The Harris Report

Show Me the Money!

The Potential for Large Scale Private Sector Investment in Social Enterprise & Simultaneous Large Scale Growth of the Social Enterprise Sector

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FOREWARD

In the spring of 2003, around the time that tax credits for community development finance came into effect, I began meeting with Mark Hambly and Bob Brennan from the Small Business Service of the Department of Trade and Industry to discuss my concerns about the issues involved in bringing large scale private sector finance into social finance.

My background as a corporate finance lawyer in the City, including pro bono work for a large international micro-finance organisation, has given me a perspective that is different from that of many others engaged in the sector.

In September 2003, I presented a Continuing Professional Development training to a large City law firm that was accompanied by a paper entitled 'Towards Viable Social Finance' and I shared a copy of it with Mark and Bob.

Our discussions continued, and in late June 2004, I began work on the 6-month research project funded by the Phoenix Fund of the Small Business Service of the Department of Trade and Industry[1] that has led to this report.

The research for this report has resulted in a dozen recommendations that I believe will contribute substantially to fast-tracking the growth of both social finance and social enterprise as well as fast-tracking the benefits of regeneration accompanying this growth.

It is with great pleasure that I present this report to the Small Business Service in particular and to the social finance and social enterprise sector as a whole. Many people within this sector have made great contributions of time, expertise and perspective to this research, and I thank you all. A number of you are mentioned specifically at various points throughout this report. At this point, I would like to especially thank Tina Baker, Ron Borod, Mark Ford, Annette Furley, Peter Head, John Hopkins, Roger Lansdown, Ian Lush, Karen Mason and Ian Williams – as well as Mark Hambly and Bob Brennan – for their support throughout the process of this report.

However, the specific analysis and recommendations in this report are mine, and I alone take responsibility for them. I certainly hope that all of us can continue to work together to help both social finance and social enterprise in the UK grow to reach its potential as quickly as possible.

In the last few years, the Government has opened a wonderful window of opportunity with legislation, strategy development and funding prioritisation. It is now up to all of us to open that window even wider. I hope that this report will facilitate that process.

Marcia Harris
31 December 2004

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EXECUTIVE SUMMARY

This report argues that:

(1) An integrated, sector-based approach will fast-track regeneration, the development of social enterprise and the attraction of large scale private sector investment into social finance.

(2) Providing the infrastructure that will facilitate private sector investment and targeting those sectors most likely to benefit from specific sector-based social finance will attract large-scale private sector investment since investors will have market-competitive investment opportunities that will enable them to do well at the same time as doing good.

The report is divided into three main chapters, each of which includes four recommendations. These dozen recommendations are also listed consecutively in the final chapter, *Summary of Recommendations*.

The first chapter, *Doing Good and Doing Well: Social Finance and Social Enterprise Support,* looks at the two main principles outlined above as they apply to the sector as a whole. It provides an analysis of some of the assumptions that are holding back growth of the sector and makes recommendations to improve the efficiency of the sector through consolidation and assessment of the contribution of different sectors.

This chapter promotes the idea that large-scale investment into the sector is most likely to occur when investors (whether corporate or charitable) are able to do well (with market-competitive terms) at the same time that they are doing good, and provides specific recommendations of how to make minor modifications in the existing legislation in order to do so.

The second chapter, *Fast-tracking Regeneration: Asset-based CDFI Investment for the Heritage and Creative Industries Sectors,* focuses on two sectors – heritage and creative industries – that have demonstrated their capacity to fast-track regeneration and develop social enterprise, and recommends ways to support these sectors in order to attract large-scale private sector investment.

With a detailed legal analysis of how to work within the current legislation and regulation, it provides a model for development of a market-competitive investment vehicle (asset-backed bond offerings of £200 million or more offering community investment tax relief) to foster the development of cultural hubs in disadvantaged areas and of restoration of heritage buildings for use as community facilities and regeneration focal points. It also points to specific types of private sector investors who would have the most to gain from this type of investment.

The third chapter *Fast-tracking Social Enterprise Development: Horizontal Integration in Sustainable Community Trusts*, looks at the role multi-enterprise community trusts can play in

enabling social enterprises to grow in size and sophistication. It focuses on practical models and methodologies for developing large, sophisticated social enterprises that can take advantage of large-scale private sector investment in housing growth areas and on the potential for new sources of funding based on gains from energy-efficiency.

Chapter 1

DOING GOOD AND DOING WELL:
SOCIAL FINANCE AND SOCIAL ENTERPRISE SUPPORT

1.1 The beginning of the 21st century in the UK saw the launch of a number of important initiatives overseen by the Small Business Service (SBS) of the Department of Trade and Industry (DTI) to bring the benefits of British economic success to all members of the population. These initiatives included the actions taken as a result of the recommendations of Social Investment Task Force; in particular, the development of Community Investment Tax Relief (CITR), Community Development Finance Institutions (CDFIs) and a community development venture capital fund, the Bridges Community Development Venture Capital Fund (BCDVCF), as well as the launch of the SBS Social Enterprise Strategy to provide a range of support to enable the growth of the social enterprise sector.

1.2 To provide a quick overview: the primary relevant legislation is the Finance Act 2002, Section 57 and Schedules 16 and 17, Community Investment Tax Relief (CITR Law). This legislation is supported by the Community Investment Tax Relief (Accreditation of Community Development Finance Institutions) Regulations 2003 (CITR Regulations). Together, these provide for accreditation of CDFIs as well as tax relief for investment in them, with the tax credits taking effect beginning in April 2003. Investment in an accredited CDFI, either through a debt or equity instrument, provides investors with tax credits at the rate of 5% per year for a five-year period (an aggregate credit of 25%.)

1.3 A UK body can achieve accreditation as a CDFI only if its principal objective is to provide finance (either directly, as a retail CDFI or indirectly, as a wholesale CDFI), or to provide finance and access to business advice for enterprises for disadvantaged communities, and satisfies any other criteria that may be specified in regulations made by the Treasury.[2] Only accredited CDFIs can provide tax credits, and these are only available for qualifying investments; i.e., a maximum of £250,000 into any one non-profit distributing enterprise and a maximum of £100,000 into any one profit distributing small enterprise, no investments in residential property and limitations on investments in commercial property.

1.4 The programme is designed to encourage up to £1 billion investment in start-up businesses and social enterprises in disadvantaged areas. However, at present, there is probably less than £60million invested by CDFIs. To date, there are over 60 CDFIs[3]; therefore, the average CDFI total investment is approximately no more than £1 million.

1.5 Research indicates that most CDFIs in the UK are under-capitalised[4] and rely on ad-hoc grant financing to cover their operating costs.[5] To date, growth of the sector has relied on public funding and the search for 'patient capital' that perceives the investment more as a form of 'good works' than as an investment with a competitive market return.[6]

1.6 The great majority of CDFIs receive support from the Phoenix Fund. Phoenix Fund support currently totals in excess of £42million.[7] Some of these CDFIs are also accredited by the Small Business Service to access private sector investment through the CITR mechanism. However, private sector investment represents a much smaller percentage of the investment in this sector than public sector investment. The private sector investment comes primarily from loans from large commercial banks, with very little corporate investor interest.

1.7 A vicious cycle currently exists, such that the difficulties generated by CDFIs' small size and legal constraints (inability to provide competitive lending rates, inability to take advantage of economies of scale, lack of liquidity for potential investors and related lack of interest in market-making) perpetuate the problems within the sector.

1.8 However, even without expanding the size of the borrower market, as discussed further in this report, CDFIs could benefit from some economies of scale merely from consolidation. Any single wholesale CDFI can provide £20 million in tax credits at one time and any single retail CDFI £10 million without recourse to special approval from the Treasury Department,[8] and there is no constraint on the maximum size of a CDFI.

1.9 Merging existing CDFIs under larger holding companies would enable individual CDFIs serving specialised geographic or other markets to retain their identities and focus, but would enable the consolidated company to gain economies of scale and provide back-office functions more efficiently by serving all the consolidated companies. In addition, the consolidated company, with a larger portfolio, would have a higher degree of risk-balance and that, in combination with its larger size, would make it more likely to attract private sector investment.

1.10 In addition, larger scale CDFIs will generate larger returns simply in terms of volume. This will enable them to use the interest generated on their own capital for revenue funding, rather than relying on external grants, and will therefore enhance their sustainability.

Recommendation 1: Consolidate existing CDFIs under larger holding companies so that that individual CDFIs serving specialised geographic or other markets do not lose their focus, but the consolidated company can provide back-office services to all its subsidiaries in a more efficient way, can more effectively target private sector finance since it can handle larger inputs of capital, and can demonstrate a more risk-balanced portfolio and can be more sustainable in the long run since it will eventually not require any external grant funding for its own revenue needs.

1.11 The Bridges Community Development Venture Capital Fund is a £40 million 50-50 partnership between national government and private venture capital funds.[9] BCDVF seeks growth companies at the early and expansion stages, as well as management buy-outs and buy-ins, and has so far invested in a total of 13 companies, for a total investment of just

under £10 million. The total transaction sizes in which BCDVF have invested have ranged from £125K to £18 million, with BCDVF's portion ranging from £125k to £2 million. More specifically, six companies received £500 to £700k and four received £1 million to £2 million.[10]

1.12 Thus the total amount of investment in social finance via CDFIs and BCDVF is approximately £100 million, of which no more than £70million has been invested to date.[11] As a comparison, in the US, CDFIs alone had approximately $5.7 billion of individual and enterprise loan financing outstanding at the end of 2001.[12]

1.13 BCDVF's mission is to invest in ambitious businesses in the most under-invested areas in England; provide hands-on support to help these businesses grow; make a financial return for its investors that will attract private sector investors into future funds of this type; and make a difference in its target areas by creating jobs, stimulating economic dynamism and fostering entrepreneurs who can become role models of business success in these areas. [13]

1.14 The original remit of the Social Investment Task Force makes the social inclusion and regeneration functions of the community development finance initiatives very specific. It calls for recommendations 'to set out how entrepreneurial practices can be applied to obtain higher social and financial returns from social investment, to harness new talents and skills to address economic regeneration and to unleash new sources of private and institutional investment.'[14]

1.15 Similarly, national and regional government have identified regeneration and inclusion purposes for social enterprise. A regional development agency has characterised social enterprise as 'business but not as we know it'.[15] They go on to point out that social enterprise is more than a business model; that it has the ability to embed economic growth in local communities.[16] The Government's Social Enterprise Strategy indicates that successful social enterprises can play an important role in helping deliver on many of the Government's key policy objectives by helping to drive up productivity and competitiveness; contributing to socially inclusive wealth creation; enabling individuals and communities to work towards regenerating their local neighbourhoods; showing new ways to deliver public services; and helping to develop an inclusive society and active citizenship.[17]

1.16 In 2003, the Small Business Service of the Department of Trade and Industry and the Community Development Finance Association issued reports[18] that evaluated the progress of the social finance and social enterprise initiatives respectively. While both reports justifiably noted the accomplishments achieved in only a few years, both also acknowledged the need for further work to achieve the ambitious goals outlined in the initial strategies.[19]

1.17 These reports did not, however, acknowledge some of the limitations of the current paths for achieving those goals. Existing community development finance, whether in the form of loans by CDFIs or in the form of equity investment by BCDVF, has primarily focused on relieving economic deprivation by investing in enterprises located in disadvantaged areas, although the legislation allows for CDFIs targeting specific communities of social

disadvantage, such as racial or gender groups, and there has been some investment into non-geographic communities.

1.18 When done strategically, geographic targeting can have a powerful regeneration effect. For example, BCDVF invested in Touch 'n' Glo Limited, developers of a new range of intelligent lighting solutions. The company is located in an eligible disadvantaged ward and over 40% of its employees live in eligible disadvantaged wards. As the company grows, it is expected that the number of employees will increase, with many of these new staff coming from eligible disadvantaged areas. Several of the company's key suppliers are also located in deprived areas and so the anticipated growth will also benefit those communities.

1.19 A strictly geographic approach has a significant potential shortcoming, though, since it can lead to the same negative results as private sector development; i.e., investment in disadvantaged areas that raises property values, pushing out the currently resident disadvantaged populations without giving them a share in the growth. For example, two of the investments by BCDVF – The Office and Quest Hotels – could produce this negative result if they are not carefully monitored.

1.20 Despite the identification of social enterprise sectors (see 1.__ below) and the prioritisation of regeneration results, there has been no publicly available national analysis of the type of enterprises (social or profit-making) that will be most likely both to spur regeneration and also to foster the development of the social enterprise sector in order in order to ensure that disadvantaged populations appropriately benefit from this investment. Additionally, there has been no publicly available research to indicate the relative strategic importance of the identified social enterprise sectors. The SBS Social Enterprise Unit has identified as one of its priorities for future action to 'conduct a UK-wide social enterprise mapping exercise to provide information on the size of the social enterprise sector, the number of people it employs and its contribution to the UK economy.'[20]

1.21 Not only should this mapping exercise also include the relative contributions of different sectors to the growth of social enterprise and social and economic regeneration, but a comparable mapping exercise should also be undertaken by the SBS Community Development Finance Unit to explore the types of enterprises supported by the social finance sector (both CDFIs and BCDVF) in order to identify criteria for investment that will maximise regeneration benefits, and minimise potential negative effects.

Recommendation 2: The SBS Social Enterprise and Community Development Finance Units should conduct a joint mapping exercise in order to identify contributions of different industry sectors and different types of enterprise in order to assess the implications of different types of investment for social and economic regeneration, and assist in the development of investment characteristic priorities.

1.22 In the spring of 2004, the Small Business Service of the Department of Trade and Industry approved the funding of research by Marcia Harris to explore the potential for large-scale

private sector investment in social enterprise and simultaneous large-scale growth of the social enterprise sector, with the concomitant social benefits.

1.23 The six-month research project[21] commenced at the end of June 2004 and was completed at the end of December 2004. This report is the outcome of the research project.

1.24 Specifically, the remit of the research project, as outlined in the initial proposal, was to explore some alternative approaches:

(1) to increase the capital available to social enterprise through models that will facilitate the development of large-scale market-competitive investment into CDFI and
(2) simultaneously increase the number and financial capacity of social enterprises so that social enterprises will be able to take advantage of the availability of this capital.

1.25 The proposal envisioned three components of the research:

(1) Legal analysis,
(2) Financial analysis, and
(3) Social enterprise sector impact analysis

1.26 The initial proposal identified the need for the research in part because a number of factors restrict the ability of CDFIs to attract investment so that both the CDFI sector and the social enterprise sector are growing more slowly than government, social entrepreneurs and other enterprises eligible for CDFI finance would like.

1.27 Some factors restricting growth relate directly to problems of the social enterprise sector. Low levels of financial literacy, high levels of grant dependence and consequently a high degree of risk aversion all limit demand for finance from social enterprises, which are perceived by themselves and for-profit financial institutions as unable to afford commercial or near-commercial loans. Additionally, because of their non-profit corporate structure[22] and unwillingness to make personal guarantees (generally for understandable reasons), social enterprises are perceived by traditional financial institutions as higher risk, and this constrains investment into CDFIs by those institutions. [23]

1.28 Similar, though slightly different, problems plague the small and medium enterprises (SMEs) that are eligible for CDFI finance of up to £100,000 because they cannot access traditional bank finance. Collateral continues to be a major consideration in lending over around £25,000, and borrowers without business or personal assets to offer as security may struggle to access traditional bank finance.[24] Additionally, start-up businesses, those with non-standard characteristics and those seeking to expand beyond their current asset base continue to find it more difficult than the majority of businesses to access debt finance.[25] Although a recent study found that only 40% of SMEs have sought external finance in the past two years[26], external sources of finance are particularly important for start-ups and small businesses that often lack retained profits to re-invest to support their own growth. While some of the businesses in these categories can access traditional bank finance with the addition of the Government's Small Firms Loan Guarantee, this is not the case for all of them, particularly start-up businesses and those with non-standard characteristics.

1.29 Other factors restricting the attraction of investment capital into the social finance sector relate more directly to CDFIs' own problems. As indicated earlier, a vicious cycle currently exists, such that the difficulties generated by CDFIs' small size and legal constraints (inability to provide competitive lending rates, inability to take advantage of economies of scale, lack of liquidity for potential investors and related lack of interest in market-making) perpetuate the problems within the sector. As discussed above, most CDFIs in the UK are under-capitalised[27] and rely on ad-hoc grant financing to cover their operating costs.[28]

1.30 To date, growth of the sector has relied on public funding and the search for 'patient capital' that perceives the investment more as a form of 'good works' than as an investment with a competitive market return.[29]

1.31 This approach reflects a discomfort with the idea of something that can function as 'charity plus' rather than 'investment minus' or 'charity minus'. Currently, the potential return in tax savings for a corporate investor to be earned from CDFI investment is less than the potential return from a charitable contribution of the same amount (though of course, the CDFI investment is repaid while the charitable contribution is not.) Nevertheless, for many private sector entities, there is a greater comfort with the familiar charitable contribution, and a greater public relations impact with being seen to be publicly 'doing good' than with a CDFI investment.

1.32 For the most part, actual 'patient capital' has come in the form of programme-related investment by charities.[30] With the change in charity law that now enables charities to invest not necessarily for the best return, some charitable foundations have been providing no or low-interest loans as an alternative to grant funding to their beneficiaries.

1.33 Unfortunately, this type of investment provides charities with the opportunity to 'do good' without enabling them to also 'do well.' However, there is no reason why charities should be negatively reinforced for investing in CDFIs; rather they should be encouraged to do so. While corporate sector investors can get an annual return 5% tax credit on investment in community development finance (equivalent in value to them of a 7% pre-tax return and potentially market-competitive), charities do not gain any advantage from a tax credit. They therefore loan money into the sector for little or no interest as a charitable gesture that provides them with, potentially, a return of the money invested but little more.

1.34 In the long run, this low rate of return on high risk investments does not benefit the charitable sector since trust funds will be depleted more rapidly without a competitive market rate of return, and there will therefore be less money to invest in charitable activity, whether through loans or grants.

1.35 What would be useful, then, is a type of tax credit that would be of use to charities for which corporate tax (and consequently corporate tax relief) is not relevant. For example, charities frequently cannot reclaim amounts paid in Value Added Tax since they do not engage in activities for which they charge Value Added Tax. Therefore, a tax credit against VAT would be much more functional for charities. With such a tax credit, charities could be

enabled to gain a comparable rate of return to private sector investors; i.e., a market-competitive rate.

Recommendation 3: Government departments, including SBS/DTI, Inland Revenue and Treasury, should work together to provide an alternatively based tax credit to charitable foundations and trusts that invest in CDFIs, perhaps based on tax credit against VAT, in order to enable charitable institutions to benefit as much from CDFI investment as private sector investors.

1.36 This is not to say that there has been no private sector investment into CDFIs. Two commercial banks, Barclays and RBOS/NatWest, have been the primary private sector investors in CDFIs. These banks are to be commended for their vision in supporting the sector; indeed, informal discussion with bank representatives and CDFI sector leaders suggests that this investment has not proved profitable for these banks and that some other major high street banks have actively turned away from CDFI investment.

1.37 On the other hand, CDFIs are limited in funding sources because there are no major alternatives to these banks for private sector wholesale capital for retail CDFIs. That means that CDFIs have had to accept less than ideal terms from these banks in order to access private sector capital in any significant way.

1.38 There is no reason, however, why other financial instruments developed by other financial institutions such as investment banks or insurance companies could not provide alternative sources for investment in retail CDFIs (i.e., serving as wholesale CDFIs.) Provided there is support from Inland Revenue and Treasury as well as the Small Business Service of the Department of Trade and Industry, it is possible to design financial instruments such as bond offerings that are market-competitive.

1.39 Such bond offerings would need to have a term of 10-12 years and offer a rate of return that is compatible with the level of risk; i.e., either some type of securitisation or guarantee if the rate of return is the 5% CITR or a 'top-up' to the CITR without such risk reduction. (Sections 2.35 to 2.47 of Chapter 2 provide an analysis of the CITR Law and CITR Regulations in order to demonstrate the feasibility of asset-backed financial instruments under the legislation, and the relevance of such financial instruments as a growth strategy for both the creative/cultural industries sector and the heritage sector.)

1.40 Additionally, the offering size would need to be in the range of approximately £200 million in order both to provide investors with a sufficient degree of liquidity and to generate interest by investment banks in making a market on these bonds.

Recommendation 4: Government departments, including SBS/DTI, Inland Revenue and Treasury should work together to facilitate the development of alternative private sector investment vehicles by explicitly providing for longer-term CITR for investment vehicles such as bond offerings of 10 – 12 years, and by providing financial support for the legal work necessary to initiate a pilot bond offering of this type.

1.41 To date, however, there has been insufficient business in the sector to justify a bond offering of this size so that there has been no reason to look for the support needed from various Government departments. Much of this report is devoted to ways to enable sufficient growth in CDFI-investment-eligible enterprises to warrant one or more such bond offerings.

1.42 Asset-based bond offerings are not the only possible alternative for potential investment into the sector. Chapter Three of this report discusses the role of multi-enterprise community trusts endowed with assets invested by developers and local authorities in combination with more traditional use of Section 106 funds. This chapter also identifies the potential role within such community trusts for Government-facilitated energy bonds that reward developments that build in energy-saving sustainable construction and make use of alternative energy sources such as combined heat-power. This chapter also points to the use of asset acquisition and sale as part of a financial resource package in a sector that integrates health and parks/green spaces.

1.43 Before going further, it is important to identify two assumptions that underlay the initial proposal for this research. The first is that it is useful to focus on strategic sectors, rather than try to develop a strategy that does not differentiate among different types of social enterprise and that consequently cannot identify the areas with the greatest potential for growth and the greatest potential to contribute to social and economic regeneration. This same assumption underlies other efforts in this area, such as the Government's Social Enterprise Strategy and the structuring of support by sector associations that are members of the Social Enterprise Coalition. For example, *Social Enterprise: A progress report on 'Social Enterprise: a strategy for success'*[31] published by the Small Business Service of the Department of Trade and Industry looks at a number of specific sectors, such as healthcare, services to children and family, cultural and sports opportunities and others, and the interaction with resources available through other Government departments. As another example, Social Enterprise London's services to social enterprises are delivered through sector-specific clusters.

1.44 The analysis in Chapters 2 and 3 of this report focuses on specific sectors which have been targeted because of their potential to contribute to social and economic regeneration, and because of their growth potential for social enterprises and SMEs, in order to provide a market sufficient to underpin market-competitive investment vehicles. In addition, focusing on specific sectors also facilitates identification of the private sector investors who would be particularly interested in supporting the development of one or another sector.

1.45 The second major assumption is that social and profit-making enterprises should complement one another in fostering economic regeneration and social inclusion. While it is commonly understood that social enterprises frequently take on tasks that would not be feasible for profit-making enterprises, there has been considerably less discussion in the UK of the interaction between the two sectors, and the ways in which their complementarity can best be implemented.

1.46 For example, one of the priorities for the UK is to increase the support available to social enterprises to respond to the procurement needs of local government. However, in the US, 'set-aside' legislation prioritises social enterprise for certain types of procurement, and therefore fosters the development of joint ventures between social and profit-making enterprises, working to the complementary development of both.

1.47 Chapters 2 and 3 of this report also examine a number of ways in which such complementarity can enhance economic regeneration and social inclusion in specific industry sectors selected for their strategic potential to contribute to regeneration and can also maximise the growth opportunities for both social and profit-making enterprises, again potentially providing a market sufficient to underpin market-competitive investment vehicles. Focusing on complementarity will involve considering not only the relationship among social enterprises and SMEs within the sector, but also the potential private sector investors and their economic self-interest in supporting one or another sector.

Chapter 2

Fast-tracking Regeneration: Asset-based CDFI Investment for the Heritage and Creative Industries Sectors

2.1 Despite the lack of a comprehensive analysis of industry sectors, two sectors stand out dramatically for their contribution to the regeneration process, and their ability to encourage the growth of sustainable social enterprises and SMEs. These are:

- The restoration of historic buildings and associated districts in what have become run-down areas
- The natural development of creative and cultural industries (CI), and their tendency to cluster in, and serve as catalysts for, the development of disadvantaged areas.

2.2 Although their contributions are consistently under-appreciated, the restoration of historic buildings and associated districts and the natural creation of areas in which the CI flourish have consistently made a significant positive impact on the regeneration of economically disadvantaged areas throughout the UK. Both of these sectors involve an interaction of social enterprise and profit-generating enterprise, with both types of enterprise typically of a relatively small scale.

2.3 This chapter will examine first the heritage sector and then the CI sector in some detail, and then propose a mechanism to fast-track regeneration by building on these sectors.

2.4 The work of the Architectural Heritage Fund (AHF) demonstrates the range of potential impact of historic restoration.[32] Since 1976 the AHF has helped social enterprises regenerate historic buildings, creating community and education facilities, workspace and homes. This has often been a catalyst for further regeneration. During this period, the AHF have supported over 750 current or past projects. Twenty to thirty projects are physically completed with their help each year.

2.5 Some of these projects are urban and some rural, and they have involved an enormous variety of historic buildings, but in each case the building has been given a new life. In most cases this has meant a new use. In almost all cases the use is genuinely 'sustainable' in the sense that the building is once again serving a useful purpose and is owned or occupied by someone who has an incentive to maintain it in the future.

2.6 The voluntary/social enterprise sector has played a key catalytic role in this regeneration, since once one building or group of buildings is regenerated, there is a ripple effect which leads others to restore their buildings too, and which helps to increase property values so that what the voluntary sector has begun becomes viable for private and commercial owners to continue.

2.7 The AHF-supported project is 28-33 & 36 Snow Hill, St John's, Wolverhampton is a prime example of the integrated involvement of social and profit-generating enterprise and the multiplier effect of heritage projects on the regeneration of disadvantaged areas. Snow Hill is a terrace of late 18th century houses built for the middle-class owners of metalworking businesses in the old Georgian heart of Wolverhampton. In time, shop fronts were added and workshops built to the rear of the houses. Today, 28-37 are listed Grade II, and situated within St John's Square Conservation Area. This is the centrepiece of St. John's Urban Village, a public/private partnership set up to revitalise this 50-acre area in the centre of Wolverhampton. [33]

2.8 In the mid-1990s the terrace and the area as a whole were in a very run-down condition. Few of the shops remained open, and the flats above had been vacant for over a decade. The council had been unable to persuade the properties' owners to undertake the necessary repairs. The Buildings at Risk Trust is a countrywide building preservation trust with a reputation for taking on large or difficult projects. It acquired the properties and found a workable solution for this part of the terrace with the assistance of the council. The Trust originally took on 28-33, and was later asked by the council to tackle 34-36 as well.

2.9 All the buildings have now been restored; the shops have been let, and a local housing association took a long lease on the flats above on completion of the building work in September 2000. The shops' freehold was sold by the Trust in July 2002, providing a source of income with which the trust can undertake future projects. The Architectural Heritage Fund assisted the Trust by providing low-interest loans totalling £344,000. Other sources of funding were Wolverhampton Metropolitan Borough Council (SRB grant & ERDF grant) and English Heritage (Conservation Area Partnership Scheme).

2.10 The project has contributed to a dramatic turnaround in the area's fortunes. Both ends of the terrace, which remained in separate ownership, are now being rejuvenated. Many surrounding properties, once derelict, are beginning to be restored by their owners, or purchased by those who have been attracted to the area. Meanwhile the council has been able to maintain the percentage of affordable housing, preventing excessive 'gentrification'. Thus the area has been upgraded, and still remains accessible to the local community. Snow Hill's improvement encouraged the City Council to improve the streetscape. Local businesses have also been offered assistance under the Heritage Economic Regeneration Scheme (HERS), a system of grants provided by English Heritage to improve the condition of their own properties. This scheme will be in place for another three years.

2.11 The success of Snow Hill has encouraged further projects within St John's Urban Village. It has therefore been a catalyst for continuing regeneration, and a key to the process of repopulating the centre of Wolverhampton. Furthermore it is estimated that it has helped to bring in a quarter of the £10 million investment that the Urban Village has already attracted.

2.12 Most projects supported by the AHF involve loans, because most projects need working capital to pay the contractors and professionals while the project is on site, and/or to acquire the building in the first place. Loans are usually essential where the building is being sold after completion. Even if the whole building cost is covered by grants, a loan is often

necessary because grant income does not come in when it is needed. Loans are made only to enterprises that are registered charities, although these charities are typically engaged in social enterprise.

2.13 The AHF has approximately £13,000,000 available in its rotating loan fund, and has been successfully and self-sufficiently operating for nearly 30 years. The AHF is a de facto CDFI since giving financial help - grants and low-interest loans - is its main business. However, because the typical loan of the AHF is larger than the maximum allowable under the CITR, because their loans are exclusively property-based and some of them are for properties to be used as residential properties (see Sections 2.35 and 2.46 below), they have not been included in the examination of successful models for CDFIs.

2.14 AHF loans are normally for up to £500,000, and frequently are for more than the £250,000 maximum for social enterprise. The AHF charges interest at 4% simple (i.e., not compound), payable in one lump sum at the end of the loan period, and takes a first charge against the building involved. Since the borrowers are not profit distributing enterprises, this interest rate would be allowable under the legislation (see 2.38 below.)

2.15 The normal loan period is two years, or until the building is sold, whichever is earlier. For an exceptionally large-scale or complex project, it can be three years. If the building is being sold on completion, the loan is usually repaid from the proceeds. If not, it is repaid from grant income, and/or from longer-term refinancing, usually by mortgaging the building.

2.16 However, where the building is planned for community use as a social enterprise facility, it is often difficult to obtain a mortgage. Thus community organisations that acquire and restore buildings frequently must sell them into private use, as they cannot access commercial bank mortgages to enable the buildings to serve the community needs identified by these organisations. In addition, with the decreasing availability of European funding in the form of Single Regeneration Budget and European Social Fund money, many projects are hard-pressed to find the finance needed to move from the short-term AHF loans to longer-term sustainable finance.

2.17 Such longer-term mortgages could be made available to these social enterprises through a specialised heritage CDFI. Where the amount of the mortgage is larger than the maximum available to a single social enterprise, the organisation could structure itself into subsidiaries to access the mortgages in acceptable units. See Sections 2.35 to 2.51 below for a legal analysis of the CITR Law and CITR Regulations to demonstrate the feasibility of such loans under this legislation.

2.18 In order to enable adequate monies to be disbursed to individual projects and to minimise risk on any project, the specialist heritage CDFI should also include services and support mechanisms in the form of training for, support advice to, and monitoring of the community enterprises. Such a specialist CDFI should include several interrelated components, some or all of which will be brought into play for any individual project:

- Affordable long-term mortgage loans to non-profit distributing enterprises that cannot obtain conventional bank mortgages

- Consultancy / counselling support and training to existing and potential community enterprises to assist in legal structuring for building acquisition, management and maintenance and to maximise financial sustainability and access to resources
- ‘Marriage brokering’ -- bringing together compatible interests and community projects with heritage buildings and one another in order to maximise sustainable social enterprise development

Recommendation 5: Develop a CDFI that provides specialised social finance and social enterprise development support to the heritage sector, building on the experience and expertise of the AHF and other sector specialists.

2.19 Creative and cultural industries have been identified by both national and regional agencies as key sectors of growth for the UK economy.[34] Creative Industries represent almost 8% of UK GDP, with a disproportionate number of micro-businesses and SMEs represented in the sector.[35] The creative and cultural industries sectors have also been a catalyst for regeneration in disadvantaged areas across the UK. NESTA’s research has found that while many investors recognised that these sectors are an area of growth they significantly underestimate their importance to the UK, not merely economically but also socially, as seen, for example, in the regeneration of Hoxton in London and the Northern Quarter in Manchester.[36]

2.20 The ‘buzz’ generated by this sector creates an active street atmosphere, drawing galleries, restaurants and entertainment venues that enliven and reawaken dormant, distressed areas. However, frequently, the creative sector is so successful in this process that property values increase to the point that they can no longer afford to remain in the area. Thus the creators of regeneration become its victims, experiencing dislocation and disruption physically, economically and psychologically.

2.21 Part of the reason why the creative industries sector falls victim to this type of dislocation is that these enterprises do not have access to the finance needed for business growth and for acquisition of their own premises so that they can participate in the benefits of the regeneration they engender. A recent report for NESTA “New Solutions to Old Problems: investing in the creative industries”[37] highlights the fact that creative entrepreneurs face barriers to finance which limit opportunities for future growth.

2.22 Chief amongst these barriers are the investment criteria used by retail banks in assessing business opportunities. NESTA’s research[38] suggests that most banks assess whether to offer debt finance to those seeking to start a business on the basis of the investment readiness of the business, and in particular look for:

- robust business plans,
- an acute awareness of markets,
- solid management structures,

• existing equity and
• clear growth potential.

2.23 Creative industries may fail to meet a number of these criteria, even though the business proposition itself may be solid:

• The nature of the business proposition they are offering does not always lend itself to description using traditional business planning models, although the potential of the proposition itself is sound;
• Their businesses often have longer lag times between the idea and its realisation as a commercial asset than more traditional business ventures – this can be problematic for a lender seeking a return within a narrow time frame;
• The major asset of these businesses is intellectual property, which often makes the relationship between the market and product difficult to gauge. For the most innovative propositions, the market may need to be built, rather than being already in existence;
• They tend to be perceived as higher risk ventures, though they potentially have higher returns.
• They are frequently perceived (often without foundation) as being lifestyle orientated, without serious commercial intent or potential; and
• They have few tangible assets such as property and capital and many are often located within deprived areas so that they experience postal code discrimination rather than recognition of the regeneration impact of these enterprises.[39]

Recommendation 6: Develop and support CDFIs that provide specialised support to the creative and innovative industries.

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2.24 In fact, Culture Finance North West is working to develop just such a CDFI, and it may be able to serve as a model for other regions throughout the country.

2.25 Additional research indicates that there is a large market for affordable workspace for the creative and cultural industries, particularly within London.[40] Moreover, the London Development Agency has prioritised the development of cultural hubs in disadvantaged areas within London.

2.26 It therefore seems reasonable to provide community development financing through which individual creative enterprises could affordably acquire their own units within buildings specifically for enterprises within a particular segment of the sector would allow these businesses to:

- Acquire assets that would facilitate their access to additional finance;
- Cluster in buildings that could provide specialised services;
- Participate in the regeneration of the area without becoming its victims.

2.27 Such financing would make it possible for these enterprises to buy their units for the same price as comparable rent, at prices within the maximum available for loans to SMEs or social enterprises through a CDFI. (See Sections 2.35 to 2.52 for the relevant legal

analysis.) Protective constraints could be built into this mechanism. For example, one of the conditions of purchase could be a covenant to protect of the buildings as affordable workspace for the creative sector. That means that unit-holders will only be able to re-sell their units for the price they paid (i.e., the amount of equity accrued and not the amount paid for interest or for building service charges), and new purchasers will pay only the original price for the unit, based on the cost of acquiring and renovating the building.

2.28 Since there is such a backlog of demand, the common-hold or freehold reversion building management will be able to re-acquire and re-sell any units with a minimum of risk. Increases in the property value of the buildings could also be accessed by the common-hold or freehold reversion building management through means other than sale of the building (e.g., through re-mortgaging to capture the increased property value) and this increased value could be used to upgrade the building or acquire additional space

2.29 The issues facing the heritage sector and the creative industries sectors could both be ameliorated by access to affordable mortgage-type loan funding for the acquisition of properties that are typically not of interest to conventional banks for mortgage funding. It seems that there is sufficient demand across the UK to justify large-scale investment. Here then, is the opportunity for private sector CITR-based investment into an asset-backed investment vehicle (so that risk and return are balanced) of a size and a term that will be of interest to corporate investors and sponsoring investment banks.

Recommendation 7: Develop property-based wholesale and related retail CDFIs that can jointly constitute a large-scale bond offering targeted to meet the needs of the creative industry and heritage markets and the potential to provide affordable incubator space for start-up businesses as a social enterprise. These can be member companies of consolidated companies that include the specialist CDFIs serving the enterprise development needs of the heritage and creative industry sectors. For example, a single retail fund could provide both the property-based and enterprise loan and financial development within a sector, and each of these could be fed by a large-scale wholesale fund specialising in property and other sources of funding for the enterprise support.

2.30 Such a CDFI would be of particular interest to certain types of corporate investors; for example, socially conscious developers and registered social landlords interested in developing housing in heritage areas or for the creative industries (e.g. live/work options) that will benefit from the development of conservation areas and cultural hubs. These investors will be able to gain a multiplier effect from their investment into these CDFIs, including a more positive hearing from local authorities when they can demonstrate their broadly based socially responsible investment in disadvantaged areas for these purposes.

Recommendation 8: For such property-based CDFIs, target as investors socially responsible property developers and other private sector corporate investors who will experience multiple gains from the regeneration of disadvantaged areas.

2.31 Specifically, one could develop a property-based CDFI in which 50% of its loan portfolio falls within the property investment limitations of the legislation, and 50% of its portfolio falls outside that limitation. Fifty per cent of the portfolio could be allocated for the acquisition of property by non profit-distributing enterprises for use as business incubator units, and office rental space for community organisations and charities. The other 50% of the portfolio could be allocated for the acquisition of premises for owner-occupiers from which to carry on their organisational purposes, whether that be, for example, operation of a creative enterprise or of a social enterprise that serves community purposes within a heritage building.[41]

2.32 In order to spread the benefits of regeneration, SMEs acquiring units in a common hold building (or through a long-term leasehold with the freehold reversion held by a company owned by the leaseholders) would only be able to re-sell their unit at the price they paid for it. Any appreciation in value would accrue only to the building as a whole, and could only be realised by the entire common hold under strictly defined circumstances, and could only be used for strictly defined purposes. (Please see the discussion in the legal analysis below regarding whether this 50% of the fund would be appropriate only for SMEs or could also include non profit-distributing enterprises.)

2.33 The loan fund is thus secured by the property, with the fund functioning as the mortgagee. Loans will be made at a rate that is competitive for mortgages. For SME borrowers, the lending rate will be calculated as a combination of the interest charged and the property appreciation value foregone.

2.34 Because the loans are secured, investment in the CDFI becomes of interest to private sector investors at the tax credit rate equivalent of pre-tax interest of 7% to corporate investors. The model is based on providing community investment tax relief ('CITR') to investors for the entire length of the investment vehicle (i.e. 12 to 20 years) so that the CITR can be provided for the full term of the mortgages securitising the offering, since private sector investors are interested in longer term investments. This guarantee of CITR (subject to the continuing accreditation of the CDFI) would need to be agreed in writing by Inland Revenue in order to attract investment by the private sector. The sections below provide the legal analysis underlying the model.

2.35 *Use of property to secure investments*. According to Schedule 1, Section 8 of the Community Investment Tax Relief (Accreditation of Community Development Finance

Institutions) Regulations 2003 ('2003 No. 96'), property investments that are not relevant investments eligible for tax credit are:

(1) Any investment which funds directly or indirectly the acquisition, construction or development of non-residential property where, on the next anniversary of the date on which the CDFI was granted accreditation, in consequence of that investment –
  (a) the total amount of investment within Case 1 below exceeds the amount of relevant investments other than those in Case 1, or
  (b) the total amount of investment within Case 2 below exceeds one half of the relevant investments within Case 1.

Case 1

1.1 Investment in a non profit-distributing enterprise, the main activity of which is to hold and invest in or to develop non-residential property.

1.2 Investment in a development trust or other social enterprise for the purpose of investment in or development of non-residential property, whether owned by the trusts or by others.

Case 2

2.1 Investment in a profit-distributing enterprise, the main activity of which is holding land with the aim of benefiting from capital appreciation of that land, or which the aim of receiving income through the exploitation of an interest in it.

2.2 Investment in a profit-distributing enterprise, the main activity of which is non-residential property development.

(2) For the purposes of paragraph (1) where a investment is a loan which authorises the CDFI to draw down amounts of the loan over a period of time, the amount of the investment is the amount drawn down at the relevant date.'

2.36 In other words, acquisition of buildings by non profit-distributing entities for the purpose of setting up business incubator rental units or office space for charities and community organisations cannot constitute more than 50% of the total CITR-relevant investments by a CDFI.

2.37 However, investments that are 'not relevant' under Case 2 (investments by profit-distributing enterprises) are only 'not relevant' when 'the main activity' of the investing enterprise is 'non-residential property development' or 'holding land with the aim of benefiting from capital appreciation of that land, or which the aim of receiving income through the exploitation of an interest in it.'

2.38 This language does <u>not</u> preclude acquisition of land or property by an enterprise with another main activity that is acquiring the land or property as an alternative to rental of premises for conducting their business. Moreover, direct property acquisition by SMEs for such purposes in circumstances under which they would be precluded from benefiting from the capital appreciation of the land or building would further eliminate the possible applicability of this clause.

2.39 The analysis of the potential acquisition of premises by a social enterprise is a little more complicated, since the preclusion language of Case 1, Section 1.2 is broader than that in

Case 2. Nonetheless, what the language precludes is investment for the purpose of investment in, or development of, non-residential property. Where acquisition is not for the purpose of 'investment in' or 'development of' non residential property, but rather for occupation as premises in lieu of rental accommodation and again, where the occupier is precluded from gaining appreciation in value, it would seem that loans by a CDFI for such purpose would not fall under the 50% restriction of Case 1.

2.40 *Relevant interest rate for loans.* According to 2003 No. 96, there is no minimum rate applicable on loans to non profit-distributing enterprises, since under Schedule 1, Section 3 of 2003 No. 96, there is a specific interest rate potential exclusion only for loans to profit-distributing enterprises.

2.41 The exclusion (from what constitutes a 'relevant investment') related to profit distributing enterprises can be broken down as follows:

- (1) Any loan to a profit-distributing enterprise which is not made at market rates or above, or where interest is not charged on loans the fee structure is not at an equivalent level.
- (2) In paragraph (1) "market rate" means the European Commission's Hurdle Rate
- which is the Reference Rate (as published at …) plus four percentage points, or more.

2.42 What is problematic here is that last clause. It seems to seek to provide a description of the European Commission's Hurdle Rate. This statement is thus a description that is not intrinsic to the legislation and this description is actually not a fully accurate description of the European Commission's Hurdle Rate.

2.43 According to the European Commission notice on the method for setting the Reference and Discount Rates (97/C273/03), '[t]he reference rates are supposed to reflect the average level of interest rates charged, in the various Member States, on medium and long-term loans (five to ten years) back by normal security' ; i.e., the 'market' or 'hurdle' rate.

2.44 The notice goes on to point out 'It should also be noted that:
- the reference rate thus determined is a floor rate which may be increased in situations involving a particular risk (for example, an undertaking in difficulty, or where the security normally required by banks is not provided). In such cases, the premium **may** amount to 400 basis points or more if no private bank would have agreed to grant the relevant loan,' [emphasis added]

2.45 In other words, the addition of 4% above the Hurdle Rate is discretionary, and is not intrinsic to the applicable Reference Rate. Thus, even if the loans would not be of interest to a private bank (i.e. very small unit holdings to SMEs within a building of SMEs), the provision of 'the security normally required by banks' would be sufficient justification for not applying any additional premium at all, or requiring a premium of less than 400 basis points.

2.46 *Size of loans.* Schedule 1, Section 4 of 2003 No. 96 limits the size of investments in non-profit-distributing enterprises to £250,000 and Section 2 limits loans to profit-distributing

enterprises to £100,000. However, the language refers to 'an enterprise.' This language does not preclude loans to several independently constituted enterprises, all of which are subsidiaries of a single holding company, since each of these is indeed a separate enterprise.

2.47 *Use of interest to fund revenue management costs.* Under Chapter 23, Schedule 15, Section 57, Community Investment Tax Relief of the Finance Act 2002 (the 'Act'), Part 3, Clause 8 defines a 'qualifying investment' om a CDFI. Only qualifying investments are eligible for CITR. However, no part of the legislation addresses the use of interest acquired by the CDFI through making loans using the qualifying investments as loan capital. It can therefore be understood that the legislation has left the use of this interest to the discretion of the CDFI, either for further investment, or for covering its management costs.

2.48 In order to clarify the model, the following sections provide examples of the three main types of loan under the model: business incubation centres, heritage buildings and creative industry hub buildings.

2.49 Example 1 is the ABC Small Business Incubation Centre. The ABC Centre is a 4-storey building that will cost a total of £2 million to acquire and renovate. ABC Charity has four trading company subsidiaries, each of which will own and manage one floor of the ABC Centre (ABC-G, ABC-1, ABC-2 and ABC-3.) ABC-G, ABC-1, ABC-2 and ABC-3 want to rent these units as business incubator space at 50% below market rate for the first year of rental, market rate for the second year of rental and 150% of market rate for the third year. Since this will encourage tenant turnover during the second year of tenancy, this will mean that the average rental rate will be no more than 75% of market rate .

2.50 ABC Charity has £1million capital in grants from various sources, and it will provide £250,000 each to ABC-G, ABC-1, ABC-2 and ABC-3. Private banks are not interested in lending money to these subsidiaries for the acquisition and renovation of one floor of this building. The CDFI can lend £250K each to ABC-G, ABC-1, ABC-2 and ABC-3 to facilitate the development of the ABC Centre. These loans will fall within the maximum 50% of the CDFI for property development.

2.51 Example 2 is the XYZ Historic Centre. The XYZ Centre is a 3-storey heritage building that has sat vacant for the last 15 years. XYZ Charity has a mix of grant and low interest short term loan funding of £2million that will enable it to acquire and restore the building as offices for voluntary organisations. XYZ Charity has set up two trading subsidiaries, XYZ G and XYZ 1 and it wishes to pass ownership of the ground floor to XYZ G and the first floor to XYZ 1 to own, manage and maintain these floors as rental space for voluntary organisations. XYZ Charity will retain ownership of the top floor for its own premises. Each of these three entities will require a mortgage loan of £200,000 to replace the short-term loan funding, and private banks are not interested. The loans to XYZ-G and XYZ-1 will constitute loans that fall within the maximum 50% of the CDFI for property development. The loan to XYZ Charity for its own premises will not fall under the exclusion.

2.52 Example 3 is the PQR Creative Industries Centre. The PQR Centre is a 3-storey former warehouse. It will cost a total of £2.5million to acquire and renovate for use by SMEs in the music industry. On the ground floor, it will contain a rehearsal and performance space that will be operated as a social enterprise; on the first and second floor, it will contain recording studio spaces that will be operated as social enterprises. The remainder of the building will be used as office/work space for the music industry SMEs. The social enterprise spaces will each cost a total of £250,000 to acquire and renovate (as separate units.) The office/work space will be divided into units that will cost individually between £50,000 to £100,000, depending on size. The loans to the SMEs and the social enterprises for their premises will not fall under the exclusion (i.e., there is no limitation on the number of such loans.)

2.53 During the research for this report, there has been a great deal of contribution and participation by various individuals and entities to the issues discussed in this chapter. In particular, Boodle Hatfield and Brown Rudnick Berlack and Israels have contributed legal pro bono time. Karen Mason, property partner of Boodle Hatfield, has contributed considerable time and expertise into the analysis of the use of common hold and/or the traditional leasehold with freehold reversion for such structures. She has also spent time reading the CITR legislation in order to familiarise herself with the relevant issues. Two corporate finance partners at Brown Rudnick Berlack and Israels, Ron Borod (an internationally recognised expert in the field of asset-based bond offerings, including bond issuances with tax credits as returns) and Tina Baker (resident in the UK office) have contributed time to discussions of the formulation of such offerings for the UK market and to the factors that would be of sufficient interest to corporate investors and the investment banking community. They have also contributed to discussions regarding the legal structure for the special purpose vehicle that would be both the offering vehicle and the CDFI.

2.54 While the research for this report has been broad ranging in sharing information and seeking input from entities engaged in the support of enterprises in the heritage and CI sector[42] Senior executives of enterprise agencies and other entities engaged in the support of enterprises in the heritage and CI sector (in addition to those mentioned above in footnote 32 to Section 2.4) who have contributed time to discussions include Chris Mackman, London Development Agency; Philip Treleaven (Pro Provost) and Daniel Brown, both of University College London; Ian Williams, Government Office for London (formerly, now of the Department of Trade and Industry); Janet Drysdale, Regeneration, London Borough of Islington; Jeffe Jeffers, Lady Margaret Hall Settlement; Richard Parkes, Prevista Ltd.; and Tim Heath, East London Small Business Centre.

Chapter 3

Fast-tracking Social Enterprise Development: Horizontal Integration in Sustainable Community Trusts

3.1 In Autumn 2001, the Social Enterprise Unit was established within the Department of Trade and Industry where it was to provide a focal point for strategic decision making across Government. Eight Working Groups, involving key stakeholders from the social enterprise community were established by the Unit, and they identified the following major barriers to growth of the social enterprise sector:

- Poor understanding of the particular abilities and value of social enterprise;
- Little hard evidence to demonstrate the impact and added value of social enterprise;
- Fragmented availability of accessible, appropriate advice and support;
- Difficulty accessing and making use of what is perceived to be limited appropriate finance and funding available;
- Limited account taken of the particular characteristics and needs of social enterprise within an enabling environment; and
- Complexity and lack of coherence within the sector, combined with widely varying skills and knowledge bases.[43]

3.2 The Social Enterprise Coalition was created to serve as a national voice for the sector, and other local associations have also been developed to support the growth of social enterprise. In addition, the development of social enterprise has been identified as a Government priority for funding in some of the more recent rounds of European Social Fund co-financing.

3.3 Nevertheless, the 2002 description of 'complexity and lack of coherence within the sector, combined with widely varying skills and knowledge bases' is still largely accurate. In addition, social enterprises are, for the most part, small enterprises[44] and frequently, they can be characterised as new or start-up enterprises, in the first year or two of operation. Therefore, even if they were profit-generating, they would not represent the type of businesses most likely to attract investment capital.[45]

3.4 However, since, as discussed in the previous chapters, it is necessary to have large-scale financial vehicles in order to attract the significant investment from private sector, it is important to consider what must be done to fast-track the sector to develop more, and more sophisticated, social enterprises in order to be of interest to investors and in order to generate the demand for the potentially large amount of community development financing.

3.5 To reiterate points made in Chapter 2: Schedule 1, Section 4 of 2003 No. 96 limits the size of investments in non-profit-distributing enterprises to £250,000 and Section 2 limits loans to profit-distributing enterprises to £100,000. For an investment vehicle of, for example, £200million, that would mean 800 to 2000 individual enterprise loan recipients.

3.6 However, the language of Schedule 1, Section 4 of 2003 No. 96 refers to ‘an enterprise.’ This language does not preclude loans to several independently constituted enterprises, all of which are subsidiaries of a single holding company, since each of these is indeed a separate enterprise.

3.7 Developing integrated social enterprises that are part of a single holding company, and that can share expertise and resources is a functional way to fast-track the development of social enterprises and facilitate their access to finance.

3.8 While there may be a number of ways to create integrated social enterprises, there are two models that have been successfully implemented in the UK, and that hold the potential for even more successful future development.

3.9 The first model is that of a multi-enterprise resident-managed community trust created as part of a new housing development and endowed with assets invested by developers and local authorities in combination with more traditional use of Section 106 funds. The second model is a community trust that is based on asset acquisition and management in connection with parks/green spaces.

3.10 Although it has experienced political difficulties and a complex learning experience for participating stakeholders, Thamesmead Community Trust, as it is now constituted, is an example of a multi-enterprise resident-managed community trust that has the potential to expand horizontally and include more social enterprises within a holding company framework. Similarly, Milton Keynes Park Trust is a successful social enterprise whose origins have been the ownership and management of parks and green space, but that also has the potential for horizontal growth.

3.11 The Government plans to deliver 300,000 new jobs and 200,000 new homes, many of them affordable and in developments of mixed housing types and mixed use, in the new growth areas in the southeast. To achieve the employment opportunities for all members of society and the necessary social amenities to achieve the ‘sustainable communities’ prioritised by the Deputy Prime Minister, even with the Government’s planned investment for such achievement, there will be tremendous pressure on local authorities, local deliverers of various social services (including education and health care) as well as on developers.

3.12 Some of the discussions undertaken for this research have revolved around the development of a community trust model for community-responsive sustainable social enterprise involving a partnership among one or more private sector businesses, a voluntary sector non-profit organisation and community members that can be used broadly as an alternative to a management company for new business, residential and mixed use developments and can deliver private services (such as maintenance) and public services (such as employment training.)

3.13 Typically, business park and housing developers put management companies into place to provide the various common services for business or residential occupiers. Until all the units are sold or occupied (often for as long as seven years), the developers must run these management companies themselves. This is generally perceived by developers as an inconvenience.[46]

3.14 In addition, developers support local authorities through the allocation of Section 106 funds. However, individual smaller developments are typically not able to provide adequate support to local authorities through the Section 106 process, even though, taken collectively, they may call for as much social, education and health care infrastructure as large developments.

3.15 Discussions for this research have been working towards developing a model for community trusts to serve as community-responsive development management companies for new residential, commercial and mixed use developments throughout England, particularly in the targeted growth areas, and towards developing guidelines for earned income sustainability for such a multi-functional social enterprise based on:

- fees for standard management company services,
- tax savings through VAT-exemption and
- investment in the community trust by developers as part of a package that includes tax credits for investment in social enterprises via community development finance institutions.[47]

Recommendation 9: Support the development of pilot multi-enterprise community trusts that serve as community-responsive development management companies and deliver other services for new residential, commercial and mixed use developments, particularly those in the targeted growth areas.

Recommendation 10: Provide additional tax incentives for multi-enterprise community trusts whose income streams include:

- **fees for standard management company services,**
- **access to some Section 106 funding,**
- **tax savings through VAT-exemption and**
- **investment in the community trust by developers as part of a package that includes tax credits for investment in social enterprises via community development finance institutions.**

3.16 Research for this report has also included more extended discussions of the potential role of such community trusts, and discussion of their potential implementation in some of the projects currently being proposed in the Thames Gateway area.[48] The following paragraph written by John Hopkins (who has contributed pro bono time to the consideration of these issues) summarises how a community trust made up of a holding company with diverse subsidiaries can provide a type of horizontal integration for many social enterprises

delivering a wide range of services to new and existing communities on the site of such developments.

3.17 'Sustainability is as much about process as it is about product. Consequently, the idea of a Community Trust as an over-arching organisation that represents the aspirations of the existing communities and those that will emerge through these proposals is proposed. The Community Trust will be owned by the community, and its objective will be to manage its operations purely for the benefits of the community. It must be business-like, very well run, and driven to reduce the costs of living [in a community] over the long-term, and to promote the social, economic and environmental well-being of the community. It may have several subsidiaries to deal with the very diverse requirements of sustainable living such as: energy production and distribution; waste management; water management and sewage treatment; local transport and car clubs; education, skills and training; food production; culture; parks and open space management and maintenance; day-care; childcare; healthcare; etc.'[49]

3.18 Such sustainability-focused community trusts also open up new opportunities for bringing in private sector investment. Energy production and distribution through combined heat and power facilities is one example of revenue generation; another is the use of energy savings to provide an asset basis for a derivative bond offering that funds the inclusion of energy saving components in new construction (or retro-fitting of older buildings) and that can then drive forward enterprises related to energy and waste management.

3.19 Initial research of energy revolving funds in various states in the United States has yielded some thought-provoking models that can be potentially included in the funding package for these community trusts.[50]

3.20 The concept of using a revolving bond fund for energy savings is well established in the United States, and a number of states run successful programmes. For example, the 'Energy Efficiency Financing Program' of the California Energy Commission provides low-interest loans at 3.95% interest per annum to non-profit-generating enterprises such as schools and hospitals for energy audits and the installation of energy-saving measures. The revolving loan fund loans up to $3 million for any qualified project and is currently valued at $65 million. Because the amount in the revolving loan fund is not sufficient to satisfy the ongoing demand for such financing, California periodically issues derivative bonds using the pledged repayments as the revenue stream on which the derivative is based. California typically obtains very favourable interest rates on the bonds it issues because its bonds are issued against the repayments already in progress from trustworthy clients performing low-risk energy efficiency projects

3.21 This model could be used to as a basis for a large-scale financing vehicle under the CITR (or other) legislation that funds certain energy and waste management enterprises within community trusts, generating long-term environmental as well as economic sustainability. Breaking activities down to meet the £250,000/social enterprise limit would meet the CITR regulatory requirements and, given California's $3 million (or approximately £1.6million) maximum, that seems as if it could be accomplished without too much complexity (See

Sections 2.49 to 2.52above for examples of how social enterprises can be broken down into relatively straightforward units.)

3.22It is worth noting that the gains from energy savings are typically realised over relatively long periods of up to 20 or more years. Therefore, again, there would need to be support from departments such as Treasury and Inland Revenue to insure the availability of tax credits to investors over this long term.

3.23However, if these issues were resolved, it seems likely that the 5% per annum tax credit (equivalent to 7% per annum to corporate investors) would be sufficient to attract large scale private sector investment since the rate of return would, apparently, be proportionate to the risk.

3.24The energy efficiency finance programmes in the US attract support from technology companies that provide the energy saving equipment and from financial institutions that manage the loan financing. This suggests that corporations from these sectors would be among those that would find investment in these financial vehicles attractive since, as discussed in Chapter 2, they would have multiple potential for gain from the implementation of such lending programmes.

Recommendation 11: Develop energy efficiency-based wholesale and related retail CDFIs or other Government-supported large-scale bond offerings to provide incentives for energy efficiency and support the development of multi-enterprise community trusts.

Recommendation 12: For such energy efficiency-based bond offerings, target as investors those private sector corporations engaged in the furtherance of energy efficiency that will experience multiple gains from such funds.

3.25As indicated in Section 3.9, the other major potential focus for fast-track development of social enterprise is through property asset acquisition and sale as part of a financial resource package in a sector that integrates health and parks/ green spaces.

3.26Alternative sources of financing for parks and green spaces is the subject of research currently funded by the Office of the Deputy Prime Minister and being conducted by PriceWaterhouseCoopers under the supervision of CABE Space and a Steering Committee on which the author of this report sits. Since that process is currently underway, it seems advisable to postpone discussion until the results are available.

3.27 However, what is not under discussion in that process, and merits further discussion after the completion of that research is the potential for broadening the definition of that social enterprise sector to include health-related activities since parks can provide the locus for a number of such activities from green gyms and actual health clubs to the psychological impact on health that comes from the placement of parks or green spaces adjacent to hospitals so that patients can look at them from their windows, facilitating their recovery.

3.28 There are other factors to be considered as well, such as the Foundation Hospitals' obligation to facilitate the development of social enterprise and the potential interest of insurance companies in investing in, or developing investment vehicles for, this sector of social enterprise.

3.29 Initial discussions with relevant entities in this sector has begun as part of this research; however, the process continues and will be part of the ongoing discussions that continue after the completion of this project.[51]

Chapter 4

Summary of Recommendations

Recommendation 1

Consolidate existing CDFIs under larger holding companies so that that individual CDFIs serving specialised geographic or other markets do not lose their focus, but the consolidated company can provide back-office services to all its subsidiaries in a more efficient way, can more effectively target private sector finance since it can handle larger inputs of capital, and can demonstrate a more risk-balanced portfolio and can be more sustainable in the long run since it will eventually not require any external grant funding for its own revenue needs.

Recommendation 2

The SBS Social Enterprise and Community Development Finance Units should conduct a joint mapping exercise in order to identify contributions of different industry sectors and different types of enterprise in order to assess the implications of different types of investment for social and economic regeneration, and assist in the development of investment characteristic priorities.

Recommendation 3

Government departments, including SBS/DTI, Inland Revenue and Treasury should work together to provide an alternatively based tax credit to charitable foundations and trusts that invest in CDFIs, perhaps based on tax credit against VAT in order to enable charitable institutions to benefit as much from CDFI investment as private sector investors.

Recommendation 4

Government departments, including SBS/DTI, Inland Revenue and Treasury should work together to facilitate the development of alternative private sector investment vehicles by explicitly providing for longer-term CITR for investment vehicles such as bond offerings of 10 – 12 years, and by providing financial support for the legal work necessary to initiate a pilot bond offering of this type.

Recommendation 5

Develop a CDFI that provides specialised social finance and social enterprise development support to the heritage sector, building on the experience and expertise of the Architectural Heritage Fund and other sector specialists.

Recommendation 6

Develop and support CDFIs that provide specialised support to the creative and innovative industries.

Recommendation 7

Develop property-based wholesale and related retail CDFIs that can jointly constitute a large-scale bond offering targeted to meet the needs of the creative industry and heritage markets and the potential to provide affordable incubator space for start-up businesses as a social enterprise. These can be member companies of consolidated companies that include the

specialist CDFIs serving the enterprise development needs of the heritage and creative industry sectors. For example, a single retail fund could provide both the property-based and enterprise loan and financial development within a sector, and each of these could be fed by a large-scale wholesale fund specialising in property and other sources of funding for the enterprise support.

Recommendation 8
For such property-based CDFIs, target as investors socially responsible property developers and other private sector corporate investors who will experience multiple gains from the regeneration of disadvantaged areas.

Recommendation 9
Support the development of pilot multi-enterprise community trusts that serve as community-responsive development management companies and deliver other services for new residential, commercial and mixed use developments, particularly those in the targeted growth areas.

Recommendation 10
Provide additional tax incentives for multi-enterprise community trusts whose income streams include:

- fees for standard management company services,
    - access to some Section 106 funding,
- tax savings through VAT-exemption and

investment in the community trust by developers as part of a package that includes tax credits for investment in social enterprises via community development finance institutions.

Recommendation 11
Develop energy efficiency-based wholesale and related retail CDFIs or other Government-supported large-scale bond offerings to provide incentives for energy efficiency and support the development of multi-enterprise community trusts.

Recommendation 12
For such energy efficiency-based bond offerings, target as investors those private sector corporations engaged in the furtherance of energy efficiency that will experience multiple gains from such funds.

Notes

[1] Technical elements of financial administration have been ably handled by Groundwork East London.

[2] Part 2, 4 (2) of the CITR Law. Specifically, a body applying for accreditation as a CDFI must satisfy the following criteria:

a) Be set up with the intention of carrying on its activities for the long term, and for a minimum of five years, as demonstrated by the body's chosen structure, its funding and investment record or strategies, its track record of existing operations as appropriate and by other aspects of its business plan for the expected period of accreditation, for example by projected income from operations contributing towards covering administrative costs.

b) Intend, throughout the period for which it seeks accreditation, that not less than 75% of the activities and operations of the body are directed at the provision of finance, or the provision of finance and access to business advice, for enterprises for disadvantaged communities (as described in paragraph 2e) below).

c) Will only provide finance to enterprises that have been unable to obtain funding from other sources, especially mainstream providers of finance, and will collect whatever information and apply whatever tests it considers appropriate as part of its loan making process. It will offer a range of products applicable to the needs of its customer base.

d) Will only provide finance to small or medium sized enterprises (SMEs) having: i) fewer than 250 employees; ii) either an annual turnover which does not exceed 40 million Euro or an annual balance sheet total which does not exceed 27 million Euro; and iii) no more than 25% of their capital controlled by an organisation that is not itself an SME.

e) Will only provide finance to those SMEs which meet at least one of the following criteria in relation to disadvantaged communities: i) are located in a geographic area identified in Annex A; or ii) are located in an area not identified in Annex A but in which, by reference to Government recognised measures of disadvantage relating to: Income; Employment; Health, Deprivation and Disability; Education, Skills and Training; Geographical Access to Services, and Housing, there is a level of disadvantage comparable to that in the areas identified in Annex A; or iii) are owned and operated by, or intended to serve, individuals recognised as being disadvantaged on account of their ethnicity, gender, age, religious beliefs, disability or other defining characteristic. Additionally, where finance is provided to SMEs that are eligible according to criterion ii), the body will also provide at least an equivalent level of finance, measured in terms of transaction value and volume, to SMEs that are eligible according to either criteria i) or iii).

f) Will not invest directly or indirectly in residential property as defined in Annex D.

Community Investment Tax Relief Material concerning the Accreditation of Community Development Finance Institutions published by the Secretary of State for Trade and Industry 15 January 2003 (SoS's CITR Material.doc mrh 15/01/03). "This material has the effect and purpose conferred by, and must be read in conjunction with, Schedule 16 of the Finance Act 2002 and the Community Investment Tax Relief (Accreditation of Community Development Finance Institutions) Regulations 2003" (SoS's CITR Material.doc mrh 15/01/03, Part 2).

[3] http://www.sbs.gov.uk/default.php?page=/phoenix/default.php

[4] Barbara Ainger, Roger Brocklehurst and Sarah Forster, *Feasibility Study into a Wholesale Intermediary fo*r Community *Development Finance*, The Housing Finance Corporation Ltd, 2002, page 3

[5] *Ibid*.

[6] Hilary Brown and Emma Murphy, *The Financing of Social Enterprises: A special report by the Bank of England*, Bank of England, May 2003

[7] *Ibid.*

[8] CITR Law, Part 3, 12 (2)

[9] In October 2002, Bridges Community Ventures raised £40 million worth of funds, £20m from the private sector and £20m in the form of matched investment from the Government. Bridges Community Ventures' founders, Sir Ronald Cohen of Apax Partners, Tom Singh of New Look and

3i, invested in the funds as did a range of blue chip institutions and individuals including HSBC, Lloyds TSB Scotland, West Midlands Pension Fund, Doughty Hanson, Lehman Brothers, Reuters, Schroder Salomon Smith Barney, South Yorkshire Pensions Authority and The Royal Bank of Scotland Group Pension Fund. www.bridgesventures.com. In addition, it should be noted that a '…portion of the Government's matching investment was subordinated, in that it takes the first risk and has a capped return. The availability of this type of matching investment was crucial to attracting private sector investment to a new field, where returns are as yet unproven.' *Enterprising communities: Wealth beyond welfare: A 2003 update on the Social Investment Task Force*, Community Development Finance Conference, July 2003 (Social Investment Task Force Update), page 4.

[10]www.bridgesventures.com.

[11] The Small Business Service has other grant, loan and venture capital programmes targeted at SMEs but these do not have the social and economic regeneration goals of social finance. In addition, these programmes have had their own problems in facilitating access to finance by the SME sector. See, for example, *Early Evaluation of the Regional Venture Capital Funds: Summary of Findings*, Small Business Service, August 2003. Also, credit unions have been characterised as CDFIs, and their numbers have been used to increase the amount of money currently under the control of CDFIs. See for example, *Promoting the growth of the community development finance sector,* Joseph Rowntree Foundation, 2001, page 1, 'Community development finance institutions (CDFIs) control £500 million of assets for lending and other investment in the UK.' However, credit unions do not make business loans, and are therefore not included within the enterprise social finance under consideration here.

[12] These figures are based on data from 512 CDFIs, which constitute a majority of the 800-1000 CDFIs that operate across the US, according to a study conducted by the US CDFI Coalition. http://www.cdfi.org/cdfiproj.asp

[13] www.bridgesventures.com.

[14] Social Investment Task Force Update at 5

[15] *Social Enterprise. 'It's business, but not as we know it.' Providing an enabling framework for Social Enterprise in the South East*, Consultation Draft, South East Development Agency, November 2003

[16] *Ibid.*

[17] *Social Enterprise: A progress report on 'Social Enterprise:a strategy for success'* (Social Enterprise Update), Department of Trade and Industry, October 2003

[18] Social Investment Task Force Update, Social Enterprise Update

[19] 'There is still much to do if we are to see social enterprise grow to a scale that is proportionate to the policy aspirations set out in the social enterprise strategy.' Baroness Glenys Thornton,'A View from the Sector.' Social Enterprise Update

[20] *Ibid.* at 65

[21] Funding was made by the Phoenix Fund to Groundwork East London, who provided the project administration. Special thanks are due to Annette Furley, Chief Executive of Groundwork East London, for her support in making this research project possible.

[22] In the UK, most social enterprises are structured as companies limited by guarantee rather than as companies limited by share, so there is no equity capital investment in them (other than a nominal amount.) See Brown and Murphy, *op.cit.*, page 17.

[23] Social entrepreneurs feel that their commitment to achieve social (and often environmental) outcomes and to re-invest earnings for social benefit (without the potential for personal profit) should preclude their being required to provide personal guarantees for the social enterprises they lead. *Ibid.* at 31, 38, 39

[24] *Graham Review of the Small Firms Loan Guarantee: Recommendations*, HM Treasury, September 2004

[25] *Ibid.*
[26] Cosh A. and Hughes A. (2003) *Enterprise Challenged: Policy and performance in the British SME sector 1999-2002.* ESRC Centre for Business Research.
[27] Barbara Ainger, Roger Brocklehurst and Sarah Forster, *Feasibility Study into a Wholesale Intermediary fo*r Community *Development Finance*, The Housing Finance Corporation Ltd, 2002, page 3
[28] *Ibid.*
[29] Brown and Murphy, *op.cit.*
[30] See Social Investment Task Force Update, Chapter 4; Geraldine Peacock, Keith Hickey, Paul Voller, Kate Sayer, Nick Wilkie*, The Magic Roundabout: How charities can make their money go further, An introductory guide to Programme Related Investment*, Sayer Vincent Bircham Dyson Bell, 2004
[31] Social Enterprise Update, o*p.cit.*
[32] Ian Lush, Chief Executive of the Architectural Heritage Fund, has been active in discussions throughout the research of this project, and has taken a lead role in discussions with members of the AHF Board, with the Association of Preservation Trusts and with other organisations in the sector. The AHF is only one of several organisations in this sector that promote regeneration through heritage. These include English Heritage, the Heritage Lottery Fund, various organisations related to the restoration and re-use of church buildings, the Association of Preservation Trusts, and the many building preservation trusts throughout the UK that are members of the association as well as private sector architects, landscape architects and other consultants. As part of the research for this project, Roger Lansdown, Director of Prometheus Limited, a prominent consultancy in the sector, has undertaken interviews and discussions with the major organisations in this sector.
[33] www.ahfund.org.uk
[34] See, for example, *Finance and the Creative Industries in England's North West: Supply and Demand Side Issues*, prepared for Culture Finance north west by New Media Partners (nmp), September 2004; *London's Creative Sector: 2004 Update* (GLA Economics)
[35] National Endowment for Science, Technology and the Arts (NESTA), *Response to call for evidence: Graham Review into the effectiveness of the Small Firms Loan Guarantee (SFLG),* April 2004
[36] *Ibid.*
[37] New Solutions to Old Problems: Investing in the Creative Industries, Nesta, 2004
[38] *Ibid.*
[39] *Ibid.*
[40] See, for example, the research on the King's Cross Swathe conducted by ITN and FashionWorks for the London Development Agency, April 2004
[41] The model has the interest and support of national and local government, charitable organisations (including the Architectural Heritage Fund and a range of heritage organisations, enterprise agencies, regeneration charities and private sector commercial and investment banks.
[42] Some of these include Creative Industries department, British Council; members of the London Mayor's Commission on the Creative Industries; the Creative Industries Development Agency; FashionWorks; Metal; the Portobello Business Centre and the Club^2 programme of the Institute of Contemporary Arts.
[43] *Social Enterprise: a strategy for success*, Department of Trade and Industry, July 2002
[44] Brown and Murphy, *op.cit.*
[45] See Teresa Graham's discussion of the particular need for Government support (through the Small Business Loan Guarantee or other mechanisms) for start-up and relatively new enterprises. Graham Review, *op.cit.*
[46] Discussions with Karen Mason, property law partner, Boodle Hatfield
[47] Pro bono contributions by Karen Mason have involved extended consideration of these issues.

[48] In order to protect proprietary interests, this report will not mention the specific potential developments where such discussions are currently underway.
[49] John Hopkins, Director, LDA Design, email communication, October 2004
[50] The potential development of energy-efficiency revolving funds in the UK was first suggested to me by Peter Head, Director, Arup, who has contributed a great deal of time and thought to the issues in this paper.
[51] I would particularly like to single out Mark Ford of Barclays Bank who is now serving with me on the CABE Space Steering Committee and who has given time and thought to many of the issues in this paper.