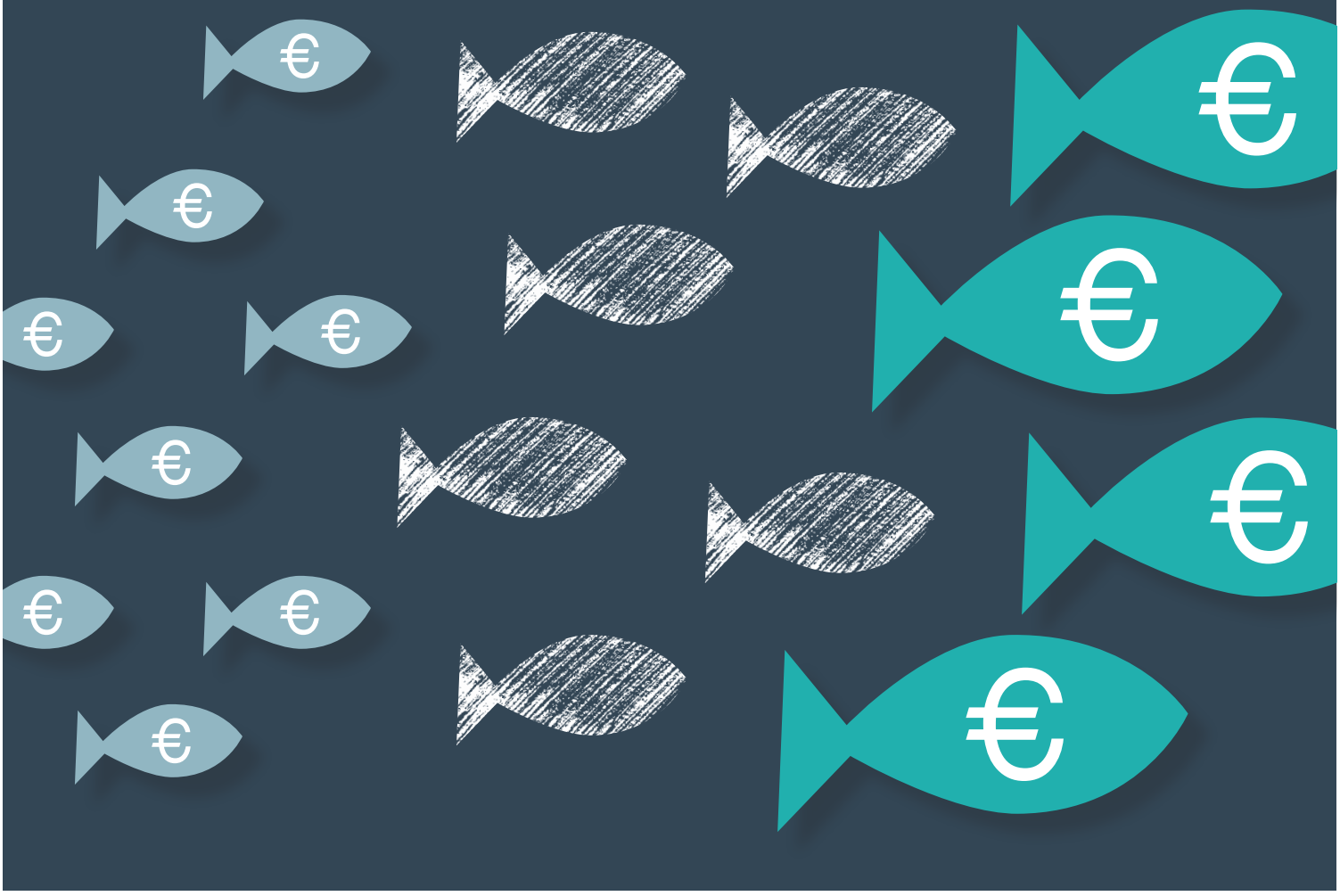
IMPACT IN MOTION

CLOSING THE GAP

2015 FEBRUARY

DEVELOPING A NEW FINANCING VEHICLE FOR SOCIAL VENTURES IN GERMANY



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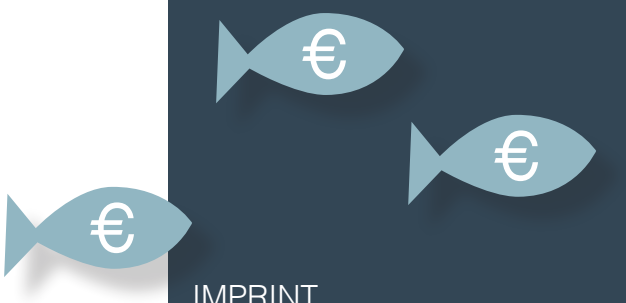

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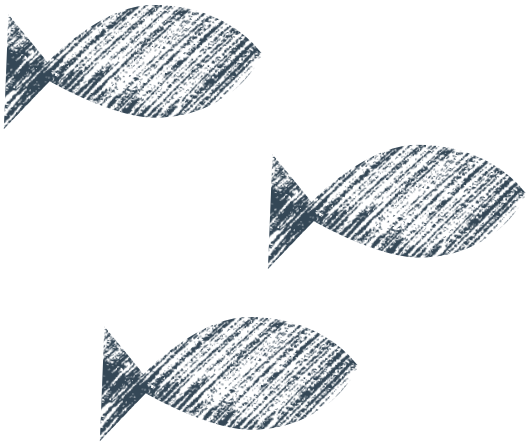


CONTENTS

1 INTRODUCTION

Background to the Project

Germany will face major social and demographic challenges in the decades to come. As the costs for the provision of health, education and social services are currently growing faster than GDP[1], experts are worried about shortfalls in the delivery of social services, if the level of available funding does not increase[2]. Clearly, new approaches, mindsets and policy frameworks are needed to mitigate this risk. In this context, social enterprises (SE) are increasingly being seen as a promising way to tackle some of the most pressing social and environmental problems with innovative solutions[3]. The Europe 2020 strategy outlines social innovation as a core element of transformative societal change and social enterprises are at the heart of this change[4]. At the same time, the European Social Fund (ESF) has now included social entrepreneurship as an investment priority in its plans for 2014 – 2024 with a widened scope for the use of financial instruments under the structural funds[5].

However, many social enterprises currently lack sufficient financing and cite this as a major obstacle to growth[6]. Recognizing the existing insufficiencies and barriers on the supply as well as the demand side for social investment, the European Parliament asked the European Commission to help develop a number of different flagship strategies and action programmes for 2014 - 2020[7]. In this context, the European Commission has set up an initiative to work with 22 organisations in several EU member states to promote new developments, foster new ideas and enhance national as well as international learning. Impact in Motion (with its co-applicants the Bertelsmann Foundation and the Ananda Social Venture Fund) have been chosen as partners for one of these projects.

Objectives and Scope

The 2014 "Impact Investing in Germany" study carried out by Impact in Motion established that many social ventures in Germany suffer from a financing gap for growth investments ranging from 100k - 500k EUR[8]. At the same time, there is a growing interest from different classes of investors (e.g. private individuals, institutional investors and foundations) in impact investing. Building on this momentum, Impact in Motion, in partnership with the Bertelsmann Foundation and Ananda Ventures, have initiated a process to establish a social finance partnership to develop a new financial instrument and to look at the implementation of this instrument in the German market. While the project itself runs until September 2015, this report represents an interim deliverable that summarizes the knowledge and insights gained during the initial project phase. The report aims to analyze the context of social venture financing in Germany and explore promising financing vehicles that could potentially close the aforementioned financing gap.

The scope of this report is focused on small- to medium sized social enterprises that aim to have a social impact, are financially sustainable and plan to scale up by raising investments between 100k - 500k EUR. Moreover, we decided to focus on ***standardized*** financial products, which are easier to scale and execute in comparison to "deal by deal" financings. We furthermore deemed conventional secured bank loans, as well as grants and donations to be outside our scope. For a more detailed definition and visualization of our scope, please refer to section 2.

Research Principles

This report draws on both primary and secondary research in order to account for the complex and dynamic nature of the subject matter. A systematic review of key publications has been supplemented with a number of qualitative and semi-structured interviews with relevant stakeholders. Our research has been guided by three principles:

Knowledge Transfer from the United Kingdom (UK)
The UK has arguably the most developed social impact investment market in Europe at the moment. Strong political support and the establishment of leading institutions and organizations has created a highly innovative ecosystem. Nonetheless, social enterprises in the UK face similar obstacles to their German counterparts. According to the 2013 Social Enterprise Survey[9], social enterprises in the UK consider access to sustainable funding to be the most crucial factor for future growth.

Knowledge Transfer from the private sector
The private sector in Germany offers a wide range of potentially relevant financial instruments that serve the needs of small to medium enterprises. While the context and charac-teristics of businesses from the social and the private sector differ, it is nonetheless appropriate to look at private sector models and investigate the extent to which they can be transferred to the social investment market and tailored to its needs.

Knowledge Exchange with other EU countries
Impact in Motion has established relationships with other EU-funded projects (e.g. from Italy and Croatia) to exchange information, explore synergies as well as cooperation opportunities and to support each other with relevant contacts.

Structure

Following this introduction, section two provides an overview of the social investment market in Germany, with an emphasis on the obstacles to the growth of social ventures from the perspective of social entrepreneurs as well as private investors. Section three outlines four different financing vehicles that have the potential to improve access to financing for social ventures and could be implemented at scale in Germany. The report concludes with a summary and an outlook on the next steps of the project.

2 OBSTACLES HAMPERING THE GROWTH OF SOCIAL VENTURES IN GERMANY

The current context of social ventures in Germany

Definition of social enterprises

The term social enterprise is currently the subject of much scholarly debate and as such there is no universally accepted definition. A recent report by the German National Advisory Board[10] highlighted two key features of social enterprises, which for the purpose of this document we will use as a definition:

- **Social mission:** The business aims to have a positive (social and/or environmental) impact, clearly going beyond mere profit-maximization (which characterizes mainstream businesses).
- **Entrepreneurial spirit:** A substantial proportion of the business's income is generated by an entrepreneurial activity that involves the commercial provision of (sometimes highly innovative) products and/or services (with minimum thresholds typically in the range of 50-75%)

Organizations with these features can be further sub-divided according to their legal form (for-profit, non-profit or hybrid), the stage of their development (idea stage, early stage, later stage), the level of financial returns expected (market returns or sub-market returns), and the degree to which their profits may be used to satisfy requirements from private investors.

Based on a classification suggested by CAF Venturesome (2007), we have profiled different types of organizations according to their primary business driver, typical legal structure, their level of financial sustainability, the degree to which profits can be distributed to investors and the degree to which the social mission is locked. Accordingly, one can distinguish between:

- **Charitable Organizations:** Non-profit organizations with a social mission (structured as e.V., gUG, gGmbH or gAG) that are largely dependent on grants and donations. Examples include a political platform such as Parlamentwatch e.V.[11]
- **Social Benefit Enterprises:** Non-profit organizations with a social mission that cover a substantial share of their costs through commercial revenue, with a limited dependence on grants and donations. Examples include a job-training service provider such as joblinge gAG[12].
- **"Mission Locked" Social Purpose Businesses:** Non-profit organizations with a social mission, that are focused on efficiently solving a social problem and are likely to reach or exceed break-even, while at the same time limiting the distribution of profits to shareholders. Occasionally, these companies use hybrid structures of non-profit and for-profit legal forms (UG, GmbH, AG) to accommodate impact investors. The social mission is usually "locked", meaning that it cannot be modified by a majority vote of the shareholders. Examples include a provider of elderly care services such as SeniVita Sozial gGmbH[13] .
- **"Blended value" Social Purpose Businesses:** For-profit organizations with a social mission that focus on profitably solving a social problem and are at the same time open to satisfying reasonable shareholder and investor demands. Unless specific legal provisions (which are usually demanded by social investors) are in place, the mission may be modified by a majority of shareholder votes. It is worth noting that some of these enterprises – sometimes considered "too charitable" by mainstream investors (e.g. due to a limited market size or limited margins) and "too commercial" by mainstream philanthropists – may be promising targets for social investment[14]. Examples include a provider of IT jobs for autistic people such as Auticon GmbH[15].

- **Socially Responsible Corporate Citizen:** Profit-maximizing enterprises whose strategy is driven by corporate social responsibility. They usually enforce high ethical standards and often use a substantial share of their returns to fund philanthropic activities.
- **Pure Commercial Enterprises:** Profit-maximizing enterprises primarily driven by the shareholder value paradigm. CSR and philanthropic activities (if any) are chiefly used to support the marketing and branding strategy.

Figure 1 summarizes these different types of organizations and shows that within the scope of this report, the term social enterprise encompasses "social benefit enterprises", "mission locked" social purpose businesses, as well as "blended value" social purpose businesses. What all these types of social enterprises have in common is that their business activity is driven by a social motivation and that they generate either a substantial portion, or all of their income, through commercial revenue.

RETURNS

Charitable ← Blended → Financial

	SOCIALLY MOTIVATED ORGANISATIONS				MAINSTREAM BUSINESSES	
	Charitable organisation	Scope of this report **Social Benefit Enterprise**	**„Mission Locked" Social Purpose Business**	**„Blended Value" Social Purpose Business**	**Socially Responsible Corporate Citizen**	**Pure Commercial Enterprise**
Primary business driver	Social mission	Social mission	Social mission, with profits as a by-product	Social mission, in lockstep with profits	Socially responsible profit-maximization	Profit-maximization
Typical legal structure	e.V., gUG, gGmbH, gAG	gUG, gGmbH, gAG	gUG, gGmbH, gAG (occasionally hybrid structures)	UG, GmbH, AG	UG, GmbH, AG	UG, GmbH, AG
Financially sustainable?	Limited commercial revnues, largely depending on grants and donations	>50%-75% of costs covered by commercial revenue, partly dependent on grants/donations	Breaking even / profitable (or potential for profitability)	Profitable / potential for market returns	Profitable / potential for market returns	Profitable / potential for market returns
Distribution of Profits	No	No	Usually no (exceptions possible)	Usually yes (within reasonable limits)	Yes	Yes
Mission lock?	Yes	Yes	Yes	Usually no (exceptions possible)	No	No

Source: Based on CAF Venturesome (2007); Impact in Motion (2012)

Figure 1: *Overview of different types of social enterprises*

In this context, the term "social venture" refers to social enterprises that are either at a relatively early stage of their development (including seed, start-up and growth) or were established some time ago and – having operated locally at a relatively small scale – have the opportunity to expand their operations. Social ventures differ from mainstream technology start-ups insofar as they usually require a longer period of time to develop and scale. Moreover, due to the nature of their business, which typically involves the provision of services to disadvantaged groups, their addressable market sizes and financial performance (e.g. as measured by operating income margin, revenue growth etc.) as well as their asset and intellectual property bases tend to be more modest. At the same time, social ventures tend to be less capital intensive than technology start-ups and less reliant on high-risk research and development.

Social enterprises in Germany

Social entrepreneurship is not an entirely new phenomenon in Germany. The idea of solving social problems by utilizing market mechanisms has a long tradition in this country. Prominent examples include the development of cooperatives in the middle of the 19th century by Raiffeisen and Schulze-Delitzsch and the re-integration of permanently unemployed people into the "second job market" by social welfare organizations in the 1980s.[16] Today, the social sector in Germany is dominated by six large and well established social welfare associations[17]: Worker's Welfare Association, Caritas, Paritätische, German Red Cross, Diakonie and Central Welfare Office of the Jews in Germany.

These associations represent over 100,000 member organisations. They include many established non-profit organizations, which usually face fewer challenges in financing their activities because they own considerable assets, in addition to generating revenue from business activities (e.g. in healthcare, elderly care, child care) that allow them to qualify for debt financing from financial institutions[18]. According to a market study carried out by Deutsche Bank, the members of these welfare associations generated 38 Billion EUR in 2008 from business activities and employed more than 1.5 million people[19]. While the members of these associations were traditionally treated as "privileged subordinated entities" with "conditional precedence" ("bedingten Vorrang") over public welfare providers, the public sector has more recently shown a tendency to open up the market to private providers in an effort to increase competition[20].

Given the dominance of the large welfare associations, social enterprises represent only a niche phenomenon in Germany compared to the UK. A 2013 study by CSI estimated the number of social enterprises in Germany was in the lower four-digit range.[21] More precise estimates about the actual number of SEs active in Germany are difficult to provide due to a variety of definitions and a lack of reliable data, owing to the heterogeneity of the organizations in question. Most social enterprises are small and operate locally, with an estimated 50% generating revenues of 250,000 EUR and less. Only about 30% are estimated to generate revenue of 1 Million EUR or more.[22] The total volume of investment in social enterprises, which can be assumed to be a fraction of the publicly raised social investment capital (an estimated 24 Million EUR in 2012), is relatively small in comparison with the UK, where the annual social investment volume amounted to 183-244 Million EUR in the same year.[23] In 2014, the volume of publicly raised social investment capital in Germany was estimated to be about 46 Million EUR.

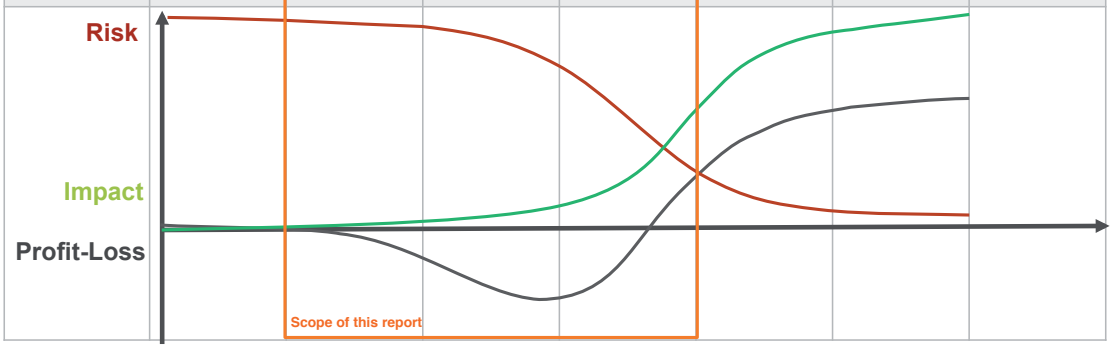
Development stages and typical capital needs

Limited access to financing has repeatedly been cited as one of the main obstacles to growing social entreprises.[24] More specifically, a recent report by the German National Advisory Board for impact investment (2014) established that financing is particularly scarce for activities relating to:

- **Prevention** – preventing social issues rather than trying to fix them ex-post
- **Innovation** – providing sufficient resources for developing and implementing innovative solutions
- **Scale Up** – scaling up proven solutions after the initial pilot project has been concluded

To put this into context, Figure 2 shows the typical stages of development of a venture throughout its lifecycle, including the typical capital needs of social enterprises and the levels of relative risk, impact and profits/losses over time. The scope of this report is marked in red and looks at the "seed", "start-up" and "growth" stages. Consistent with this scope, prevention, innovation and scale up tend to be the most relevant objectives for the early stages as well as the growth stage.

	IDEA STAGE	EARLY STAGE		LATER STAGE			EXIT
		Seed	Start-Up	Growth	Maturity	Consolidation	
Characteristics	Proof of concept, business plan development	Company founded, product develoment, pilot production / delivery	Execution of market launch, first commercial revenues	Early scaling of business, significant growth (reaching break even)	Breakout scaling, increased standardization (positive cash-flow)	Full scale, approaching saturation; M&A driven growth	IPO, share buyback, trade sale, merger or liquidation of assets
Typical Capital Need of SEs (EUR)	0 – 100k	100k – 500k	100k – 1,5m	> 100k	> 500k	> 500k	



Source: Own Illustration

Figure 2: *Typical lifecycle of a social venture*

Figure 3 provides an overview of the typical financing needs of a social venture, correlated to the level of uncertainty associated with each stage of development. Social ventures face different financing needs throughout their lifecycle, from basic research & development, to capacity building and innovation, soft and hard growth capital (depending on the uncertainty and financial risk associated with scaling-up), capital expenditure, pre-funding of fundraising (including "last brick financing" – the need for a partial financing of a building or refurbishment project in order to allow for its commencement while the actual fundraising is still ongoing), knowledge sharing & public education, to turnaround and the transition to new business models. We excluded research and development and knowledge sharing, which are best addressed by grants and would otherwise be subject to disproportionally high risks, from the scope of this report. For the same reason, we also considered high-risk turnaround situations to be outside our scope. Additionally, since capital expenditures are usually asset backed and already fairly well addressed by secured bank loans, the main financing needs that remain in scope include:

- Capacity Building / Innovation / Transition to new business models
- Soft Growth Capital / High Risk Scale Up
- Pre-funding of fundraising
- Hard Growth Capital / Low Risk Scale Up

Figure 3: *Typical financing needs of a social venture throughout its lifecycle*

	IDEA STAGE	EARLY STAGE		LATER STAGE			EXIT / LIQUIDATION EVENT
		Seed	Start-Up	Growth	Maturity	Consolidation	
Characteristics	Proof of concept, business plan development	Company founded, product develoment, pilot production / delivery	Execution of market launch, first commercial revenues	Early scaling of business, significant growth (reaching break even)	Breakout scaling, increased standardization (positive cash-flow)	Full scale, approaching saturation; M&A driven growth	IPO, share buyback, trade sale, merger or liquidation of assets
Typical Capital Need of SEs (EUR)	0 – 100k	100k – 500k	100k – 1,5m	>100k	>500k	>500k	
Research & Development /							
Knowledge Sharing & Public Education							
Turnaround							
Capacity Building / Innovation / Transition to new Business Model							
Soft Growth Capital / High Risk Scale Up							
Pre-Funding of Fundraising							
Hard Growth Capital / Low Risk Scale Up		Scope of this report					
Capital Expenditure							

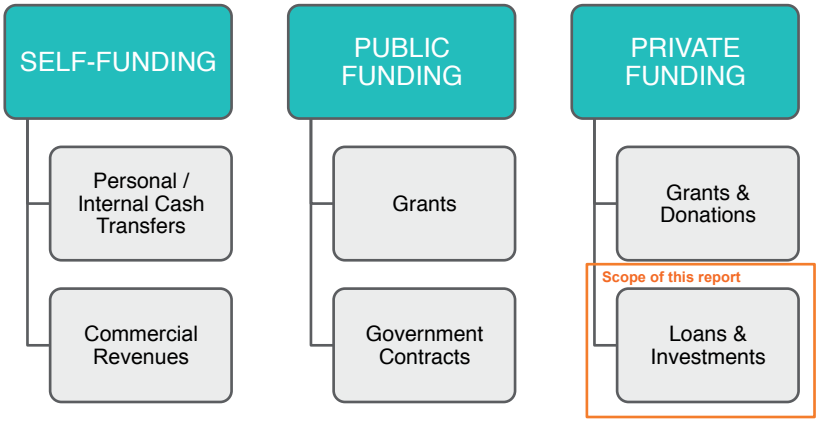
High Uncertainty ↑ ↓ Low Uncertainty

Source: Own Illustration

Sources of financing for social ventures in Germany

Types of financing sources

In general, there are three basic types of financing that can be accessed by social enterprises: self-financing, which is made up of commercial revenues and contributions from founders and parent organizations or shareholders, public financing, which includes grants as well as government contracts, and private financing, which consists of either grants and donations or loans & investments (see figure 4).



Source: Based on Schellberg (2004)

Figure 4: *Basic types of financing sources*

Obstacles to scaling social ventures through public financing

Public grants and government contracts represent a major source of funding for the social sector in Germany. However, numerous obstacles to scaling up innovative solutions are directly or indirectly related to the public funding structure and characterize the current state of the social sector in Germany[25].

- Limited flexibility: Public funding comes with a resource-intensive administrative burden. By stipulating inputs rather than focusing on actual outcomes, public funding often restricts how funds may be used and provides a disincentive for entrepreneurship and improved performance. A related challenge associated with public (as well as private) grants is the emphasis placed on funding projects, as opposed to capacity building and organizational development.
- Lack of public funding and collaboration: Many municipalities suffer from a lack of public funds to invest in innovative or preventive solutions. Instead, the limited funds available are often used to fix social problems in a market environment that puts significant pressure on the costs of social service delivery. The highly competitive mindset amongst service providers also prevents them from entering into partnerships or learning from each other. Moreover, government purchasing processes tend to be bureaucratic and favour large and well established service providers over smaller organisations.
- Limitations of grant-based funding: A complex and fragmented structure of public administration in combination with a practice of municipal self-governance makes it difficult for social enterprises to pinpoint clear responsibilities for the provision of grants. In addition, once the funding for a pilot project, which is usually granted for a limited time period, expires, social ventures often struggle to fill this financing gap and find that they need to develop a more economically viable business model.
- Limitations of legal forms: While the current legal form for public benefit companies in Germany (gGmbH, gUG, gAG) provides tax benefits for the company as well as for donors, it restricts

organisations from building reserves and international expansion. This legal form is also not attractive to financial investors due to restrictions in terms of profit participation and severely limited exit opportunities. In practice, complex legal structures combining public benefit and for-profit entities can be designed, but public benefit and commercial interest need to be carefully balanced to maintain the status of a public benefit company.

It is clear that greater private financing is needed to supplement the public financing available and better enable social ventures to scale up innovative solutions. For the purpose of this report, we are going to focus on private financing in the form of loans and investments. The following chapter elaborates on the obstacles to scaling, innovation and prevention, as they are perceived by both private investors and social enterprises.

Obstacles to scaling social ventures through private investment

Based on a study by the Centre for Social Investment (2013)[26], key challenges private investors face include:

- Relatively High Financial Risk. From the perspective of social enterprises it seems as if most impact investors are risk averse, as they seem to "cherry pick" only the most prominent success stories. From the investors' perspective, many social enterprises appear to be relatively risky investment targets. For example, revenues may be based on temporary projects or on pricing structures, which require a social premium and may therefore be challenging to grow or sustain. New and innovative approaches tend to find it challenging to attract funding without a proof of concept and sufficient evidence regarding their potential impact. In many cases, especially in the early stages, the risk of insolvency appears prohibitively high when taking into account typical limitations in terms of profit margins or the availability of entrepreneurial talent. On the other hand, it can be argued that social ventures tend to be more careful in managing liquidity and growth and are more incentivized to build sustainable businesses rather than growing too aggressively.
- Relatively Low Financial Upside. From the social enterprise's viewpoint, investors tend to think too short-term and neglect the social/environmental impact of an investment. This makes the enterprise valuation – which is already a challenging aspect of deal negotiations with conventional ventures – even more difficult. From the investors' perspective, comparably low margins and financial return profiles, in addition to long holding periods and hardly any exit possibilities, justify a significant need for better upside participation and a functioning secondary market.
- Tensions Regarding Control. Social entrepreneurs usually want to maintain control over their company as Managing Directors in order to avoid mission drift and ensure continued ownership. Investors on the other hand desire a minimum level of control in order to manage execution risk. It is quite common that the founder CEO takes on other roles and has an interest in hiring a more experienced CEO as the venture matures. Clearly, there are substantial conceptual and cultural differences between social entrepreneurs and investors that need to be overcome. A reasonable balance needs to be found between the social entrepreneurs' desire for autonomy and the investors' desire for risk management.
- High Transaction Costs. Especially from the perspective of small and early stage social enterprises, small volume financing for growth and organizational development in the range of 100k - 500k EUR is difficult to obtain. From the investors' perspective small volumes of financing tend to be associated with disproportionately high transaction costs, which include expenses for due diligence and other overheads. For an investment to be efficient, there is a need for standardized financial products and processes that can keep transaction costs low.
- Tension Between Grants And Capital Returns. From the perspective of social enterprises, impact investment comes with the risk of putting off donors who have no interest in their funds beings used to pay for private financial gain. From the investors' perspective there is often a lack of understanding of impact investing not only as an alternative to donations but also as an

investment strategy by its own right, especially among family offices and commercial investors. There is a need to reconcile grant giving with impact investing, for example by making clear that donations can catalyze private investment and that impact investing complements rather than competes with charity.

- Impact Measurement. From the social enterprise's perspective, impact measurement requirements from investors (as well as grant providers) are often perceived as being too complex and resource-intensive, distracting from the actual delivery of impact. From the investors' perspective, there is often insufficient data available to validate potential outcomes and evaluate the effectiveness of interventions. This challenge is exacerbated by a lack of standards with regard to impact measurement. There is a need to provide sufficient resources and – if necessary – tools and expertise for data collection and impact evaluation

The aforementioned obstacles provide an indication of what solutions may be needed to balance the needs of social ventures with the needs of private investors. The financial instruments and financing vehicles described in the following chapters can address these obstacles in a number of ways. These include, for example,

- balancing market-conforming downside protection, upside participation and control provisions with an appreciation for the social/environmental value generated by impact investing,
- working around the lack of securities or collateral,
- taking advantage of first-loss capital and guarantees whenever possible,
- managing transaction costs by minimizing legal and due diligence costs by offering standardized financial products.

A complementary relationship between impact investing and donations can be promoted by positioning the latter as a form of catalytic capital (see chapter 3.4). Finally, for each vehicle adequate resources and capabilities for impact measurement should be considered.

The current private investment landscape in Germany

In general, there are different types of private investors, who usually provide a range of equity, mezzanine and/or debt financing. As Figure 5 shows, these include private investors, investment funds, other specialized institutional investors and crowdfinancing platforms. Examples of typical private financing sources are listed for each category of investor. Additionally, there are numerous public programmes that support early stage technology start-ups: While some of the "blended value" social purpose businesses – especially those that take advantage of innovative technology – qualify for these programmes, this level of support is not available for many social ventures where innovation tends to be non-technological in nature.

	EQUITY	MEZZANINE	DEBT
Private Investors	• Friends & Family • High Net Worth Individuals (HNWI) • Business Angels		
Investment Funds	• Seed Capital Funds • Venture Capital (VC) Funds • Social VC Funds • Corp. VC (CVC) Funds • Private Equity (PE) Funds		
Other Institutional Investors	• Banks (Own investments) • Family Offices		• Banks • Social Banks • Loan Funds • Guarantee Funds • Microfinance Funds
Crowdfinancing Platforms	• Crowdinvestors		• Crowdlenders

Source: Own Illustration

Figure 5: *Overview of private investors and typical financing instruments*

It is worth noting that banks, which social ventures have historically struggled to access financing from, are today probably even more difficult to access due to stricter regulatory and capital requirements, such as BASEL III.[27] These regulations require commercial banks to demand securities for loans, which social ventures are usually unable to provide. Moreover, with the exception of social banks, profit-maximizing financial institutions such as commercial banks tend to underappreciate the wider social impact and only focus on the financial risk-return profile. Finally, they have limited experience with the social sector and therefore may be more conservative with regard to the evaluation of default risks.

Figure 6 provides an overview of the current landscape of financing sources available throughout the various stages of a venture's lifecycle. As is clear from the scope of this report (highlighted in red), most funding sources that are currently available are geared towards mainstream investments and don't address the specific needs of social ventures. This impression is confirmed when taking a closer look at the current impact investing ecosystem in Germany shown in Figure 7.

Figure 6: *Overview of the typical sources of private financing throughout the lifecycle of a social venture*

	IDEA STAGE	EARLY STAGE		LATER STAGE			EXIT / LIQUIDATION EVENT
		Seed	Start-Up	Growth	Maturity	Consolidation	
Characteristics	Proof of concept, business plan development	Company founded, product develoment, pilot production / delivery	Execution of market launch, first commercial revenues	Early scaling of business, significant growth (reaching break even)	Breakout scaling, increased standardization (positive cash-flow)	Full scale, approaching saturation; M&A driven growth	IPO, share buyback, trade sale, merger or liquidation of assets
Typical Capital Need of SEs (EUR)	0 –100k	100k – 500k	100k – 1,5m	>100k	>500k	>500k	
> 1,5m			• VC / CVC Funds	• VC / CVC Funds	• VC / CVC Funds • PE Funds • Banks • Social Banks	• PE Funds • Banks • Social Banks	
500k – 1,5m			• VC / CVC Funds • Social VC Funds • Seed Capital Funds • Crowdfinancing	• VC / CVC Funds • Social VC Funds • Crowdfinancing	• VC / CVC Funds • Social VC Funds • Banks • Social Banks	• Banks • Social Banks	
100k – 500k		**Scope of this report** • Seed Capital Funds • Business Angels • Crowdfinancing	• Business Angels • Crowdfinancing	• Business Angels • Crowdfinancing			
0 – 100k	• Friends & Family	• Business Angels • Crowdinvesting/-lending • Microfinance Funds • Friends & Family	• Business Angels • Crowdinvesting/-lending • Microfinance Funds • Friends & Family				

Source: Own illustration

Within the German impact investing ecosystem, various stakeholders play complementary roles, from providing grants and investment advice to incubation, networking, financial product development, impact asset management, crowdfinancing and social banking. Figure 7 provides a high-level overview of the main players in Germany. Apart from a number of organisations providing significant grants to support social enterprises, there are only a few investment vehicles that directly invest in social ventures – Ananda Social Venture Fund and BonVenture as independent social venture funds, social business angels from the Ashoka network in collaboration with FASE, and Tengelmann Social Ventures as a social venture capital fund with a corporate background. Among these investors only three players have made impact investments in the range of 100k - 500k EUR in the past: FASE/social business angels, BonVenture and Tengelmann Social Ventures. However, while FASE is focused on seed stage companies, both BonVenture and Tengelmann Social Ventures tend to invest volumes of 250k EUR and above in growth stage ventures.

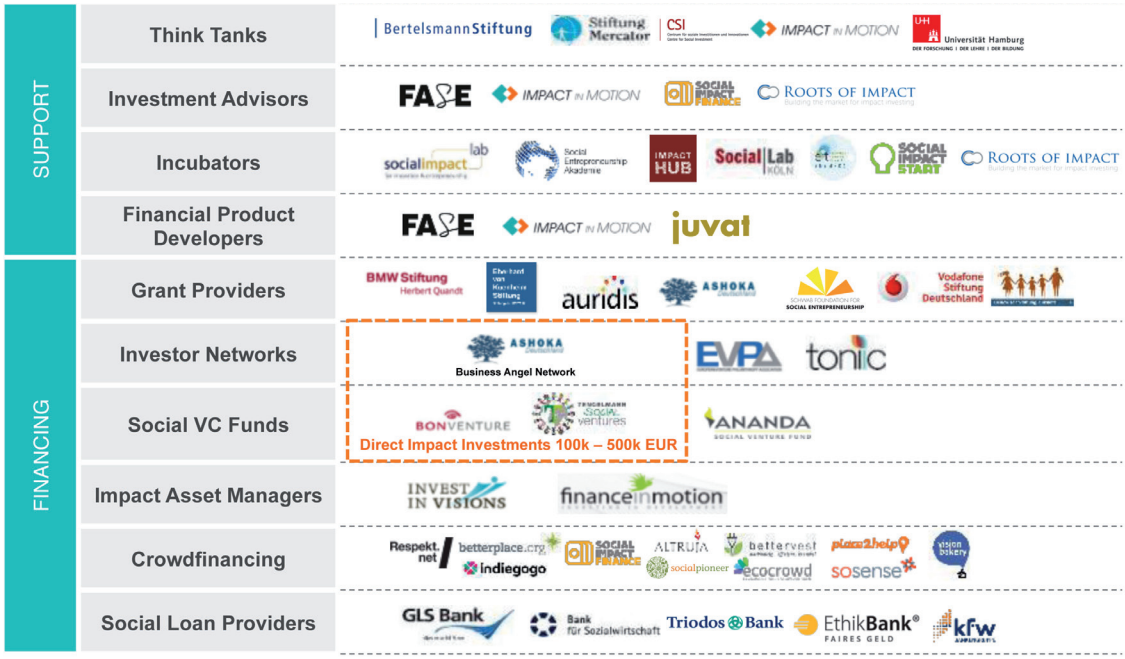


Figure 7: *Overview of the German impact investing ecosystem*

Source: Based on Impact in Motion (2012)

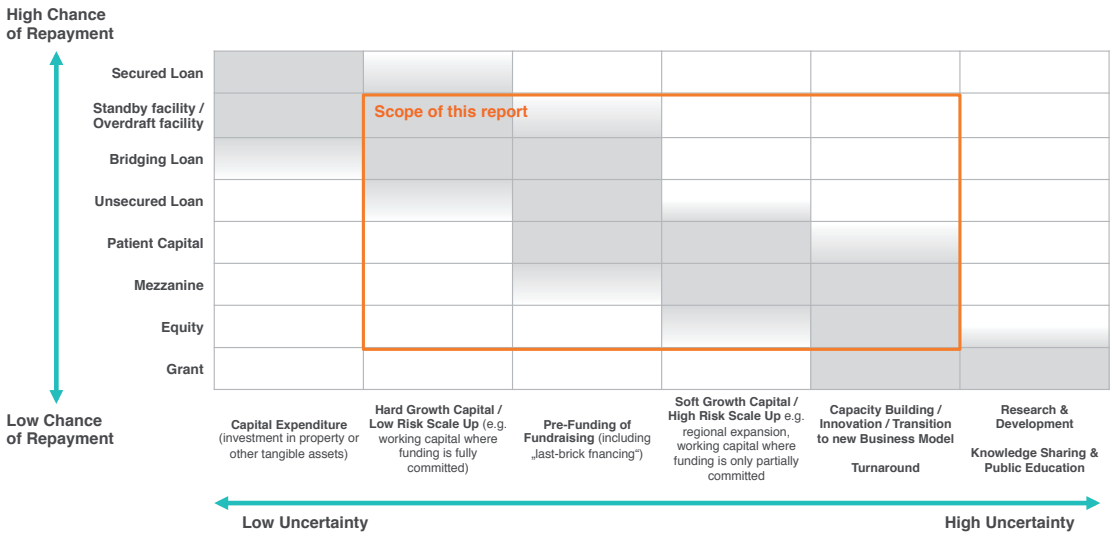
The following chapters outline four promising financing vehicles that could address the limited availability of capital for social enterprises in Germany in the range of 100k - 500k EUR:

- Social Loan Fund
- Social Early-Stage Mezzanine Fund
- Catalytic Capital Fund
- Social Crowdfinancing Platform

This is not intended to be an exhaustive list of all possibilities, but instead reflects the specific situation in Germany, the scope of this report, our own expertise and the feedback from several expert interviews. For example, we decided to deprioritise the idea of a financing vehicle dedicated to social impact bonds, due to the relatively high transaction costs per deal, which would also require an investment amount well above 500k EUR for a Social Impact Bond to be economically viable. Furthermore, the challenging German legal context regarding the implementation of Social Impact Bonds means that it may take considerable effort and political will to implement the first large-scale Social Impact Bond in Germany. Another promising idea that we excluded for the purpose of this report was an intermediate public benefit organization (also known as "Durchleitungsstiftung") which would pool grants and donations from several foundations with the purpose of utilizing them for social investments on behalf of these foundations[28]. This way, the legal uncertainties and limitations that are currently hindering German foundations from using part of their budget for impact investment could be addressed. However, it is our view that such an organization essentially represents an innovative fundraising approach rather than a financial product offering per se – the intermediate organization would still need to decide which type of financing it wants to offer. It could, for example, invest directly in deal-by-deal investments or into an existing fund. It could also establish any of the four financing vehicles, which we describe. In this case, a catalytic capital fund would probably be most likely, given its catalytic impact potential and the challenge of raising a catalytic capital fund otherwise.

To set the stage, we begin with a general overview of financial instruments. Chapter 2.1 described the different financing needs throughout the lifecycle of a typical venture. Based on an overview by CAF Venturesome (2007), Figure 8 illustrates how each of these finan-cing needs can be met by different financial instruments, ranging from different types of loans such as secured loans, overdraft facilities, bridging loans, unsecured loans and patient capital (described in more detail in chapter 3.1) to mezzanine financing and equity (described in more detail in chapter 3.2) to standby (or underwriting) facilities (described in more detail in chapter 3.3) and grants. The scope of this report is marked in red.

Figure 8: *Overview of financial instruments and different financing needs of social ventures*



Source: Based on CAF Venturesome (2007)

3 INNOVATIVE FINANCING VEHICLES TO SUPPORT SOCIAL ENTREPRENEURS IN GERMANY

Figure 9 provides a more detailed overview of the structure of section 3 and its chapters by financial instrument. Note that catalytic capital (chapter 3.3) and crowdfinancing (chapter 3.4) represent cross-cutting concepts as they can either utilize debt, mezzanine, equity or grant instruments to serve their purpose. The overview also lists financial instruments and asset classes that are considered outside the scope of this report, such as public debt, public bonds, real assets, public equity, or social impact bonds.

High Chance of Repayment ↕ **Low Chance of Repayment**

FINANCIAL INSTRUMENTS		Reference	CATALYTIC CAPITAL	CROWDFINANCING	OTHER INSTRUMENTS (Outside Scope)
			Chapter 3.3	**Chapter 3.4**	
Private Debt	Secured Loan	**Chapter 3.1**	Standby / Underwriting Facility Guarantee	Crowdlending	Public Debt Real Assets Public Bonds
	Overdraft Facility / Bridging Loan	**Chapter 3.1**			
	Standby / Underwriting Facility	**Chapter 3.3**			
	Unsecured Loan	**Chapter 3.1**			
	Patient Capital	**Chapter 3.1**			
Mezzanine	Mezzanine Debt	**Chapter 3.2**	Subordinated Loan Liquidity Backstop Common Equity	Crowdinvesting	Public Equity Social Impact Bonds
	Mezzanine Equity	**Chapter 3.2**			
Private Equity	Preferred Equity	**Chapter 3.2**			
	Common Equity	**Chapter 3.2**			
Grant	Grant	**Chapter 3.3**	Grant	Crowdfunding	

Source: Own illustration

Figure 9: *Overview of the structure of section 3*

Each of the following chapters begins with an overview of general concepts related to the financing vehicle, followed by an example to outline the vehicle's conceptual basis and illustrate its practical application. This chapter concludes with an outlook on the possible adaptation of the presented idea to the German social investment market based on two questions from the perspective of the demand side on the one hand and the supply side on the other:

- Who could benefit? How attractive could the financing vehicle be to social ventures?
- What could be provided? How attractive could the financing instrument be to potential investors?

These initial thoughts and reflections represent the preliminary results of an on-going project and serve as a starting point to prioritise and further develop the ideas generated so far.

Social Loan Fund

BACKGROUND CONCEPT: Debt Financing

Debt financing, which ranges from loans (i.e. debt transactions between two parties) on the one hand to bonds (tradable debt securities) on the other, is the most basic form of financing. More specifically, a loan can be defined as an agreement between two parties where a lender provides a certain amount of money (the principal) to a borrower, for a defined period of time. A typical loan agreement specifies the principal amount, the interest rate, the date of repayment, and any collateral, (a property which is pledged by the borrower to ensure repayment in case of default). Accordingly, a loan is either referred to as a **secured loan** if collateral has been pledged, as is the case with a mortgage for example, and as an unsecured loan if there is no collateral. **Unsecured loans** usually demand higher interest rates than secured loans due to the increased risk in case of insolvency. An unsecured lender's claims are limited to the borrower's unencumbered assets (i.e. assets that are not already pledged to secured loans).

Other notable types of loans include:

Overdraft facility – a flexible line of credit usually provided by banks when a borrower's current account reaches zero. An overdraft occurs when money is withdrawn and the available balance goes below zero. Up to a specified limit, credit is granted at agreed conditions with no fixed repayment date.

Bridging loan – a short-term loan (usually less than 1 year) to address temporary cash flow shortfalls in light of anticipated future payments. Insofar as the bridging loan is based on relatively certain future cash flows (e.g. from committed grant payments or a robust sales pipeline) the default risk and interest rates are relatively low. However, bridging loans may also be used to pre-fund less certain future payments (e.g. from on-going or future fundraising efforts), where higher interest rates are more common.

Patient capital (or "soft loan") – a longer-term loan (usually more than 5 years) granted at below-market conditions, typically subordinated, unsecured and featuring no or relatively low interest rates, favorable grace periods or a combination of both. For the purpose of this report, forgivable loans, i.e. loans that can be converted into grants[29], are considered a type of patient capital.

In most countries, loans provided by banks serve as an important source of funding, especially for small- to medium sized companies. Despite having been a mainstay of the financial system for some time, there is still room to develop new and innovative products, for example by creating loans that feature greater flexibility by tying interest rates and maturities to company performance, or by making more extensive use of the internet, e.g. through crowdlending platforms, as described in chapter 3.4.

Bonds represent an alternative form of debt financing. A bond can be defined as a debt security, according to which the issuer of a bond owes the holder the bond (who may be different to the original purchaser), an amount of money (the principal) and is obliged to pay them interest (the coupon) and repay the principal on specific payment (coupon) dates or at the final maturity date. In contrast to a loan, a debt security can be bought and sold on a secondary market. While public stocks represent tradable securities as well, the main difference is that stockholders own an equity stake in a company, whereas bondholders own a creditor stake and hence will be repaid before stockholders in the event of bankruptcy.

The most common process for issuing bonds is through underwriting. When a bond issue is underwritten, one or more securities firms or banks purchase the entire issue of bonds from the issuer and re-sell them to investors. Since issuing bonds requires relatively high transaction costs, mainly due to the need to provide a formal legal offer document (prospectus), small organizations are usually unable to afford this type of financing. For this reason, publicly offered bonds are considered outside of the scope of this report. However, an alternative process for bond issuance, which is used for smaller issues and avoids some of the transaction costs, is the private placement bond. Since these bonds are sold directly to a private group of buyers, they cannot be traded as easily as publicly offered bonds. For the sake of simplicity and given our focus on standardized financial products, we opted for a pure loan fund as a promising financing vehicle for the German context. The loan fund would provide social enterprises with debt financing, which they otherwise would not receive from a bank. Recently, a similar fund has been successfully raised in the UK: The Third Sector Loan fund.

EXAMPLE: The UK Third Sector Loan Fund

The Third Sector Loan Fund (TSLF) was launched in November 2014 by Social and Sustainable Capital (SASC), a regulated fund manager and social enterprise providing finance to charities and social enterprises. The purpose of the TSLF is to supply registered charities and regulated social enterprises with secured and unsecured loans of 250,000 – 3 Million GBP, which many social organisations have traditionally had difficulty accessing. The fund will last 10 years with a 7 year investment period.

SASC is financially supported by the Social Investment Business (SIB), one of the UK's leading social investors, who have invested more than 340 Million GBP in 1300 charities and social enterprises since 2002. The SIB provided a catalytic first loss investment of 1.5 Million GBP, which was instrumental to the creation of the fund and will be further described in chapter 3.4.2 as a model example of a catalytic capital investment. Figure 10 provides an overview of the key characteristics of the TSLF[30].

Fund Size	30 Million GBP targeted (current size: 6.5 Million GBP)
Legal Form	English Limited Liability Partnership (LLP)
Investors	Big Society Capital, The Social Investment Business, Santander
Target Market	United Kingdom
Target Group	Registered charities and regulated social enterprises
Financial Instrument	Secured and unsecured loans
Loan Volume	250,000 – 3 Million GBP
Target Interest Rate	6-12%

OUTLOOK: Potential adaptation to the German social investment market

Who could benefit? How attractive could the financing vehicle be to social ventures?

Potential target clients for the Social Loan Fund could include social benefit enterprises as well as "mission locked" and "blended value" social purpose businesses that are capable of paying an economically viable rate of interest. In some cases, charitable organisations could be considered as well, depending on the likelihood that the loan can be repaid, through bridging loans for example or loans in combination with grants or guarantees (which could be provided by a catalytic social capital fund described in 3.3, for example).
In general, target clients are likely to be at a more advanced stage of development, with an emphasis on growth and maturity as illustrated in Figure 11. Considering the broad range of social enterprises and development stages addressed, the market size for the Social Loan Fund could be relatively large. However, given the current economic environment and the early stage of many social ventures in Germany, interest rates would probably need to be somewhat lower than 6-12% in order to appeal to a mass market.

Figure 11: *Overview of the development stages and types of organizations served by the Social Loan Fund*

	IDEA STAGE	EARLY STAGE		LATER STAGE			EXIT / LIQUIDATION EVENT
		Seed	Start-Up	Growth	Maturity	Consolidation	
Characteristics	Proof of concept, business plan development	Company founded, product develoment, pilot production / delivery	Execution of market launch, first commercial revenues	Early scaling of business, significant growth (reaching break even)	Breakout scaling, increased standardization (positive cash-flow)	Full scale, approaching saturation; M&A driven growth	IPO, share buyback, trade sale, merger or liquidation of assets
Typical Capital Need of SEs (EUR)	0 – 100k	100k – 500k	100k – 1,5m	>100k	>500k	>500k	
Charitable organisation							
Social Benefit Enterprise				Social Loan Fund			
„Mission Locked" Social Purpose Business							
„Blended Value" Social Purpose Business							
Mainstream Businesses							

Source: Own illustration

What could be provided? How attractive could the financing vehicle be to potential investors?

The Social Loan Fund could provide secured and unsecured loans with volumes ranging from 100k to 500k EUR and at interest rates ranging, for example, between 3-9%. The relatively low interest rates would probably need to be supported by guarantees or in combination with grants or other forms of catalytic capital. A similar mechanism is going to be utilized by a new social loan fund in the UK that aims to provide low interest loans to social enterprises at volumes below 250k GBP. The fund is currently under development by "Access", a newly established charitable foundation, which has been setup by the Big Society Trust to increase access to social investment.
Figure 12 provides an overview of the possible financial instruments and financing needs addressed by the Social Loan Fund. Possible financial instruments include debt financing ranging from patient capital to bridging loans. Typical financing needs served range from capital expenditure to the pre-funding of fundraising. The emphasis on lower-risk uses implies that the potential to create new impact through innovation would be relatively limited in this case.

It is currently assumed that the Social Loan Fund could provide (unsecured) loans more easily than strictly regulated banks. However, the degree to which a social loan fund could indeed serve as an effective financing vehicle in Germany needs to be further explored. Since large welfare associations enjoy reasonable access to debt financing, it is primarily small social enterprises that find themselves in need of financing. If this financing mostly served high-risk uses such as soft growth capital or capacity building, interest rates would need to be relatively high to account for the default risk and still allow for a reasonable financial return. Considering the economic burden of high interest rates for early stage ventures, as well as the frequent need for hands-on business development support, equity or mezzanine financing might be more suitable for this particular segment of the market.

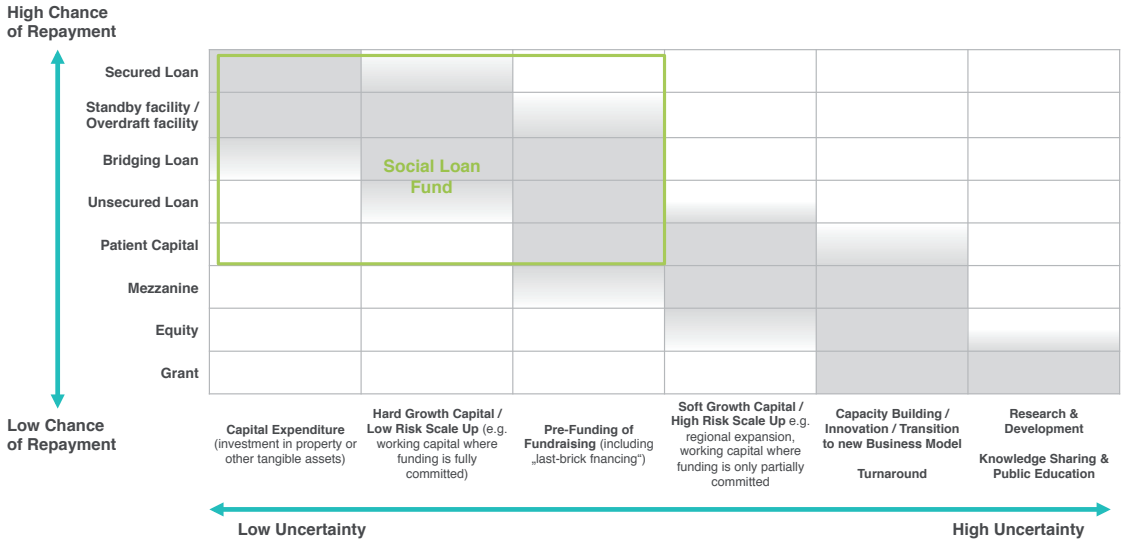


Figure 12: *Overview of the financial instruments and financing needs addressed by the Social Loan Fund*

urce: Own illustration, based on CAF Venturesome (2007)

Early-Stage Social Mezzanine Fund

BACKGROUND CONCEPT: Venture Capital and Mezzanine Financing

Venture Capital is an important source of early-stage funding for technology start-ups. At this early stage, companies are usually cash-flow negative and unable to offer significant collateral or a robust financial track record. The variety of uncertainties results in a high level of insolvency risk, meaning they rarely qualify for ordinary bank loans. For the same reason, they usually don't have access to capital markets, where tradable shares would be offered to the public.

In a venture capital deal, the investee raises funds by selling part of its equity in a private transaction to one or more venture capital investors. In order to manage execution risk, maximize downside protection and upside participation, these funds typically receive preferred equity in return. In contrast to common equity, **preferred equity** features special rights concerning economics and control, such as liquidation preferences, (payable in kind) dividends, anti-dilution protection, protective provisions and board seats[31]. To realize their returns, investors usually rely on exit events such as initial public offerings, trade sales or share buybacks rather than dividends.

Figure 13 illustrates different financial instruments ranging from senior debt on one end of the spectrum to common equity on the other end. As highlighted in Figure 13, in addition to investing in preferred equity, venture capital investors regularly provide **mezzanine debt**, a hybrid form of capital, which shares properties of debt and equity. Mezzanine debt usually takes the form of an unsecured subordinated loan, and may be combined with warrants, a revenue sharing agreement or conversion rights in order to improve financial upside participation.

Figure 13: *Layers of the capital structure and typical financial instruments used by venture capital investors*

DEBT		• Interest-bearing loans with strict amortization schedules. • Usually requires securities/collateral or guarantees for downside protection. Least at risk in case of an insolvency
MEZZANINE	Venture Capital **Mezzanine Debt**	• Subordinated, unsecured loans with limited or no amortization. • A conversion feature, revenue sharing agreement and warrants allow for upside participation.
	Mezzanine Equity	• Includes profit participation certificates and silent partnerships, for example. • While investors may participate in any upside, the absence of voting rights allows the issuing company to maintain control / their charitable status
EQUITY	Venture Capital **Preferred Equity**	• Shares that feature special rights such as liquidation preference, protective provisions, voting rights, dividends or anti-dilution protection. Highly dilutive.
	Common Equity	• Ordinary shares with voting rights. Downside protection is very limited. • This layer is most at risk in case of an insolvency. Highly dilutive.

Source: Own illustration

There are numerous advantages to using Mezzanine debt. Due to their relative simplicity, Mezzanine financing agreements tend to be faster and easier to negotiate than equity investment agreements and require less rigid terms than senior debt. While the subordination feature allows the lender to obtain senior debt more easily in the future, the preferable position in the capital structure allows for a lower cost of capital compared to equity. A conversion feature enables the loan provider to postpone a controversial negotiation point such as company valuation to a future date, when more data is available. As long as the conversion has not taken place, shareholders avoid unnecessary dilution. At the same time, the lender has the option to benefit from the upside partici-

pation through converting to equity in case of successful development, while maintaining the better downside protection of subordinated debt over common equity.

Over the past decades, Mezzanine debt has become a widely used instrument to fund high potential - high risk businesses. The following example of the HTGF demonstrates that – as a standardized financial product – mezzanine debt can serve as a feasible seed-funding instrument for early stage start-ups. We believe that at a smaller scale, this mechanism could be also transferred to social ventures.

EXAMPLE: High-Tech Gründerfonds (HTGF)

The HTGF was founded in August 2005 based on an initiative by the German Federal Ministry for Economic Affairs and Energy as part of its "Partners for Innovation"-strategy. The main goal of the initiative was to improve the financing terms for technology-oriented startups in Germany. As most capital-intensive technology-oriented start-ups were struggling to find sufficient funding in the aftermath of the collapse of the dotcom-bubble in 2000, the HTGF was set up to foster and revive the seed-investment market in this sector.[32] Today, the fund is mainly owned by public investors (the German Federal Ministry for Economic Affairs and Energy and KfW Banking Group) while 17 corporate partners account for a minority stake of less than 20%.

The HTGF provides mezzanine financing in the form of subordinated convertible loans of up to EUR500k, with the possibility of additional follow-on financing of up to 1.5 m EUR. Thanks to standard processes, documents and terms, which leave limited leeway for negotiation, transaction costs are kept relatively low. Figure 14 provides an overview of the key characteristics of the HTGF[33]. Since its inception, the HTGF has invested in about 250 companies with a team of 27 investment managers mainly from professional backgrounds in natural sciences, computer science, engineering and law. The work and impact of HTGF has been positively perceived and evaluated by all those involved[34].

Fund Size	573.5 Million EUR (Fund I: 272 Million EUR; Fund II: 301,5 Million EUR)
Legal Form	Limited Liability Company (GmbH)
Investors	German Federal Ministry for Economic Affairs and Energy, KfW Banking Group, ALTANA, BASF, B. Braun, Robert Bosch, CEWE, Daimler, Deutsche Post DHL, Deutsche Telekom, Evonik, Lanxess, media + more venture Beteiligungs-GmbH & Co. KG, METRO, Qiagen, RWE Innogy, SAP, Tengelmann, Carl Zeiss
Target Market	Germany
Target Group	SMEs according to EU definition (<50 employees, < 10 Million EUR annual turnover) with an office in Germany who are less than a year old that focus on technology with technological know-how with protected or protectable intellectual property, available exclusively and without restrictions and owned by the company
Financial Instrument	7 year subordinated loan, convertible into a 15% nominal shareholding
Investment Size	Initial Investment of up to 500k EUR; up to 1,5 Million EUR follow-up financing
Target Interest Rate	10% (deferred for the first four years)

OUTLOOK: Potential adaptation to the German social investment market

Who could benefit? How attractive could the financing vehicle be to social ventures?

Potential target clients for the Early Stage Mezzanine Fund include "mission locked" and "blended value" social purpose businesses that have an attractive value proposition, but are still too early stage for established social venture funds. Figure 15 shows that the fund would focus on "seed" and "start-up" ventures given that the established social venture funds tend to be most active in the growth stage. The number of social ventures with the appropriate characteristics to receive financing would be relatively small in comparison to the number of socially motivated organizations that are looking for investment.
The uncertainties and risks involved in early stage financing demand a selective and careful approach. In comparison to social venture capital funds which make relatively few and extensively evaluated deals, the early stage mezzanine financing vehicle would need to find a suitable balance between making a larger number of smaller bets with lower levels of selectivity and transaction costs per deal, while at the same time selecting the social ventures with the highest impact and financial return probabilities.

Figure 15: *Overview of development stages and types of organizations served by the Social Early Stage Mezzanine Fund*

	IDEA STAGE	EARLY STAGE		LATER STAGE			EXIT / LIQUIDATION EVENT
		Seed	Start-Up	Growth	Maturity	Consolidation	
Characteristics	Proof of concept, business plan development	Company founded, product develoment, pilot production / delivery	Execution of market launch, first commercial revenues	Early scaling of business, significant growth (reaching break even)	Breakout scaling, increased standardization (positive cash-flow)	Full scale, approaching saturation; M&A driven growth	IPO, share buyback, trade sale, merger or liquidation of assets
Typical Capital Need of SEs (EUR)	0 – 100k	100k – 500k	100k – 1,5m	>100k	>500k	>500k	
Charitable organisation							
Social Benefit Enterprise							
„Mission Locked" Social Purpose Business		**Social Early Stage Mezzanine Fund**					
„Blended Value" Social Purpose Business							
Mainstream Businesses							

Source: Own illustration

What could be provided? How attractive could the financing vehicle be to potential investors?

The Social Early-Stage Mezzanine Fund could replicate key characteristics of the HTGF. For example, the Fund could offer subordinated convertible loans of 100k - 500k EUR at standard terms, while being adapted to meet the specific requirements of social ventures. Low transaction costs could be ensured by the standardization of processes, documents and investment terms. Nevertheless, the active sourcing, negotiation and management of the investments would require a highly skilled team and implies relatively high running costs and management fees. An alternative approach could be a relatively passive fund, which would almost automatically co-invest alongside qualified lead investors. Such a fund could probably be classified more adequately as a catalytic capital fund as described in chapter 3.3.

Figure 16 provides an overview of the financial instruments and financing needs addressed by the Social Early Stage Mezzanine Fund. The typical financing needs served are capacity building & innovation and soft growth capital. The focus on innovation at the early stage of develop-

ment implies that the overall impact unlocked by the fund could be substantial. We learned from our research, for example, that numerous innovative pilot projects – which otherwise would be deprioritised or put on hold – are more likely to go ahead if a realistic prospect of subsequent early stage financing was available.

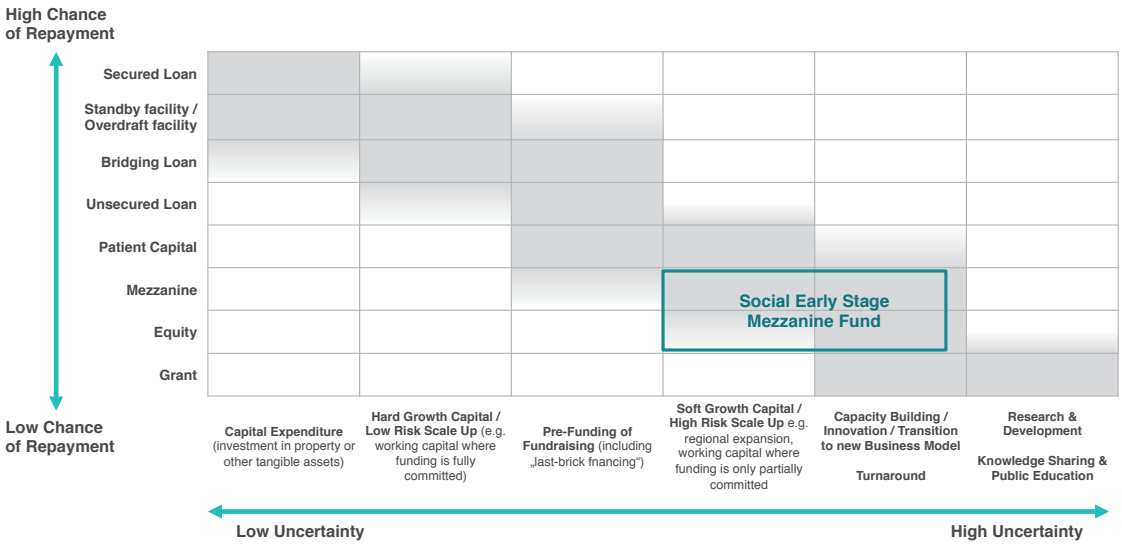


Figure 16: *Overview of financial instruments and financing needs addressed by the Social Early Stage Mezzanine Fund*

Source: Own illustration, based on CAF Venturesome (2007)

Catalytic Capital Fund

BACKGROUND CONCEPT: Catalytic Capital

Catalytic capital can be defined as capital provided by a third party that enables or triggers the flow of capital from another, usually more risk averse party, which otherwise would not have occurred. In general, catalytic capital can be deployed in different forms:

Matched Financing: This type of catalytic capital requires a commitment by a catalytic investor to co-invest alongside other investors, thereby effectively increasing the total investment amount and level of diversification. The terms are usually similar ("Pari Passu") and risks are equally shared and spread across several parties. To minimize transaction costs, responsibilities for specific due diligence tasks, deal structuring and investment management may be delegated to a lead investor. A typical example of matched financing is the European Angels Fund, an initiative advised by the EIF, which provides qualified business angels with 50% co-investment for deals in the range of 250k to 5 Million EUR[35]. Matched financing may also be employed in debt financing, in which case several parties provide loans with similar conditions.

Commitment for Last Resort Financing: Financial instruments that provide last resort financing, such as underwriting (or standby) facilities and liquidity backstops, represent another form of catalytic capital. In general, a third party makes a commitment for capital to be available if other sources of financing don't work out. More specifically, in terms of equity investments, **liquidity backstops** refer to a commitment to purchase any unsubscribed portion of shares in a securities offering. By providing a vote of confidence as well as ensuring the continuation of the business independent of the actual fundraising process, the deal becomes more likely to succeed. In terms of debt financing, **a standby (or underwriting) facility** is a commitment from a lender to advance a specified amount of funds for a period of time for a defined project, which may only be drawn down if a budgeted income does not materialize. Interest is only paid on the amount drawn down.

Catalytic First-Loss Capital (CFLC): By co-investing into a layer of the capital structure which is more junior or at a first-loss position, therefore absorbing some of the insolvency risk, a third party can entice more risk-averse investors to participate in funding. For debt financing, this role can be served by guarantees, subordinated loans or patient capital. On the equity side, a commercial preferred equity investment can be catalyzed for example by a 3rd parties' co-investment into a first-loss equity layer. In this case grants (as well as donations), which make a positive contribution to the value and financial health of the receiving organisation can serve as catalytic first-loss capital equally well. Depending on the timing and the conditions, it can be ensured that the granted funds are not used to pay for investors' financial gains, but rather serve as a catalytic co-investment to support the growth of a social venture. For the purpose of this report, repayable grants, i.e. grants that can be converted into loans based on the ability of the grantee to repay the grant in case of success[36], are considered a specific type of grant, which bear the characteristics of a first-loss layer in the capital structure.
According to the Global Impact Investing Network, CFLC can be defined by three main features[37]:

- **Clearly identified provider that will bear first losses.** The amount of loss covered is typically set and agreed upon upfront.
- **Catalytic.** By improving the recipient's risk-return profile, CFLC encourages the participation of investors who otherwise would not invest.
- **Purpose driven.** CFLC aims to channel commercial capital towards the achievement of certain social and/or environmental outcomes. In addition, the purpose can be to demonstrate the commercial viability of investing in a new market.

Given these characteristics, providers of CFLC will typically be foundations, high-net-worth individuals or public funds driven by a social mission.

It is important to note that CFLC does not represent a financial instrument as such. Rather, it is a mechanism that may utilize different financial instruments and may provide finance not only to social enterprises directly, but also to intermediary financing vehicles, by improving their capital structure. The following example describes how the capital structure of the Third Sector Loan Fund in chapter 3.1 serves as an example of a catalytic first loss investment. Additionally, the example of the German Guarantee Banks ("Bürgschaftsbanken") illustrates how state-supported financing vehicles have supported thousands of small-to-medium enterprises with catalytic guarantees.

EXAMPLE: Structure of the Third Sector Loan Fund

The Third Sector Loan Fund is a £30 million Fund, which invests in social enterprises and charities across the UK through secured and unsecured loans. To set the Fund up, the Social Investment Business (SIB) has provided a catalytic £1.5 million repayable grant and agreed not only to bear any losses before other investors but also to forego any profits. Big Society Capital (BSC) has committed £15 million of risk capital and will be next to bear any losses, but will receive all excess returns from the fund. Lastly, Santander has provided £13.5 million of senior debt, at a fixed-income return and will only face losses if the other investors lose all their capital. Santander's investment is believed to be the biggest single commercial investment by a mainstream UK financial institution into a third party fund lending to social ventures.[38] It can be argued that the catalytic first-loss investment of £1.5 million provided by the Social Investment Business has been instrumental in establishing a fund 20 times its size.

Figure 17 illustrates how the Fund has been designed to accommodate different investors' risk profiles. The Fund is structured so that the grant is repaid by the first 50% of net income generated, as well as the second 50% at maturity once the mezzanine investor (BSC) has received back their principle (including income). According to a representative of Social and Sustainable Capital (SASC), the most difficult task was to find an institution investing first-loss capital due to limited (usually negative) financial return prospects.

Layer in Capital structure	**Catalytic First-Loss**	**Mezzanine**	**Senior-Debt**
Investor	Social Investment Business	Big Society Capital	Santander
type of capital	Catalytic capital	Mission driven risk capital	Loss averse socially motivated capital
Amount	1.5 Million GBP	15 Million GBP	13.5 Million GBP
Financial Risk	Very high	High	Very low
Financial Return	Capped upside (repayable grant)	Variable Return (Levered upside and downside)	Fixed risk adjusted return
Social return	Very leveraged	Leveraged	Leveraged

Source: Social and Sustainable Capital 2014

EXAMPLE: The German Guarantee Banks ("Bürgschaftsbanken")

The first German Guarantee Banks were founded between 1949 and 1955 by key private sector stakeholders of the German economy to encourage post-war reconstruction. After the reunification in 1990, new banks were founded in the Eastern German states. The idea was to create a system of institutions founded and owned by the private sector to support private sector activities with guarantees.[39] Today, there are a total of 17 guarantee banks, operating regionally in each federal state.[40] These Guarantee Banks are credit institutes according to §1 of the German Banking Act, owned either by financial institutions such as banks and insurance companies, or by business associations. By providing guarantees of up to 1.25 Million EUR and up to 80% of the total volume, the German Guarantee Banks in combination secured a total of 6,700 credit schemes with guarantees of 1.1 Billion EUR, which enabled a total credit volume of 1.7 Billion EUR in 2013. The financial commitments made by the Guarantee Banks are in turn guaranteed by the German federal states (up to 65% of guarantee value in Western Germany and 75% in Eastern Germany).

The German Guarantee Banks collaborate closely with publicly supported investment funds ("Mittelständische Beteiliungsgesellschaften" (MBGen) which – like the Guarantee Banks – are not-for-profit organisations that focus on facilitating regional development through local investment. Currently, there are 14 MBGens who in 2013 invested 180 Million EUR in private equity in 600 investment cases. They typically invest in silent participation rights (see chapter 3.3), which become significantly more attractive as a financial investment in partnership with a Guarantee Bank. All Guarantee Banks and public investment funds are grouped under one umbrella organization, the "Association of German Guarantee Banks" ("Verband deutscher Bürgschaftsbanken").[41]

Figure 18 provides an overview of the key characteristics of the German Guarantee Banks[42].

Volume	In sum all German Guarantee Banks provided guarantees over 1.1 Billion EUR (2013)
Legal Form	GmbH
Investors	Various (private investors)
Target Market	Germany
Target Group	Commercial enterprises and self-employed people that lack sufficient loan collateral but have a reliable business perspective. Supported activities include: start-up and acquisition, investments and financing for growth, working capital (including line of credit), bank guarantees, bills of exchange
Financial Instrument	Default guarantees for loans
Investment Size	Up to 1.25 Million EUR or 80% of the total volume
Target Interest Rate	n/a (processing fees)

OUTLOOK: Potential adaptation to the German social investment market

Who could benefit? How attractive could the financing vehicle be to social ventures?

Potential target clients for a Catalytic Capital Fund in Germany include social purpose businesses (although a share of "blended value" social purpose businesses might be disqualified from the perspective of philanthropic investors, unless they have committed to a legally binding "mission lock"), social benefit enterprises and even charitable organizations which hitherto were not considered investable but could become viable investment targets when combined with first-loss capital. Figure 19 shows that the catalytic investment would support social ventures in the earlier stages of their lifecycle (seed, start-up, growth) given that it should be relatively easy for more mature companies to obtain financing without catalytic capital.

A Fund dedicated to providing catalytic first–loss capital would probably be the first of its kind in Europe and would therefore be highly attractive to social ventures and social investors alike. Moreover, catalytic capital could be of particular interest when designing new investment vehicles for social ventures, where it is the vehicles themselves that would benefit from a catalytic first-loss layer. Of the financing vehicles described in the previous chapters, the Social Loan Fund and the Social Early Stage Mezzanine Fund, could benefit immensely from a first-loss anchor investment.

	IDEA STAGE	EARLY STAGE		LATER STAGE			
		Seed	Start-Up	Growth	Maturity	Consolidation	
Characteristics	Proof of concept, business plan development	Company founded, product develoment, pilot production / delivery	Execution of market launch, first commercial revenues	Early scaling of business, significant growth (reaching break even)	Breakout scaling, increased standardization (positive cash-flow)	Full scale, approaching saturation; M&A driven growth	IPO, share buyback, trade sale, merger or liquidation of assets
Typical Capital Need of SEs (EUR)	0 – 100k	100k – 500k	100k – 1,5m	>100k	>500k	>500k	
Charitable organisation		**Social Catalytic Capital Fund**					
Social Benefit Enterprise							
„Mission Locked" Social Purpose Business							
„Blended Value" Social Purpose Business							
Mainstream Businesses							

Source: Own illustration

Figure 19: *Overview of the development stages and types of organizations served by the Catalytic Capital Fund*

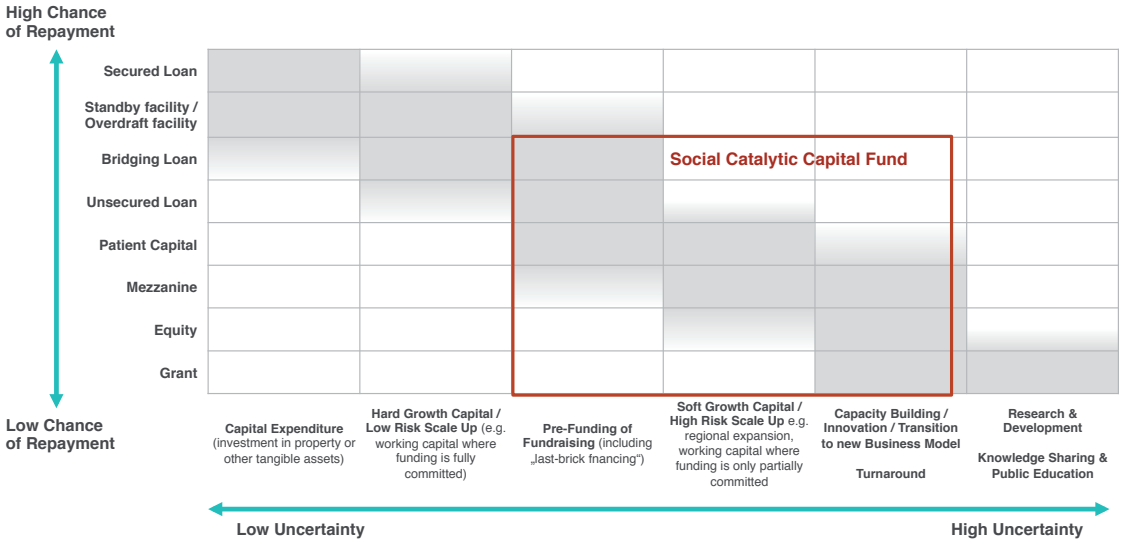
What could be provided? How attractive could the financing vehicle be to potential investors?

A Catalytic Capital Fund could provide a range of catalytic financing instruments (including matched financing, commitments for last resort financing, patient capital, guarantees, first-loss equity or grants) to serve various financing needs. Figure 20 provides an overview of the different financial instruments that a Catalytic Capital Fund could offer, as well as the type of financing needs it could address. Typical financing needs range from pre-funding of fundraising to more risky activities such as capacity building, innovation and the development of new business models.

The question of which specific financial instrument to utilize and how best to design a structure incorporating Catalytic First Loss Capital would need to be the subject of a more detailed feasibility study. Transaction costs per deal and the skillset of the investment team would depend on the type of catalytic capital provided – matched financing or guarantees could be provided relatively

efficiently, whereas the structuring and management of first-loss equity investments would demand more time and effort per deal. In terms of financial viability, the Catalytic Capital Fund is probably the most challenging to implement due to its limited (potentially negative) expected financial return, which would require funding from philanthropic and public sources.

Figure 20: *Overview of the financial instruments and financing needs addressed by the Catalytic Capital Fund*



Source: Own illustration, based on CAF Venturesome (2007)

Social Crowdfinancing Platform

BACKGROUND CONCEPT: Crowdfinancing

Crowdfinancing is a popular source of funding for SMEs in the private sector that has gained considerable momentum in recent years. The total funds raised by all types of crowdfinancing increased from around 530 Million USD in 2009 to around 5.1 Billion USD in 2013.[43] About 30% of these funds were raised for social causes. According to the World Bank in 2013 there were 674 crowdfinancing platforms in 45 countries, including 26 in Germany.[44]

The idea behind crowdfinancing is that small amounts of money are collected via online platforms ("digital marketplaces") from a large number of individuals or organizations ("the crowd") in order to fund a project, a business or a loan.[45] The concept originated in 2006/07, when web 2.0 applications developed in the US and UK made crowdfinancing platforms viable.[46]

There are three basic types of crowdfinancing platforms:[47] crowdfunding, which typically offers donations, crowdinvesting, which mainly offers equity and mezzanine investments, as well as crowdlending, which offers debt financing.

- **Crowdfunding** is the most commonly used type of crowdfinancing today. The funding is provided by the crowd as a donation, often in exchange for a gift or a discount on the company's product (reward-based crowdfunding), or as a pre-order for an innovative product or service that is usually still in development. The largest established crowdfunding platforms include kickstarter.com and indiegogo.com. This type of financing is particularly relevant for early stage social enterprises, as it facilitates grant-like funding from donors, who are interested in funding innovative ideas.
- **Crowdinvesting** has attracted comparatively less attention when it comes to funding social enterprises according to recent studies[48]. Crowdinvestors take an equity or quasi-equity stake in a company – in Germany usually in the form of silent partnerships, profit participation rights or profit participation loans.[49] Crowdinvesting can be considered as a form of venture capital, offering the investor a high-risk opportunity to be part of the venture's value creation. Examples of well-established crowdinvesting platforms include crowdfunder.com and angelist.com.
- **Crowdlending** refers to the online brokerage of loans from many small lenders to individuals and organizations. The lenders receive a pre-determined rate of return on their loan in relation to the company's risk profile. Social lending is based upon similar principles to crowdlending, however lenders do not expect to receive a financial return. Rather, those who lend aim to provide patient capital to SMEs with a philanthropic and primarily social focus. In comparison to a donation the advantage is that if the borrower does well, the lender gets his share of the loan repaid, allowing him to invest in new projects. The US-based social lending platform KIVA.org[50] is perhaps the best-known example in this sector offering micro loans to businesses and individuals in developing and emerging countries.

EXAMPLE: Crowdlending platform Funding Circle

Funding Circle was founded in 2009 and became the first site to offer peer-to-peer lending for SMEs.[51] Today it is one of the leading online marketplaces for SMEs to borrow capital worldwide, with operations in the UK and the US.[52] Since 2010, around 465 Million GBP has been lent to 5,000 businesses by more than 35,000 people. Current estimated returns for investors are 7.5% per year (as of December 2014).
The company itself has recently raised 65 Million USD in a fourth investment round to scale-up its operations and to further develop its technology. The total amount of equity raised by Funding Circle to date is 123 Million USD[53]. According to Funding Circle, the UK business has been growing at 150% a year over the past four years and is expected to grow even more rapidly in the future.[54]

Since launching Funding Circle has developed a lean borrowing process:

1. Online check (10 minutes) to determine whether the company is eligible for application
2. Submission of full application
3. Response by Funding Circle within two hours
4. If Funding Circle accepts the application, the company is presented on the platform
5. Over the course of a week, investors bid in an auction how much money they want to lend at what interest rate

Fees are charged only if a loan is accepted and range between 2-5% for borrowers, whereas investors pay an annual fee of 1% and a 0.25% fee for selling-on loans. Funding Circle takes three different types of security from borrowers: (1) Director's personal guarantee, (2) a charge across all a company's assets, (3) a security on a specific asset.

Figure 21 provides an overview of the key characteristics of Funding Circle[55]

Lending Volume	Approximately 465 Million GBP
Legal Form	Ltd. Company
Investors	Around 35,000 mainly private investors since 2010
Target Market	United Kingdom
Target Group	Businesses including partnerships, limited and non-limited companies • that are based in the UK • that are creditworthy and established (no focus on startups) • that have a minimum turn-over of 50,000 GBP • that have a minimum of two years of filed or formally prepared accounts • that have no outstanding Country Court Judgments
Financial Instrument	Secured loan with monthly repayment rates (no payment protection insurance for borrower)
Investment Size	Loans between 5,000 – 1 Million GBP
Target Interest Rate	9 – 17.5% for 24 months / 12.5 – 21% for 60 months

EXAMPLE: Crowdinvesting platform Ethex

Ethex was launched in February 2013 with a clear philanthropic mission: to offer investors the opportunity to make 'positive investments' in ethical businesses that deliver social and environmental benefits alongside financial returns. Between February 2013 – September 2014 over 1,000 people have invested more than 6 Million GBP in 30 positive investments.

Ethex is supported by a number of trusts and foundations providing a mixture of grants and favorable loans. The organisation's goal is to become self-sustaining, with income generated from business and investor members. Ethex was originally founded as a not-for-profit online web portal aimed at building a better marketplace for ethical savings and investments.56 Consequently, Ethex not only offers crowdinvesting opportunities but also tradable financial products (see below).

Fees vary by investment type and business and are set to recover transaction costs:

- No charges on saving accounts and saving bonds, withdrawable shares (commonly issued by co-operatives or community benefit societies) or depository receipts
- Charges are for both buying and selling transferable shares and bonds
- Normal fees are 1.5% of the investment amount
- Portfolio Service subscriber fees are 1% the of investment amount.

Figure 22 provides an overview of the key characteristics of Ethex57

Lending Volume	Over 6 Million GBP (February 2013 – September 2014)
Legal Form	Not-for-profit social enterprise
Investors / Owners	Around 3,500 mainly private investors (February 2013 – September 2014)
Target Market	United Kingdom
Target Group	Businesses • that actively pursue social or environmental impact • that have a clearly defined social mission • that have high standards of governance and performance • that have a track record of at least three years • that have a turnover above 500k GBP • that already have external investors and advisors • that have their investment products legally approved • that have high reporting standards and transparency
Financial Instrument	Shares, charity bonds, business bonds, savings accounts etc.
Investment Size	Flexible (Individual users can contribute between 1 – 1000 GBP)
Target Interest Rate	Usually between 0 – 7%

OUTLOOK: Potential adaptation to the German social investment market

Who could benefit? How attractive could the financing vehicle be to social ventures?

The overview of the current German impact investing ecosystem in chapter 2.4.4 shows that there are numerous crowdfinancing platforms dedicated towards crowdfunding social projects and enterprises, while there are hardly any social crowdlending or crowdinvesting platforms in Germany. In general, there are few mainstream crowdinvesting and crowdlending platforms online. Although most platforms are open to any startup including social ventures, the particular characteristics of social ventures outlined in chapter 2.1 are usually not taken into account. Despite the current shortage of equity or debt related social crowdfinancing solutions, it can be expected that a social crowdinvesting and crowdlending platform would likely compete with the numerous existing social crowdfunding platforms.

A social crowdfinancing platform could address the largest target group of the four financing vehicles, covering all types of socially motivated organisations in the "seed", "start-up","growth" and "maturity" stages (see Figure 23). However, while crowdfinancing may initially seem relatively easy to access, executing a successful fundraising campaign can be challenging. Moreover, while most crowdinvestors or -lenders are socially motivated and value any social impact, they also tend to be less sophisticated and may have unrealistic expectations in terms of risks and returns. Since we excluded both crowdfunding and grants from the scope of this report, Figure 23 shows that the idea stage, a typical sweet spot of crowdfunding, is currently not being covered. For the same reason, charitable organisations are not being covered as well.

Figure 23: *Overview of the development stages and types of organisations served by a Social Crowdfinancing Platform*

	IDEA STAGE	EARLY STAGE		LATER STAGE			EXIT / LIQUIDATION EVENT
		Seed	Start-Up	Growth	Maturity	Consolidation	
Characteristics	Proof of concept, business plan development	Company founded, product develoment, pilot production / delivery	Execution of market launch, first commercial revenues	Early scaling of business, significant growth (reaching break even)	Breakout scaling, increased standardization (positive cash-flow)	Full scale, approaching saturation; M&A driven growth	IPO, share buyback, trade sale, merger or liquidation of assets
Typical Capital Need of SEs (EUR)	0 – 100k	100k – 500k	100k – 1,5m	>100k	>500k	>500k	
Charitable organisation							
Social Benefit Enterprise		**Social Crowdfinancing Platform**					
„Mission Locked" Social Purpose Business							
„Blended Value" Social Purpose Business							
Mainstream Businesses							

Source: Own illustration

What could be provided? How attractive could the financing vehicle be to potential investors?

Figure 24 provides an overview of the different types of financial instruments that a social crowdfinancing platform could offer, as well as the range of financial needs it could address. The scope of the social crowdfinancing platform is the largest in comparison to the other financing vehicles. Excluding grants (crowdfunding), possible financial instruments range from equity and mezzanine (crowdinvesting) to unsecured loans and patient capital (crowdlending). The crowdfinancing platform could for instance offer secured and unsecured loans and bonds alongside equity and Mezzanine financing, including amounts outside the 100k -500k EUR range. Assuming that capital ex-

penditures are best addressed by (social) banks or loan funds, the social crowdfinancing platform could provide financing to meet a range of needs from "hard growth capital" to capacity building & innovation.

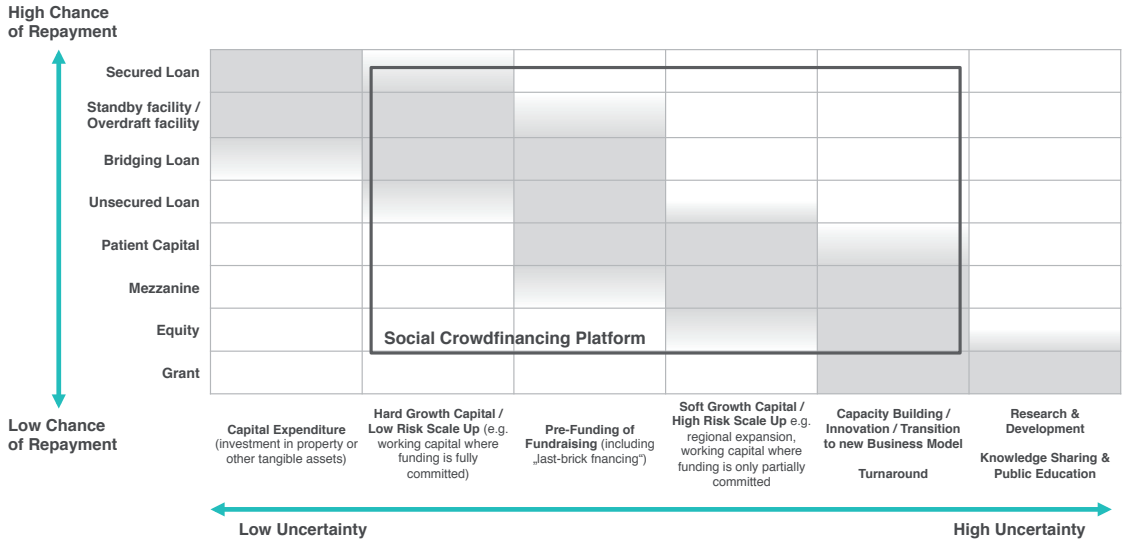


Figure 24: *Overview of the financial instruments and financing needs addressed by a Social Crowd-financing Platform*

There are numerous advantages to the concept of a social crowdfinancing platform. Due to the use of digital technology, both crowdinvesting and crowdlending offer the benefit of significantly reduced transaction costs, which usually prevent mainstream venture capitalists from investing in deals of less than 500k EUR. Furthermore,, crowdfinancing could potentially address the lack of exit opportunities for investors (similar to how Funding Circle and Ethex have succeeded in creating a secondary market), where investors can trade company and loan shares or investment certificates. Crowdfinancing also has the potential to engage a large number of small investors, thus increasing the amount of private investment capital that could be mobilised. On the other hand, detailed due diligence may be too expensive for most individual members of the crowd to conduct, making an adequate assessment of risk difficult. Moreover, it would be important to further study the extent to which a social crowdinvesting or crowdlending platform would mobilise new users or simply substitute existing social crowdfunding activities.

Further exploration could investigate whether to focus the concept of a crowdfinancing platform on loans or investments or possibly both, as well as the specific resources that would be needed to build and operate such a platform successfully. However, developing a crowdfinancing platform from scratch would be highly resource and capital intensive. Securities laws related to crowdfund investing may be complex.58 Besides the legal and technological challenges that would need to be overcome, it would also be necessary to heavily invest in branding and marketing the platform to build a big enough community of crowdinvestors and/or crowdlenders.

4 OUTLOOK AND NEXT STEPS

In this report, we have outlined four different financing vehicles, which each have the potential to facilitate better access to social finance in the range of 100k - 500k EUR, based on an analysis of the current obstacles hampering the growth of social ventures in Germany. For each financing vehicle, we have provided at least one real-world example, as well as our initial thoughts and reflections.

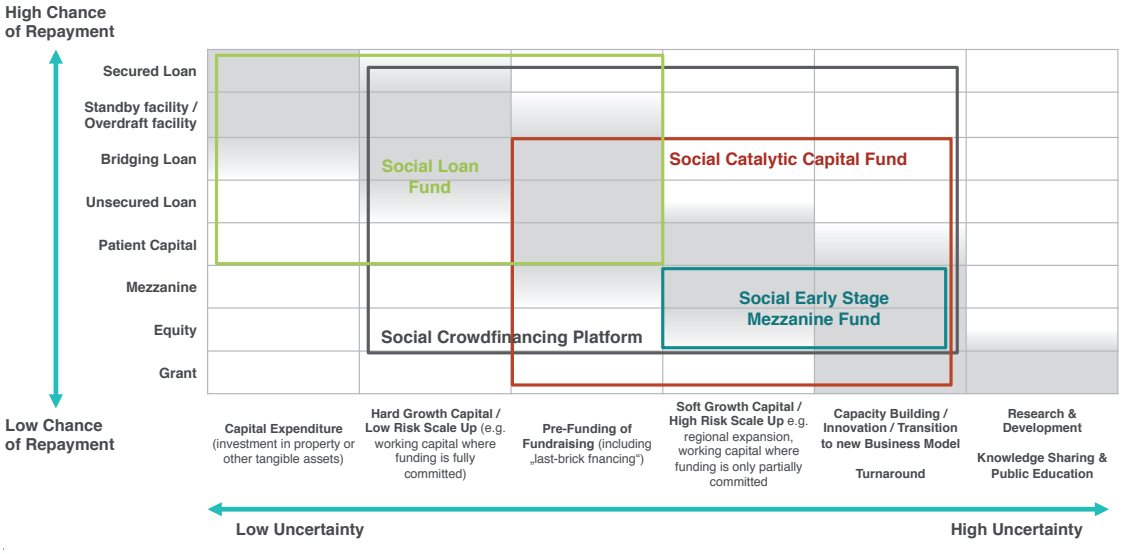
Figures 25 and 26 highlight the similarities and differences of the four financing vehicles.

Figure 25: *Overview of the development stages and types of organizations served by the different financing vehicles*

	IDEA STAGE	EARLY STAGE		LATER STAGE			EXIT / LIQUIDATION EVENT
		Seed	Start-Up	Growth	Maturity	Consolidation	
Characteristics	Proof of concept, business plan development	Company founded, product develoment, pilot production / delivery	Execution of market launch, first commercial revenues	Early scaling of business, significant growth (reaching break even)	Breakout scaling, increased standardization (positive cash-flow)	Full scale, approaching saturation; M&A driven growth	IPO, share buyback, trade sale, merger or liquidation of assets
Typical Capital Need of SEs (EUR)	0 – 100k	100k – 500k	100k – 1,5m	>100k	>500k	>500k	
Charitable organisation		**Social Catalytic Capital Fund**					
Social Benefit Enterprise		**Social Crowdfinancing Platform**		**Social Loan Fund**			
„Mission Locked" Social Purpose Business		**Social Early Stage Mezzanine Fund**					
„Blended Value" Social Purpose Business							
Mainstream Businesses							

Source: Own illustration

Figure 26: *Overview of the financial instruments and financing needs addressed by the different financing vehicles*



Source: Own illustration, based on CAF Venturesome (2007)

In the next phase of this project we will further analyse the most promising financing vehicle and look at the feasibility of its actual implementation in collaboration with relevant social finance partners.

An approach, which we believe merits further consideration, is to explore how the different concepts could be combined to create new hybrid models. For example, the Social Loan Fund, Early Stage Social Mezzanine Fund and the Catalytic Capital Fund could all be supported by a crowdfinancing platform to fundraise, enhance communication and enable small-scale investors to take part in financing deals they are passionate about. Moreover, the concept of catalytic capital could be combined with each of the three Fund concepts. For example, the Social Loan Fund could use catalytic loans or guarantees to offer its loans at reduced interest rates, the Early Stage Mezzanine Fund could support co-investment into catalytic first-loss equity, and the Social Crowdfinancing Platform could use catalytic crowdfunding to increase the size of its investments.

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[3] National Advisory Board Germany (2014), p 26.

[4] European Commission (2013), p 3.

[5] European Commission (2013), p 4.

[6] Scheuerle et al. (2012), p 9.

[7] European Commission (2013), p 5.

[8] Some of our interview partners indicated that the financing gap could also be described as ranging from 50k– 250k EUR, while others indicated a particular unmet need between 250k and 500k EUR

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ABOUT THE PROJECT LEADER

Impact in Motion is an impact investing think tank and consultancy. Through its activities Impact in Motion aims to contribute to the development of the impact investing market, and to enable investors to make investments with a positive social, environmental and financial return.
(www.impactinmotion.com)

ABOUT THE PROJECT PARTNERS

The Bertelsmann Stiftung is dedicated to ensuring that everyone in society is given a chance to participate. It executes projects in the areas of education, democracy, social affairs, health, culture and business. Through its civic engagement, it wants to encourage others to support their own communities as well. Founded in 1977 as a registered charity, the Bertelsmann Stiftung is majority shareholder of Bertelsmann SE & Co. KGaA. Structured as a private operating foundation, it is politically nonpartisan and works independently of Bertelsmann's corporate operations.
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(www.socialventurefund.com)