

Public-benefit foundations are asset based and purpose-driven. They have no members or shareholders and are separately constituted non-profit bodies. Foundations focus on areas ranging from the environment, social services, health and education, to science, research, arts and culture. They each have an established and reliable income source, which allows them to plan and carry out work over a longer term than many other institutions such as governments and companies. In the context of VP, foundations are non-profit organisations that support charitable activities either through grant making or by operating programmes. *Source:* www.efc.be

Fund

A fund is a vehicle created to enable pooled investment by a number of investors and which is usually managed by a dedicated organisation.

Grants

Grants are a type of funding in the form of a cash allocation that establishes neither rights to repayments nor any other financial returns or any form of ownership rights on the donor.

Grant-maker

Grant-makers include institutions, public charities, private foundations, and giving circles, which award monetary aid or subsidies to organisations or individuals. Generally known as foundations in Continental Europe, grant-makers also include certain types of trusts in the United Kingdom.

Guarantee

A guarantee is a promise by one party (the guarantor) to assume the debt obligation of a borrower if that borrower defaults. A guarantee can be limited or unlimited, making the guarantor liable for only a portion or all of the debt. In the VP context, guarantees are one of the financial instruments available for VP/SI organisations to support SPOs. The VP/SI organisation in this case does not need to supply cash up-front, but it opens up access to bank funding by taking on some or all of the risk that the lender would otherwise incur.

High-engagement partnership

Creating hands-on relationships between the supported organisation's management and the VP/SI organisation. This practice foresees VPO/SIs taking board seats in the organisations they invest in or give a grant to, and/or to frequently meet with investees' management.

Hybrid financial instruments (HFIs)

HFIs are monetary contracts that combine features of the traditional FIs (grants, debt instruments and equity instruments) in order to achieve the best possible alignment of risk and impact/financial return for particular investments.

Hybrid financing mechanisms
Financing schemes developed, on a deal-by-deal basis, to increase the resources brought to impact-oriented investments by reducing the risks associated with achieving impact or financial goals.

Hybrid financing vehicles
Funds set up to provide finance to the SPOs in a more efficient way, while satisfying different risk/return/impact profiles of investors. These vehicles are typically managed by VP/SI organisations acting as financial intermediaries.

Hybrid structure
The hybrid structure of the SPO is a combination of a for-profit entity and a not-for-profit entity. The hybrid structure is an innovative way to address the issue of access to finance. By setting up a hybrid structure, the SPO can attract grants through the non-profit entity and social investment through the for-profit entity, hence increasing the pool of resources available while channelling them in the most effective way.

Impact investing
Impact investing is a form of investment that aims at generating social impact as well as financial return.

Impact measurement
Measuring and managing the process of creating social impact in order to maximise and optimise it.

In-house resources
Resources provided within the venture philanthropy organisation itself, through its staff members or volunteers, as opposed to people within the greater network of the venture philanthropists, service providers, or portfolio organisations.

Investee
The social purpose organisation that is the target of the VPO/SI activity and the recipient of financial and non-financial support.

Investment
An investment is the use of money with the expectation of making favourable future returns. Returns could be financial, social, and/or environmental.

Mezzanine finance
Mezzanine finance is a hybrid of debt and equity financing, usually used to fund the scaling of an organisation. Although it is similar to debt capital, it is normally treated like equity on the organisation's balance sheet. Mezzanine finance involves the provision of a high-risk loan, repayment of which depends on the financial success of the SPO. This hybrid financial instrument bridges the gap between debt and equity/grant through some form of revenue participation. Examples include a loan that is only repayable through royalties based on the future sales of a product or service; or a royalty-sharing agreement that can be activated once an agreed profitability threshold has been reached. These hybrid financial instruments can offer an appropriate balance of risk and return (Balbo et al., 2016).

Non-financial support
The support services VP/SI organisations offer to investees (SPOs) to increase their societal impact, organisational resilience and financial sustainability, i.e. the three core areas of development of the SPO.

Organisational development
Added value support services that VP/SI orgnisations offer to investees (SPOs) to strengthen the SPO's organisational resilience and financial sustainability by developing skills or improving structures and processes.

Organisational resilience
The assessment of the degree of maturity of an SPO, in terms of the degree of development of the management team and organisation (governance, fund raising capacity etc.).

Organisational support (also known as capacity building)
Approach aimed at strengthening organisations supported to increase their overall performance by developing skills or improving structures and processes.

Outcomes
The changes, benefits, learnings, or other effects (both long and short term) that result from the organisation's activities.

Outcome-based mechanisms
Contracts through which societal challenges are tackled in an innovative way, by stimulating the efficiency of social investors to generate a greater social impact. Outcome-based mechanisms are contracts financed by a risk-taking social investor to de-risk (from an impact risk perspective) the investment for other type of actors, such as public entities (see below the examples of SIBs), philanthropic donors (see below the example of DIBs) and commercial investors (see below the example of the Social Success Note)

Outputs
The tangible products and services that result from the organisation's activities.

Portfolio
A portfolio is a collection of projects and/or organisations that have received sponsorship from the investor. A distinction is often made between 'active' and 'past' portfolio, distinguish between the organisations with which the investor is actively involved. Usually, however, all portfolio organisations are included in the greater network of the investor.

Pre-investment stage
The pre-investment stage is the process during which the investor examines the operations and leadership of the project or organisation with a view towards making an investment. This might include a detailed review of the financials, operations, or reference checks for organisational leaders. The term due diligence is also used, which has a legal definition as a measure of prudence. In other words, the investor is assessing if it is likely to get what it thinks it is paying for.

Private equity
Ownership in a firm which is not publicly traded and which usually involves a hands-on approach and a long-term commitment for the investors.

Recoverable grants
Recoverable grants are grants that can be returned to the VP/SI organisation, under certain terms and conditions agreed in advance by the VP/SI organisation and the SPO. Recoverable grants are "*designed to focus the recipient on sustainability and reduced risk of grant dependence*". (Varga and Hayday, 2016).

Return on Investment (ROI) (see also Social Return on Investment (SROI)
The Return on Investment (ROI) is the profit or loss resulting from an investment. This is usually expressed as an annual percentage return.

Scaling up
Processes of developing and growing the activities of an SPO to expand its social reach and increase its social impact.

Seed financing
Seed financing is money used for the initial investment in a start-up company, project, proof-of-concept, or initial product development.

Social enterprise
Social enterprise is an organisation that focuses on achieving social impact, applying market-based solutions to address public sector and market failure in innovative ways. Social enterprise can take on a variety of legal forms. (*Source:* Maretich, M., and Bolton, M., (2010), "Social enterprise: From definitions to developments in practice", EVPA.)

Social entrepreneur
Social entrepreneur is defined by the Schwab Foundation as "a leader or pragmatic visionary who:

- Achieves large scale, systemic and sustainable social change through a new invention, a different approach, a more rigorous application of known technologies or strategies, or a combination of these.
- Focuses first and foremost on the social and/or ecological value creation and tries to optimise the financial value creation.
- Innovates by finding a new product, a new service, or a new approach to a social problem.
- Continuously refines and adapts approach in response to feedback." (*Source:* http://www.schwabfound.org/content/what-social-entrepreneur)

Social finance (or investment)
Social finance "may be understood as a broad area wherein various forms of capital are structured in ways that consider and value both financial performance and social value creation".
Source: Emerson, K. Freundlich, T. and Fruchterman, J. (2007), "*Nothing Ventured, Nothing Gained:*

addressing the critical gaps in risk taking capital for social enterprise" Skoll Centre for Social Entrepreneurship, Said Business School, University of Oxford.

Social impact

The attribution of an organisation's activities to broader and longer-term outcomes. To accurately (in academic terms) calculate social impact you need to adjust outcomes for: (i) what would have happened anyway ('deadweight'); (ii) the action of others ('attribution'); (iii) how far the outcome of the initial intervention is likely to be reduced over time ('drop off'); (iv) the extent to which the original situation was displaced elsewhere or outcomes displaced other potential positive outcomes ('displacement'); and for unintended consequences (which could be negative or positive).

Social investment intermediaries

Organisations that aim at increasing the pool of financial resources available for SPOs to reach and scale their social impact by bridging the demand and the supply side of capital, channelling funds towards SPOs in a more efficient way and bringing more resources into the VP/SI space.

Social Purpose Organisation (SPO)

An organisation that operates with the primary aim of achieving measurable social and environmental impact. Social purpose organisations include charities, non-profit organisations and social enterprises.

Socially Responsible Investing (SRI)

Also known as sustainable, socially conscious, "green" or ethical investing, this term defines any investment strategy seeking both financial return and social good. In its broadest usage, SRI refers to proactive practices such as impact investing, shareholder advocacy and community investing. Socially responsible investments encourage corporate practices that promote environmental stewardship, consumer protection, human rights and diversity. They can also represent the avoidance of investing in industries or products that can be socially harmful, including alcohol, tobacco, gambling, pornography, weapons and/or the military. The term dates back to the Quakers, who in 1758, prohibited members from participating in the slave trade.

Social Return on Investment (SROI)

The SROI concept, essentially a cost-benefit analysis, is used by charities, donors and non-profit organisations to rate the results of their endeavours with firm evidence of impact and value created. The idea of social return on investment was pioneered in the 1990s by a U.S. venture fund called REDF and has since caught on.

Social venture capital

Social venture capital is an enterprise approach to tackling social problems through investment, supporting the creation and the expansion of commercially sustainable enterprises to maximise social and financial returns. In developing countries, this approach is used to create jobs and empower the poor.

Tailored financing

The process through which a venture philanthropy organisation or a social investor (VP/SI organisation) finds the most suitable financial instrument(s) to support a social purpose organisation (SPO), choosing from the range of financial instruments available (grant, debt, equity, and hybrid financial instruments). The choice of the financial instrument(s) will depend on the risk/return/impact profile of the VP/SI organisation and on the needs and characteristics of the SPO.

Venture philanthropy

VP is a high-engagement and long-term approach to generating social impact through three practices:

- Tailored financing: using a range of financial instruments (including grants, debt, equity and hybrid financial instruments) tailored to the needs of organisation supported.
- Organisational Support: added-value support services that VP/SI organisations offer to investees (SPOs) to strengthen the SPO's organisational resilience and financial sustainability by developing skills or improving structures and processes.
- Impact measurement and management: measuring and managing the process of creating social impact in order to maximise and optimise it.

Venture Philanthropy Organisation (VPO)

Organisations following the venture philanthropy approach. A Foundation can be a VPO.

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The European Venture Philanthropy Association (EVPA)

Established in 2004, EVPA works to enable venture philanthropists and social investors to maximise societal impact through increased resources, collaboration and expertise.

EVPA's membership covers the full range of venture philanthropy and social investment activities and includes venture philanthropy funds, social investors, grant-making foundations, impact investing funds, private equity firms and professional service firms, philanthropy advisors, banks and business schools. EVPA members work together across sectors in order to promote and shape the future of venture philanthropy and social investment in Europe and beyond.

EVPA is committed to support its members in their work by providing networking opportunities and facilitating learning. Furthermore, we aim to strengthen our role as a thought leader in order to build a deeper understanding of the sector, promote the appropriate use of venture philanthropy and social investment and inspire guidelines and regulations.

http://www.evpa.eu.com

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