Factsheet 5: Capital finance

5.1 Types of capital

All organisations need capital finance to provide them with the assets they need to do their work and to cover their cashflow. There are four main types of capital finance:

Grants, gifts and donations: Money that is freely given by donors who support the purpose of the organisation, without any expectation of or right to a return on their gift. This form of charitable giving is by far the largest and most common source of capital finance for many organisations pursuing a social or community purpose.

Retained profits: Profit or surplus is reinvested by the organisation, rather than distributed to stakeholders in the form of bonuses, profit-shares, dividends or some other vehicle for distributing profits.

Debt: Borrowed money from a third party, which normally must be repaid over an agreed period, and which attracts an agreed rate of interest payment. Bonds are a form of debt, as are debentures, lease agreements, overdrafts and loans.

Equity: Investment in return for shares that gives shareholders legal rights over the organisation. These rights may include a right to receive interest on the investment and/or a dividend, as well as the right to vote on issues affecting the organisation. The organisation is usually under no obligation to refund shares, although it is a matter of good practice to ensure that shareholders can sell their shares, or withdraw their investment under agreed terms and conditions. Equity investment is fully at risk; ordinary shareholders are the last in the line of creditors should the organisation be declared bankrupt.

5.2 What is the best type of capital finance?

Grants, gifts and donations are best if the most important thing is not to put a financial strain on the organisation. But there are drawbacks. The amount of money supporters can afford to give might be limited. Unlike equity investment, there is no formal relationship between the organisation and the donor. Also, charitable funding can limit the organisation's freedom to trade as a business. Donors might expect the organisation to provide free or subsidised services.

Retained profit is an excellent source of capital but, for organisations that aim to provide affordable services, making large amounts of profit might compromise their objectives. Even for profitable organisations, relying on retained profits for all capital investment can slow the rate of growth, and lead to missed opportunities.

Debt finance has its attractions, not least its availability for well-established organisations with plenty of financial reserves (retained profit) and a strong track record. But for new organisations, without the reserves or track record, debt finance can be hard to obtain and very expensive. And the big drawback of debt finance is that it has to be repaid. This can place a burden on organisations to generate additional profits to repay loans, or to take out new loans at additional cost. This burden can be reduced by obtaining longer term debt finance, which is often used to finance capital assets such as property, which can be used to provide security to the lender.

Equity finance has a number of significant advantages over other types of capital finance. It is an excellent way of engaging supporters, making them members and part-owners of the organisation. Unlike debt it is permanent capital, which is not redeemable by a fixed date. The interest paid on share capital is usually limited, and subject to the organisation's ability to pay. With the shareholders' consent, there is no need for the organisation to be highly profitable, because it does not have to repay borrowed capital, or even build up reserves. Equity finance provides new ventures with the time to establish and consolidate a successful business model and aligns organisational and investor commitment to the long-term future.

One of the main drawbacks of equity is that the dividends or interest paid on this type of capital is not treated as a pre-tax expense, whereas interest paid to bondholders is a pre-tax expense. There are also organisational and communication responsibilities in having a large body of member shareholders. Members must be given a copy of the annual report, invited to all General Meetings of members, including the Annual General Meeting, and allowed to vote in member ballots, including the election of directors. Other costs include maintaining an up-to-date register of shareholders.

5.3 Different types of equity

There are three main types of equity: withdrawable share capital, ordinary (transferable) shares and preference shares. It is very important to understand the differences between these types of equity from both a financial and a legal perspective. This section examines the differences between these three types of share capital from a financial perspective; Factsheet 6 examines the differences from a legal perspective.

> **Withdrawable share capital** is unique to IPSs. Shareholders can withdraw their capital from the IPS, subject to the rules governing share capital, including the discretionary power of the directors of an IPS to refuse withdrawal. IPSs that decide not to grant directors this discretionary power must treat their withdrawable share capital as debt not equity. Because members can withdraw this type of share capital, it is vital for IPSs to hold sufficient reserves to meet requests for withdrawals. Members will withdraw their capital for a variety of reasons, ranging from the highly personal, which may have nothing to do with the IPS, through to purely commercial reasons, based on the performance of the IPS. This possibility places a healthy pressure on IPSs to satisfy the needs and interests of their members. Withdrawable share capital is highly attractive to community investors because it provides a simple and straightforward way of selling shares, especially compared with other types of share capital (See Factsheet 4).

> **Ordinary shares** in companies, including CICs, are transferable rather than withdrawable. This means the shareholder can sell their shares to another person, although the company can, through its constitution, place some restrictions on how this is done. IPSs can also issue shares that are only transferable. They can also issue shares that are both transferable and withdrawable. The advantage of transferable shares, from an organisational point of view, is that once the money has been invested, there is no obligation ever to refund that capital. Another advantage of transferable shares is that the dividend or interest payable on these shares is variable, and determined by the directors and members, although this is also true of withdrawable share capital.

> **Preference shares** are different from ordinary shares and withdrawable shares in two important ways. Firstly, preference shares usually have a fixed interest rate or dividend, which might encourage investors to invest. Secondly, preference shares do not confer membership or voting rights, which is not so good in terms of community engagement, but means the organisation is not subject to any of the potential drawbacks associated with membership. Preference shareholders are ahead of other shareholders in the priority list of creditors, should the organisation get into financial difficulties, which can be an added attraction for investors.

IPSs can issue share capital that is transferable only, or withdrawable only, or transferable and withdrawable, although the exact nature of the share capital must be stated clearly in the organisation's rules. Companies can issue redeemable shares, which give the shareholder the option to sell their shares back to the company at some point in the future.

5.4 Different types of debt

Debt is money owed to a person or organisation for funds borrowed. There are lots of different types of debt instruments, each with their own characteristics and purposes, expressed in the agreement between the borrower and lender. There are four key elements to any debt agreement:

- the interest payable
- the repayment schedule (interest and capital)
- the security and guarantees attached to the debt
- other charges, terms and conditions.

These elements can be designed and packaged in a variety of ways to create an array of debt instruments ranging from overdraft agreements (typically with high variable interest rates charged daily, with the lender maintaining the right to recall the capital owed at any time, and often with high levels of associated charges) to mortgages (long-term loans secured against a property asset). Other types of debt instrument include secured and unsecured loans, credit cards, hire purchase agreements and some types of leasing arrangements.

Given this wide variety of debt instruments, it is important to negotiate each element of a debt agreement with the lender, with the aim of designing a package that is best suited to the intended purpose of the loan.

Bonds, which might also be called loan stock or debentures, are the most common type of debt instrument for community investment purposes. They all share the common characteristic of being an unsecured loan for a fixed period of time, usually with a fixed interest rate. They carry no ownership rights.

Compared with other types of debt, community bonds have a number of advantages, principally that they are usually unsecured loans, giving the organisation the scope to use their assets and resources to secure debt from other sources. Interest rates are fixed and the repayment of capital is not required until the agreed redemption date. Community investors will often accept lower interest rates than commercial lenders, making it a cheaper form of debt, although the cost of marketing community bond offers can be higher, and subject to greater risk of failure, than turning to commercial lenders.

5.5 Gearing: getting the right mix of capital

The term gearing, in a financial context, refers to the ratio of debt to the equity and reserves held by a company. This ratio is important to lending institutions because it provides some indication of security for the lender. Lenders know that if a company gets into financial difficulties they will get their money back before the shareholders, who are always last in the line of creditors. If the ratio is less than one (borrowings are less than shareholder capital plus accumulated reserves) then the lending is secure.

A company is said to be highly geared (or leveraged) if its debt far exceeds its equity and reserves combined. For new businesses, which have not had time to build up reserves, or may even have made significant losses, and which have little or no share capital, attracting lenders can be very difficult. Lending institutions might ask the directors for personal guarantees, where loans are secured against their personal assets rather than the assets of the business.

In social enterprises, where the directors are not trying to maximise their wealth, it is usually considered unreasonable to expect directors to provide personal guarantees. But it is also unreasonable to expect commercial lenders to take large risks. In recognition of these issues, the government has promoted the development of Community Development Finance Institutions (CDFIs), which specialise in making unsecured loans to social enterprises in disadvantaged communities.

The main advantage of debt over equity is its comparative speed and flexibility, especially for organisations that are low-geared. Low-geared organisations can usually obtain debt finance as and when they need it. Borrowing can be short term, meaning that the cost of borrowing is short term too, compared with the long-term commitment of equity, and its associated long-term costs. So, for most social enterprises, the right mix of capital is part accumulated reserves, part equity, part debt, and, if available, part grants, gifts and donations.

5.6 Timing: when to raise community investment

The scope for community investment is strongly affected by the phase of the organisation seeking the investment, and the nature of the development it is proposing. The following table (on the next page) distinguishes between organisations in the start-up phase and those which are already established. Generally speaking, the involvement of established organisations improves the likelihood that people will back a community investment proposal.

Community Shares

promoting enterprise, equity and engagement through community shares and bonds

Scope for community investment at different phases of development

Phase	Development	Description	Scope for community investment
Start-up	New ventures	Greenfield development created from scratch as an independent entity	Generally weak but can be strengthened by strong social objectives, sound business model, and project team with strong community reputation
	Franchise, replication, or use of specialist developers	New start created with support of franchise or replication team, or specialist developers (e.g. Energy4All)	Very good if community investment is part of the model and promoter has a good track record
	Community buy-outs and asset transfers	Purchase of existing business or asset by new venture or established organisation	Community investment more likely to succeed if led by established organisation with good track record
Established organisations	Early-stage growth	Organisation experiencing rapid, early-stage growth in demand for its products and services	Good if community investment was part of original development strategy
	Organic growth	Organisation experiencing steady growth over extended period (5 years +)	Better chances of success if subscriber approach is used, allowing growth in investment to match growth in organisation
	Acquisitions and mergers	Finance sought to fund acquisition or merger with another organisation as part of growth and development strategy	Harder proposal to explain to most communities, so likely to be more successful as part of financial restructuring after acquisition or merger, requiring financial intermediary
	Diversification, spin-offs	Established organisation developing new trading activity as semi-independent entity	Affected by how much parent organisation is prepared to invest, but generally good scope for community investment