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The Emergence and Growth of Social Finance in the UK

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Abstract

This paper presents an exploratory case study of the factors that explain the emergence and growth of social finance in the UK. Social finance refers to an array of activities that address societal issues using finance tools and logic. The practice of social finance manifests itself in the investment in social organisations and enterprises. Investments in social finance, ultimately aim to generate both a social and a financial return. While, the results imply that the practice of social finance is far more complex that the theory suggests, evidence maintains that social finance is nonetheless a growing movement. As such, four factors have emerged as explaining the emergence and growth of social finance. The first factor is that the practice of social finance is predominantly justified by the desire to tackle major social and environmental issues. The scope of these issues is limited to some general macro themes, such as education, social care, health and environmental sustainability. The second factor is the aim of making both a financial and social return on investment. The findings suggest that investors have needed to prioritise either social or financial returns in that respect. Thirdly, the emergence of social finance can be explained by the goal of transforming the social sector by reducing dependency on grant-funding and increasing effectiveness and financial sustainability. Finally, actors and institutions involved in social finance have been sustained by the ultimate effort to build a social finance market. In this respect, social finance initiatives have been as much about solving societal and environmental problems effectively as it has been about building a new market out of it.

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Key concepts – Social finance, social investment funds, blended value, UK, social sector, social enterprises

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1. Introduction

1.1 Aim and research questions

Social finance is the notion of actively, purposefully and deliberately seeking social and environmental impact on investment. Social investors intentionally apply financial tools, instruments, and strategies to enable capital to achieve a social, environmental as well as a financial return (Harij & Hebb, 2010: 2). This simplified definition brings to light the three most important aspects of social finance. The first is that social finance is a movement seeking to address social and environmental issues. The second aspect is that it is making use of mainstream finance to address these problems. Investment strategy is used to generate a positive impact on society and the environment (Weber, 2012: 2). Finally, the third aspect is that social finance attempts to achieve a positive social and environmental impact while at the same time generating financial returns.

Social finance embodies the belief that the efficiency of mainstream investment and the market could be transcended to the social sector. Specialised social investment funds provide capital to socially driven organisations and enterprises as an alternative to grant funding in the hopes of giving them greater financial sustainability and the opportunity to keep their projects running in the long-term.

In the wake of the financial crisis, the UK has been faced with severe economic restraints. While all sectors of the economy have been suffering, the social sector has been particularly affected. With the decrease in institutional and individual grant funding and in a time where third sector services are most needed, charities and other socially driven organisations are struggling financially. As such, the social sector has been looking for different sources of funding for new and innovative ways of running their businesses. The UK as a country represents an ideal case for the study of social finance. The country has witnessed, alongside a growing demand for social capital, a significant increase in the number of social investors and funds (Brown and Swersky, 2012). The actual size of the social finance movement is not as significant as the pace of its

development. Although, social finance is a notable phenomenon in its own right, compared to the mainstream financial market, it is relatively small.

This thesis will analyse what factors explain the emergence and growth of social finance in the UK. Focussing on the investment side of the movement raises an interesting debate on the changing nature of social funding. On the one hand, the financial sector, traditionally focussed on financial returns and profits, is becoming increasingly socially oriented. On the other hand, the charity sector is becoming increasingly more business oriented and financially sustainable. The thesis investigates the social finance phenomenon from the point of view of the investors and funders. There is a lot of debate surrounding the plausibility of social finance; at the same time social finance is at the forefront of a new and innovative form of social change. This case study will be a contribution to the subject of welfare management. As such, the thesis will attempt to answer the following research question:

What factors explain the emergence and growth of social finance in the UK?

1.2 Concepts

Although, there is little or no consent throughout the literature on the terminology of social finance, the term *social finance* will be used throughout this study to include a large scope of activities and understandings. Also known as impact investment or social investment, it is used to describe the use of financial strategy to tackle social and environmental problems in the hope of generating both a social and a financial return.

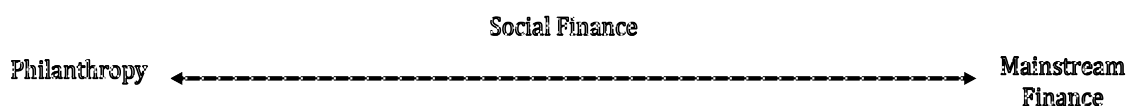
Generally, definitions of impact investment and social investment will include the expectation of financial returns (Gregory et al. 2012; Harij & Hebb, 2010, Weber 2012, Monitor Institute, 2009). In using the term *social finance*, a broader understanding is being considered for the scope of this study. In the context of the thesis, the concept of financial return will not be limited to the notion of *profit distribution*, whereby financial gains are returned to the investor. Financial returns will be used in a larger sense and include notions such as *active grant making*, whereby investors do not expect any financial returns. Indeed,

while impact investment and social investment have stricter rules concerning financial returns, social finance is more flexible in that regard.

While offering a broader definition, social finance does exclude the concept of Socially Responsible Investment (SRI), which will be explained in further detail in the theoretical section. As such, the definition of social finance can be narrowed to all investment initiatives into organisations that 'tackle social problems', that aim to be financially sustainable, and that 'aim to scale what works' (Shanmugalingam et al., 2011: 12). The meaning of social finance is illustrated below in *Figure 1.1* as an area that stretches out between philanthropy at one end of the spectrum and mainstream finance at the other (Weber, 2012). Social finance offers financial initiatives that range from grant funding to investment in to commercial businesses in underserved areas. Investments made in social finance can be placed anywhere along this axis, varying between greater focuses on social or financial returns. While providing somewhat of an overly simplified representation, *Figure 1.1* allows for a visualisation of the spectrum of social finance and provides an ideal starting point.

Throughout the paper there will be numerous references to the social finance movement. The size and novelty of the social finance sector means that it is still in somewhat of a construction phase. There is, however, evidence of growth though not enough to refer to it as a market, for this reason it is more relevant to speak of a social finance 'movement' when referring to the growing scale of the sector.

Figure 1.1 – Social finance spectrum



Source: Authors design (Emerson 2003; Weber 2012; ClearlySo 2012)

1.3 Historical background

Although social finance is particularly relevant today, social and environmental responsibility has been present for decades. Already in the 1950s public and private sector groups started investing in emerging-market enterprises to fight poverty, and then throughout the 1960s with the social awareness movement, social and environmental responsibility arose naturally alongside capitalism and globalisation. It was during the 1980s, that social and environmental factors began to be incorporated into company logistics (Propper de Callejon, 2012: 1). Throughout the 1990s, the focus was directed more generally towards socially responsible and ethical investment. Emerging Socially Responsible Investment (SRI) funds began using negative screening to avoid investments in harmful sectors and to encourage responsible behaviour across the business sector (SITF, 2010: 6). The UK Social Investment Forum (UKSIF), a membership network promoting responsible investment, was launched in 1991 following the same initiative in the US just two years prior. These efforts and initiatives marked the beginning of what UKSIF calls the 'Ethical Era' (UKSIF).

Yet, the actual social finance movement where financial instruments were being used in the aim of actively making a social impact only truly started in the 2000s. By creating the Social Investment Task Force (SITF) in 2000, the UK government became one of the leading actors in the development of social finance. The initiative was put forward in order to have 'an assessment of the ways the UK can achieve a radical improvement in its capacity to create wealth, economic growth and an improved social fabric in its poorest communities' (The Social Investment Task Force). The SITF emphasised the fact that the poorest communities in the UK are dependent on philanthropy and public money, which in turn has been contributing to discouraging private investment opportunities in those areas (SITK, 2000: 4). There was no doubt at the time that these communities were holding large pools of entrepreneurial and business-minded talent that could benefit the community at large. Thus, the SITF promoted 'a culture of empowerment, entrepreneurship and initiative' (Ibid) and saw the beginning of the community building movement.

Generally speaking though, much of the social finance movement developed organically during the latest decade. The economic recession has meant that the country is functioning with an increasingly smaller public purse. Additionally, in the attempt to restore the economy, numerous welfare cuts have been made. Yet, the financial and economic crisis has hit all sectors of the economy and there is need for an increase in social support and services. The social sector, while needing to take on a strong role in delivery services, has also been faced with severe financial difficulties. There has been a constant decrease in philanthropic grant donations. Social enterprises and charities are increasingly looking for non-grant funding such as loans to help develop their business, which has stimulated the demand for social finance (Clearly So, 2011). The economic crisis has created new opportunities in the social sector and has contributed to the growing number of social enterprises (Huybrechts and Nicholls, 2012).

Additionally, there has been 'an increasing number of investors looking for opportunities in the market to invest in mission-driven organisations in order to maximise a blended social and financial value on their investment' (Harij & Hebb, 2010: 2). These investors have asked for more choice than just traditional investment or pure philanthropy (Monitor Institute, 2009: 11). Until recently, there were only a few options available for investors seeking financial returns while at the same time contributing to social and environmental challenges. Social finance has provided a middle ground for individuals who found themselves between donors and investors.

2. Theory

2.1 Background knowledge

This following part offers important knowledge on two topics that are closely related to social finance that must be acknowledged prior to continuing the theory of social finance. The first topic, socially responsible investment (SRI), must be explained in the context of social finance in order to clarify the differentiation between the two. Although, SRI has significant importance in it's own right and in relation to social finance, the differences between SRI and social finance need to be made explicit in order to fulfil the purpose of this study. The second topic is the social sector, which needs to be acknowledged as playing a central role in social finance. Indeed, the social sector is comprised of socially driven organisations seeking capital and thus is at the heart of social finance.

2.1.1 Socially responsible investment

The term social finance can sometimes include the notion of *socially responsible investment* (SRI) in the definition, but as mentioned previously, social finance is used here in the sense of explicitly aiming to tackle social and environmental issues. As such, SRI must be excluded from the definition, which can be cause for confusion. Although there is overlap with social finance (ClearlySo, 2011: 18), SRI is an investment concept or tool that is being used in mainstream investment strategies to promote more responsible and socially aware investment decisions. It is the incorporation of environmental, social or governance issues (ESG) into investment decisions (Ibid: 14). Increasingly it is becoming comparatively advantageous for financial institutions and businesses to consider what kind of an impact they are making. Yet, this growing social and environmental awareness movement does not share quite the same motives as impact investment. While SRI attempts to make the investment world more responsible by using negative screening or eliminating investments that aren't compliant ESG issues (Ibid:14), social finance is the development of a new market that prioritises impact over profit, 'its drive for engagement is the impact

that an investment can create' (Ibid) rather than the harm that an investment can avoid.

SRI, in contrast to social finance, can be used as a way to manage risk and create higher returns, rather than actively aim to create positive environmental and social impact (Weber, 2012: 4). The rationale behind SRI can be a number of reasons such as risk mitigation, marketing, shareholder accountability or peer pressure. The main issue with SRI is that it can be understood as a benchmark for doing good, or as a pledge that investors can take. Indeed it is more of a label for doing good and as such is discretionary by nature. There is a growing belief that companies pursuing this approach are transforming the business landscape and outperforming their peers financially in the long term (Propper de Callejon, 2012: 2), which means that the scope of SRI is not at all negligible and is a positive approach to investment. Nevertheless, it is the fact that SRI focuses primarily on avoiding investments in harmful companies and encourages improvement in corporate practices that sets it apart from impact investment (Monitor Institute, 2009: 7). Social finance must be distinguished from SRI as having 'social impact is at the core of the value proposition, rather than a side effort' (Etzkowitz, 2012: 196). It goes beyond improving current business practices and ultimately aims to put impact first by making it a business objective or goal.

2.1.2 Social sector

The social sector provides social investors with social investment opportunities and propositions. As mentioned previously, social finance uses capital in the aim of creating a social impact. In order for this to happen, the capital must be invested in enterprises and businesses that provide a service or a product that will have a positive social impact on the community or society at large. The social sector can also be referred to as the third sector as it distinguishes itself from the private for-profit sector and the public sector (Defourny, 2011: 1). It emerged in the 1970s bringing together organisations and enterprises that had the redistributive power of providing a wide range of services to deprived people (Ibid). Organisations in the social sector operate under a wide variety of legal forms (Ibid); 'in many ways they represent the new or renewed

expression of civil society against a background of economic crisis, the weakening of social bonds and difficulties of the Welfare State' (Ibid). The social sector holds a key role in the management and distribution of welfare provisions.

Investment interest in this sector lies in the notion of *social entrepreneurship*, which can be defined as 'any innovative action that individuals, organizations, or networks conducted to enhance or reconfigure existing institutional arrangements to address the inadequate provision, or unequal distribution, of social and environmental goods' (Nicholls, 2009: 755). In other words, social entrepreneurship is responsible for introducing change and innovating economic practices in the aim of serving the community (Defourny, 2011). While the social sector refers to the provision of social services outside the private and public sectors, social entrepreneurship only represents a section of it. As such, social entrepreneurship shares a similar goal with social finance, which is pursuing new opportunities to serve a mission (Huybrechts and Nicholls, 2012: 34). Additionally, 'all definitions of social entrepreneurship agree on the central focus on social or environmental outcomes that has primacy over profit maximisation' (Ibid). The same can be said for social finance. The merging of social finance and social entrepreneurship has created a pool of opportunities, the supply as well as the demand for an emerging social finance market.

The social sector is becoming increasingly comprised of social enterprises, as opposed to traditional non-profit organisations. As such, social enterprises can broadly be defined as socially innovative initiatives that use commercial models as the vehicle by which social impact is achieved (Huybrechts and Nicholls, 2012: 33). They include trading charities, social enterprises and social purpose businesses, early-stage social ventures and start-ups. The notion of innovation is central to social entrepreneurship implying the pursuit of "new organisational models and processes, through new products and services, or through new thinking about, and framing of, societal challenges" (Ibid: 35). The potential that lies within these social enterprises is not financial profitability, but rather the determination, creative and resourcefulness to solve a social problem (Dees, 2007: 24). There is a genuine belief within the social finance and social entrepreneurship sectors, that these entities can bring about social change and provide social services in a more effective way than is currently being carried out (Huybrechts, and Nicholls, 2012 and Dees, 2007). Social enterprises hold expertise in their area

and would allow for social services to be delivered bottom-up. Effectively, it is by investing in social enterprises that social finance can achieve its potential.

Nevertheless, it is important to note that the social sector is a decentralised area. There are many difficulties associated with managing it and it is hard to sustain accountability in the case of negative social impact or other negative externalities. It can also be said that there are some unrealistic expectations regarding the potential of social enterprises. These entities while being innovative and creative, are also generally lacking in overall business skills. The management and running of these social enterprises has to be excellent in order for it to be sustainable as well as produce the social impact intended. The cost associated to providing social services at this level may pay off in that the enterprise is run successfully, but the internal weakness of social enterprises can reveal fragile (Defourny, 2001: 26). Furthermore, managing the sector in terms of the services it provides could become a problem. These issues create concerns that affect both the delivery of social services as well as the chances of successful implementation of social finance. There are untapped opportunities within the social sector, but discovering them is very much a question of trial and error.

2.2 Social finance logic

The logic behind social finance is in the way it is used to address major social and environmental challenges using financial instruments while generating revenue (Harij & Hebb, 2010, Weber 2012, Monitor Institute, 2009). The use of capital to enable change and achieve holistic goals is at the heart of the social finance paradigm. Social finance seeks the best of both the financial and the philanthropic sectors by merging the two together forming a hybrid social and financial sector. Overall, it is about using financial theory and strategy to bring about social and environmental change. Social finance actors and institutions are daring to reject the traditional structure of the market and the social sector, whereby financial, social and environmental goals need be achieved independently. The logic behind how this blended-value can be achieved is complex. The following section aims to make sense of how social finance is implemented.

2.2.1 Social finance and mainstream finance

It is important to remember that the logic behind social finance is embedded in the realm of traditional finance theory and logic. Mainstream finance in a general sense is the application of economic principles to decision-making that involves allocations of money under conditions of uncertainty (Drake and Fabozzi, 2010: 1). As a discipline it involves the study of how to transfer funds from entities that have funds to entities that need funds (Ibid). The principle idea is that individuals and institutions that have money to invest do so in the aim of making a financial return for their service, in other words a profit. The demand for investment is simply the need for capital towards the creation or expansion of a business, product or service.

While sharing many similarities with the mechanism and logic of mainstream finance, impact investment does represent somewhat of a break from mainstream finance, notably due to the addition of social value creation. Rather than merely acknowledging the need for greater social and environmental awareness, investors in the social finance sector are making it their priority. This is the foundation and the core of social finance and is what sets it a part from SRI. Within the social finance world there is a genuine belief that financial, social and environmental success is manageable and accessible simultaneously. Jed Emerson, a leading scholar in the field of social finance, believes that 'our understanding of both investment and return is founded upon a traditional separation in the creation of social versus economic value' (Emerson, 2003: 4). He claims that although it is logical and reflects a common understanding of the world, that it is also 'inherently wrong' (Ibid). The current belief systems claims that 'doing well' and 'doing good' are priorities that can only be achieved separately, explaining why we have for-profit and non-profit organisations as separate entities.

Emerson wants to promote the idea of a blended-value proposition that assumes that all investments operate simultaneously in economic, social, and environmental realms (Ibid: 13). The proposition puts forward an attempt for companies and businesses to create social and financial value regardless of the organisation structure. In effect, the social finance movement is in pursuit of this embedded value, where social, economic and environmental returns are not independent from each other but rather are all interrelated (Ibid: 4-6).

However, social finance in practice has proven that although this blended-value is possible, there are unfortunately trade-offs associated with it. While, investor expectation in social finance does tend to be somewhat lower than in mainstream finance, the costs associated to social finance are arguably higher. While it is true due to the fact that social finance by nature is more complex, investors are effectively more diligent knowing that their capital is also producing a social return. The term 'patient capital', which is more frequently used in US, is an appropriate terminology for social finance. Patient capital refers to flexible capital that has a long-term perspective. At the current stage of social finance, there is evidence, though arguable, that there is somewhat of a negative correlation between social and financial impact. This implies social impact will decrease in the case financial returns increase, and financial returns will decrease where impact in increased.

2.2.2 Impact maximisation versus profit maximisation

According to the European Venture Philanthropy Association, the distinguishing feature of social finance that sets it apart from mainstream finance and philanthropy is the idea of *impact first* or *impact maximisation*. Social finance may generate a financial return, but the social returns are 'defined as a priori and are not an incidental side effect of a commercial deal' (Brown and Swersky, 2012: 3). This distinction between impact maximisation and profit maximisation illustrates the negative correlation between social and financial returns. They also represent the two extreme ends of the social finance spectrum (See Figure 1.2 below). The spectrum below also illustrates philanthropy at one end, which uses non-repayable grants for 'impact only' goals, and mainstream finance at the other end, which uses loans and equity and ultimately seeks *profit maximisation* (See Figure 1.2).

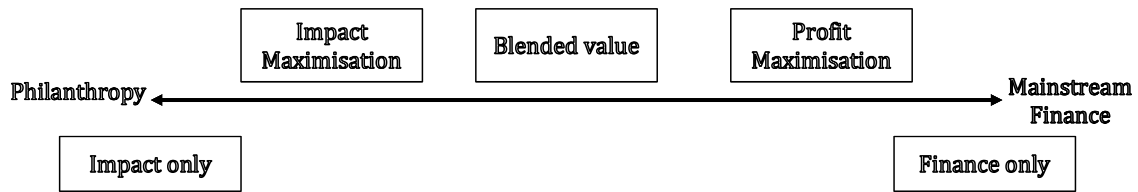
In the case of impact maximisation it is often the case that finance returns are not expected at all. Market orientation is manifest in a variety of ways in social finance (Huybrechts and Nicholls: 36). Where impact is maximised, profits are generated to reinvest in the social mission (Huybrechts and Nicholls: 36). Also referred to as active grant making or venture philanthropy, financial repayment is

sacrificed for the sake of the social impact. Social enterprises will have an asset-lock, meaning that it is not profit-distributing and that the company shares must be used for the benefit of the social mission (ClearlySo, 2011: 13). Active grant making and impact maximisation are usually the focus on a certain section of the market; usually organisations that either have a not-for-profit structure or that are still in an early stage of development. The reason for this is that these organisations will generally have the greatest difficulties in demonstrating a viable business model or a revenue track record, but their expertise will mean that they have the most potential for maximising their social mission.

Alternatively, profit maximisation within social finance is manifest in investments that are made at a stage when social enterprises have already developed into sustainable businesses. A proven business model and proof of revenue is a safe investment opportunity for a social investor. Where profits are maximised, investments will be made where the future prospects of the social enterprise are predictable. These can be referred to as financial-first impact-driven investments. The negative correlation happens when the future scalability and profitability is prioritised over the potential of making a social impact.

The image below (Image 2) offers a simplified visualisation of these notions in the context of distinguishing profit from impact. The spectrum has a basic structure also known as 'an investment plane' that stretches out between philanthropy and traditional finance. In between these two extremities, closest to charity are instruments that seek full social value and returns, with little or no consideration of financial performance and return, while at the other end of the plane, nearer to traditional finance, are instruments that do take social value into consideration but also measure performance on financial and economic terms (Emerson, 2003: 4). In the middle, the blended-value approach is the intention to make a social and financial return simultaneously. The negative correlation is made clear when explicit efforts are made to maximise either the social or the financial return.

Figure 1.2 – Social finance spectrum



Source: Authors design (Emerson 2003; Weber 2012; ClearlySo 2012)

2.3 Funding

Social investors believe that the efficiency of mainstream investment could be transcended to the social sector. It is the idea of transferring money in a way that will be more sustainable than grant funding in the hopes of giving organisations and enterprises the opportunity to keep their projects running in the long-term. Investors in mainstream finance generally use two kinds of financial instruments when making an investment, debt and equity. These instruments are also known as *securities* in that they secure future benefit in the company in the form of cash flows (Landuyt et al., 2010: 14). Debt and equity are also the main financial instruments used for social finance. However, although the management of capital is similar to regular finance, the contracts used in social finance differ regarding securities, interest rates and financial return expectations in general.

The following parts will first discuss the different types of financial instruments available for social finance. Firstly, the use of debt and equity instruments will be explained individually. Then, the section will end with a discussion on the other types of funding used in social finance.

2.3.1 Debt

Debt funding is the most commonly used instrument in the area of social finance and comes in the form of a loan. The issuing of a loan means that money will be leant to the social enterprise and the investment fund will expect the full

amount to be paid back. In the case of mainstream investment, an interest on the payment or a percentage of the face value of the debt will be fixed contractually (Landuyt et al., 2010: 15). This provides the investor with an additional financial return to the money he has provided. However, in the case of social finance, while this can also be the case, the return rate will be somewhat lower and will differ accordingly, depending on the financial organisation issuing the investment or on the social organisation receiving the loan.

There are two broad types of debt, which are used in both mainstream finance and social finance. Secured and unsecured loans differ with regards to their rate of return and the terms of the contract. A secured loan is backed by a secured asset, usually in the form of a property, thus reducing the risk associated with lending. This means that in the case when an investment fails, the lender can make a claim to this security. Alternatively, an unsecured debt implies the absence of a secured asset. For this reason, unsecured debt is the commonly used in social finance, since projects that need funding in the social or voluntary sector often do not have the resources to purchase such a security in the first place. The lack of secured assets makes the investment too risky for commercial investment funds or banks, and this is where social finance organisations are attempting to fill the gap by providing unsecured debt with a reasonable but slightly higher rate of return than for a secured loan. Unsecured loans are the largest type of social funding available (ClearlySo, 2011, Chart 4.7.3: 70).

2.3.2 Equity

Equity is the ownership of assets, such as shares, dividends or bonds, in a company and investors are paid based on earnings (Landuyt et al., 2010: 16). While, equity confers both ownership and voting rights, debt remains favourable in social finance as it offers a less permanent option that makes it preferable in situations of the ‘winding-up’ of a company (Ibid: 6). Due to the fact that equity is most generally used for early-stage ventures and start-ups, the level of risk associated to equity funding is much higher, especially in social finance, where often the success of a businesses or enterprise is uncertain. Nevertheless, in the case of success and growth, the rewards gained from this type of investment tend

to exceed those of debt funding. The amount of equity funding in social finance is relatively small.

Equity in social or mainstream investment is especially appropriate for investments in start-ups or early-stage enterprises. However, start-ups in the social sector tend to start with an only idea and usually lack fundamental business skills. The lack of a clear business model means that although equity is available in the market, ‘enterprises often cannot accommodate it, as legal structures of many social enterprises do not offer share capital’ (ClearlySo, 2011: 24). When compared to the commercial sector, equity is invested into proven scalable businesses and the expectations are high. The risky nature of social enterprises is perhaps too much of a trade-off for social investors.

As such, even though there are opportunities in equity investment in early-stage enterprises, the level of risk has meant that grant funding still plays a large role in this area. Effectively, support for private equity for social enterprises has been largely philanthropic (Ibid: 62). There is also such a thing as quasi-equity, which is a form of an equity-like investment that does not confer ownership rights to the investor. It is particularly appropriate for social finance, notably when social enterprises cannot afford regular equity (Ibid: 108). Quasi-equity has a ‘revenue participation agreement’, whereby investors are guaranteed a share of the revenue if the social enterprise is successful, but the risk migration is not associated with a minimum guarantee return (Ibid). Quasi-equity is equivalent to unsecured loans, though much less used in the sector.

2.4 Social finance management

Investment management is the area dealing with the managing the funds of individuals or institutions (Drake and Fabozzi, 2010: 6). In the case of social finance, where social returns are part of the equation, managing goes beyond the handling and transferring of capital. This following part will discuss social investment funds and other organisations that are active in the social finance market.

2.4.1 Social investment funds

As mentioned previously the idea behind investment is to transfer funds from investors with money to individuals and institutions that need funds for a project or a business. Due to the uncertain nature of investment, in most cases it is the role of investment funds to manage the transfers. In mainstream finance, there are two broad types of investment funds, regular mutual funds who invest in scalable businesses, and venture capital funds who specialise in high risk, early-stage businesses. They play an important role by acting as a link between investors and the entities seeking funds. They manage the funds to the benefit of the investors who seek to be compensated for the risk they are taking.

Investment funds facilitate the flow of capital between the two entities by reducing the risk via diversification. This means that assets are collected in a common investment pool, which is then allocated to a number of different investments. Indeed, individuals with capital to invest, will generally want to avoid investing it all into a single investment transaction, but at the same time splitting their funds into a variety of projects would mean that each investment would not yield any significant returns. As such, investment funds have more funding available to invest that can be diversified across a large range of investments. They manage the funds for the benefit of the investors, in this case known as fiduciary investors, who bear the risk or reward proportionally to their investment in the fund. For individual investors, this allows to diversify their risk profile without compromising between risks and returns, which they would not be able to do with a smaller amount of capital. This is also referred to as portfolio management; in this sense portfolios are the set of investments being managed within an investment fund.

Social investment funds have a slightly more complex task at hand. In the case of fiduciary investors, where investments must be made the benefit of the investor, the portfolios will be managed in a similar way to mainstream investment funds. Nevertheless, social investment funds are also expected to generate social returns. Meaning that they must also be prepared to entertain trade-offs between social and financial goals (Brown and Swersky: 2012: 6). In some cases, the investors will only expect to be paid back the amount of their

investment and sometimes a bit less, content with knowledge that their capital contributed towards a social impact. This is particularly the case in areas focussed of *impact maximisation*. Social investors in this case will be willing to sacrifice some of their capital in the aim of yielding greater social returns.

Social investment funds also facilitate the flow of capital by reducing the cost for contract and information processing. Social investment funds are entities that hold expert knowledge in their investment field. The cost is therefore effectively reduced for investors, since in the case of direct investment transfers, the investor must undertake the costly and time-consuming research and risk profiling for each individual investment. Indeed, investment funds are not only specialist of the investment world, but they are also important actors within the field. This is particularly relevant for social finance. Social investment funds are expert in their area and they have a superior understanding of social business models. Therefore, they are able to take higher risks on innovations with primarily social, rather than financial, returns (Ibid).

2.4.3 The funding of funds

This part will discuss how investment funds are funded. Due to the fact that social finance does not generate high financial returns, the source of funding for social investment funds is quite diverse. The source of funding is important to discuss as it has a significant role to play in dictating how the investment transactions are planned out. It is often the case that social investment funds are one part of a larger organisation, charity or fund. While still being socially motivated, many larger organisations or investment funds earn an income based on more commercial services such as traditional investment, trading or providing fee-paying services. Social investment funds in this case will be funded from the earned income of the overall organisation.

Social investment funds that want to maximise impact will generally have access to mixed-income funding. This usually implies funding that is based partly on earnings and partly on grants. Mixed income is generally the case for trading charities, social intermediaries aiming to maximise on impact making it interesting for other social funders such as charities and government institutions to

offer grants in support for the initiative. As we have already discussed, maximising on impact generally implies a financial trade-off, making it harder for an organisation to yield significant financial returns or a stable income.

In effect, the source of income ultimately means that the social investment fund is accountable to those who provided the capital. The distinction between profit maximisation and impact maximisation is important in relation to the source of the funding. The terms *fiduciary investor* implies that the assets have to be managed for the benefit of the investor. As in mainstream finance, this means that the investor has entrusted someone to make investment decisions on their behalf to enhance profitability. This is usually the case for social investment funds that are funded by private-capital. *Non-fiduciary investors* invest for the benefit of the social mission and won't except returns on their investment. In this case, the social investment fund must recycle the capital and aim to maximise their social impact.

Furthermore, as the UK impact investment sector is growing larger, it is also growing stronger through the means of partnerships and syndication. The diversity of agents and organisations is resulting in an intertwined network of knowledge. The impact investment market in the UK is still somewhat small in comparison to the mainstream market or the third sector. Many funds and organisations are benefiting from partnerships that can contribute to shared-learning. Syndication is the merging of similar funds in the aim of making them more prominent in the field. All these efforts contribute to accelerating development of a social finance sector, whereby the sharing of data will help enable construction of a common infrastructure such as databases, models, platforms and reporting techniques.

2.4.2 Social finance intermediaries

Social finance intermediaries are organisations that play the role of promoting and supporting social finance through a variety of services. Intermediaries can include can include a variety of organisations such as thinktanks, charity foundations, and consultancy firms. There is no general rule as to what constitutes a social finance intermediary. However, their presence in the

sector is prominent. Overall, they provide three broad types of services that help 'investors and investees meet common aims' (ClearlySo, 2011: 3). The first is providing business support and mentoring for organisations and enterprises. The second is linking social enterprises to investors, helping facilitate communication and the flow of capital. Finally, the third way social finance intermediaries provide services is in the form of research. Research in social finance can include monitoring the sector or publishing works that contribute to growing awareness of the movement. Social finance intermediaries along with social investment funds form the infrastructure of social finance 'necessary to boost social entrepreneurship' (Ibid: 134).

Another category of social finance intermediary is involved in *fund of fund investing*. Their role is to invest in social investment funds. One of the most predominant funds of funds is Big Society Capital, which was launched in April. It is a government owned wholesale bank that is planning on injecting a large amount of capital into the social finance market. The money is from inactive bank accounts, which was legally made available to use following the passing the Dormant Bank and Building Society Accounts Act (Big Society Capital). The growing social finance sector in the UK has to a large extent been driven by government initiatives ever since the launch of UK Social Investment Task Force in 2000. Big Society Capital will be investing in new and existing social investment funds over the next few years; 'the innovative but small social finance and intermediary sector needs a champion if it is to develop' (Ibid: 130). The hope is that Big Society Capital will develop and strengthen the infrastructure for social finance.

2.5 Limitations of social finance

This following part will discuss some of the limitations associated with social finance. The first limitation relates to the level of risk and uncertainty linked to social finance. The second focuses on impact measurement and the lack of standardised practises in the social finance sector. Finally, the third part is an account of some of the trade-offs associated with social finance, between social and financial returns.

2.5.1 Risk and uncertainty

To begin, the level of risk involved in investing in social enterprises is generally much higher than in mainstream investment. The commercial scalability of social enterprises is limited in a majority of cases. This can be due to a flawed business model or a weak management team. Risk is particularly high in the section of the market that invests in start-ups and early stage businesses, and although social investment funds and intermediaries have adapted to the realities of the social sector, it is often the case that the cash flow projections are unrealistic (Hattendorf, 2012). The shortage of investable propositions is potentially the reason why so many social investment firms have focussed on funding social businesses that already have a proven track record and proof of stable revenue (CearlySo, 2011: 69).

The question of investment readiness is a challenge for the investors, noting in particular the lack of suitable financial skills as a 'critical barrier' (Gregory et al., 2012: iv). In effect, there is a real complexity of skills required in the social finance world that social entrepreneurs often do not possess (Shanmugalingam et al., 2011: 22). Investors have reported that they are often approached too early (Gregory et al., 2012: iv). The resources needed for training people and developing a project in order for it to be investment ready are often inaccessible to social entrepreneurs due to high costs. Indeed, JP Morgan, a global finance institution, in the Global Impact Investment Survey witnesses that the largest majority of investments are made to projects that are already in the 'growth stage' (JP Morgan, 2013: 8). The time and cost factors are a real concern for investors and investees and only heightens the risk.

In addition, if social investment funds were to implement risk-adjusted rates of returns, the requirement would be hard if not impossible for social enterprises to meet (ClearlySo: 31). Unfortunately, in social finance it is often the case that avoiding risk is more is more important for investors than the potential for high returns (Ibid). This explains the prominence of grant funding for start-ups. It is this high-risk area that has the most potential to generate innovative social returns (Brown and Swersky, 2012: 17). At the same time, areas with the

greatest social issues tend to those with the lowest investment potential. Areas commonly used as an example for this, deal with long-term unemployment, such as people faced with severe disabilities or those that hold criminal records. The cost associated to investing in this area is high and there is possibility for failure.

Partnerships and mixed funding sources are a form of risk mitigation, allowing for greater trial and error. Nevertheless, risk and uncertainty in social finance are holding back the sector. One can believe that ‘until a tremendous amount of resources are invested in creating a comparable infrastructure for measuring and analysing the results for the social sector with an integrated cost approach, it will remain more like an art form than a widespread science’ (Tuan, 2008: 7). Due to the lack of common language, common measures and quality transparency, risk and uncertainty will remain high for social finance.

2.5.2 Impact Measurement

In academia there is some evidence of attempts at understanding the methods and practices used to measure social impact. The question of impact in itself is also cause for tension. There is very little common agreed idea of what social impact is. ‘The case for impact is dubious’ and there is confusion about when social finance is successful and when it not. (Starr, 2012: P1). Accountability in social finance remains low, and there is little in the way of collective monitoring of practices.

Regarding impact measurement, it is most often in the field of accounting and management that one can find notions such as ‘blended value accounting’ (Nicholls, 2009). However, many of these measuring efforts are taking place at the level of the enterprise or the business, such as book keeping, but there is not a standardised method for measuring social impact. Social investment funds and other social intermediaries have so far followed their own methods of measurement. Actively investing for impact naturally means that any investor interested in taking a ‘blended proposition’ wants to be assured that the intended social impact materialises, especially if financial returns have been sacrificed (ClearlySo, 2011: 89). In fact, it is generally the case that most measurements are made on a case-to-case basis.

The lack of social impact measurement limits social finance by preventing it from having the rigour and accuracy available in the mainstream financial markets (Ibid: 89-90). The subjective nature of social returns make it all the more complicated to compare social returns across benefits generated (Ibid). Payment by result and social impact bonds were created as a way to minimise financial waste and to strengthen accountability. Yet, social change, aside from the fact it is hard to measure, does not come about at fixed points in time. Social impact should be measured on the long run. Targets and numbers that must be reached do not reflect the complexity of social and environmental issues.

Efforts to standardise impact measurement are taking place. In academia, as well as in the social finance sector, intermediaries such as monitoring organisations are taking on the task. Without these efforts, the social finance sector will remain fragmented and small. Yet, the question remains whether standardised measurement practises will stifle innovation and dishearten emerging social enterprises.

2.5.4 Trade-offs

Financial and social returns in reality are not as harmonious with each other as Emerson’s blended value proposition suggests, and ultimately social investors tend to make their priority either profit or impact. In this sense, social investment funds will vary in their risk profiles as well as in the social and environmental returns they seek (Harold, 2007: 6). Of course ‘there is no single monolithic blended value investing strategy’ (Harold, 2007: 6).

One of the major trade-off relates to the high cost of management of social investment. Enterprises require tailored support, whether it is for training the management team or developing a scalable business model (ClearlySo, 2011: 63). In addition to cost, social investment funds also offer their time and their resources by providing additional business support, such as mentoring, and in some cases office space. In effect, social finance has to a certain extent created the illusion that traditional business models can solve big problems, when in fact the right capital structure needs to be applied to the right organisation at the right time (Hattendorf, 2012: P2). In addition, managing social enterprises as part of a

mainstream portfolio is time consuming and problematic as they require social analysis and impact measurement (ClearlySo, 2011: 63). The cost factor explains why such a large portion of the social finance market is classified as financial-first impact rather than impact maximising. Indeed, social investment funds must also sustain themselves.

On the impact side, there are also potential trade-offs. Grant funding allows those in charge of the social project complete independence, as is the case for charity. When business models are being used to replace traditional philanthropic organisations, there could be tensions between running a viable business and staying true to ideals, and this is due to competing stakeholders demands (Dixon & Clifford, 2006: 328). The question to ask is whether social entrepreneurs can operate as viable businesses while retaining their core values especially if there is pressure from the investors to make profits. There is also the question of whether social entrepreneurs get influenced by the funding available while going about solving the social problem that they are passionate about (Felix Oldenburg, in Achwal, 2011). Indeed, it is equally important for social entrepreneurs to choose their investment source wisely, as it is for the investors when choosing their project. While investors "need to step back and think about exactly what problem they want to solve and how best to deploy capital to do it, entrepreneurs need to think hard about the kind of capital they need, given the mission, stage, and scale of their enterprise" (Hattendorf, 2012: P2). It often the case that the expectations, on both sides, are just too unrealistic.

In addition, there is a much larger implication at hand. The effects of social finance are potentially putting a great deal of pressure on third sector and philanthropy at large. Organisations in the UK and globally are now facing the pressure of taking up loans (Starr, 2012: P1) and are having to conjure up business plans to attract investors. It is hard to see whether social finance is causing pressure or whether it is a response to it. Either way, the social sector must face the decrease in grant-funding as best it can.

3. Method

3.1 Case study research

The case study as research design was chosen for this thesis due to the openness of the choice of methods, making it an adaptable framework to use. This was particularly useful for studying the novel field of social finance. However, a case study represents more than just an adaptable design, case study is used in qualitative research in order to study a phenomenon in great detail. It is about understanding how and why something might have happened by looking at the subject from many and varied angles with a great deal of intricacy, allowing the researcher to 'get closer to the 'why' and the 'how'' (Thomas, 2011: 4). Thus, the conduct of case study can be said to be the 'investigation' of one or a few cases in considerable depth (Gomm: 2006, 3) making it possible to look at relationships and processes of a given situation, and helping us understand the details of what is happening (Thomas, 2011: 37). The aim is to capture cases in their uniqueness, rather than to use them as a basis for a wider generalisation (Gomm, 2006: 3). They can be understood as 'detailed portraiture' (Ibid 121) of the social world, together forming a much larger collection of knowledge. The study of the social finance phenomenon is still in its initial phase in that there is not a lot known about it. This case study aims to become a building block contributing to the growing understanding of social finance.

Methodology research has extensively covered the question of the generalisability of a case study. The notion *working hypothesis* was first mentioned by the psychologist Lee Cronbach in 1975. He emphasised that the uniqueness and detailed analysis of case studies cancels out the option of generalisation and ultimately contradicts it. He continues by saying that it is important to realise that there are always differences in context from situation to situation, and even the single situation differs over time (Gomm, 2006: 39). Cronbach states that 'when we give proper weight to local conditions, any generalisation is a working hypothesis not a conclusion' (Cronbach in Gomm, 2006: 39). As such, the point of the case study is to be a representative sample within a larger context (Ibid: 40), suggesting complexities for further investigation

(Stake, 1994: 245) not a concluding statement. The case study must open the debate and entice further investigation, but not to end the discussion.

Social finance is a recent trend that remains in the process of being defined in a variety of disciplines. Case studies are more suited to expansionist than reductionist pursuits (Stake in Gomm, 2006: 24), which is especially appropriate here. Social finance as concept needs an increasing amount of work before it can be fully grasped and understood in its entirety. For this reason it is of great importance that the specificity and the uniqueness of the context be made clear throughout this paper. It is equally important to acknowledge that this is an exploratory case study.

3.2 Case selecting and semi-structured interviewing

The cases for this study were selected using two approaches, part snowball sampling and part purposive sampling (Bryman, 2008: 459). The actual size of the social finance sector in the UK is relatively small. It was therefore logical to use available directories of known organisations. For example, accessing the directory of an organisation that is promoting the development of social finance was helpful in the initial sampling task. Then there was also purposive sampling used to access leading social finance organisations that hold particularly important roles in the sector. Purposive sampling is used in a strategic way on the basis of wanting to interview people relevant to the research question (Ibid: 458). Overall, eight interviews were conducted and represent a balanced and varied account of social finance in the UK.

Research interviews are a method used to produce knowledge (Kvale and Brinkmann, 2009). The conversational nature of qualitative interviews allows the gathering information from the subject's point of view (Ibid) and the flexibility of the interview structure permits new topics to arise during the discussion that may otherwise have not have been considered beforehand. Semi-structured interviews with open-end questions provide detail and depth, while at the same time hypothesis testing (Leech, 2002: 665), guiding the respondents in the direction of the research topic. Semi-structured interviews allow respondents to be the expert

and to inform the research (Ibid: 668). Interviews made it possible to gather in-depth information that may be intentionally or unintentionally unavailable through other sources such as websites or articles and potentially get 'surprising answers and learn something new' (Ibid). Furthermore, the open-ended discursive nature of the interviews allowed for topics identified by earlier interviewees to be taken-up and presented during following interviews (Beardsworth and Keil, in Bryman, 2008: 489).

It was necessary in the time frame of this research to conduct telephone interviews, which allowed for greater cost-efficiency and fast results (Shuy, in Gubrium et al, 2001: 540). The respondents were all based in the UK and interview dates were often organised spontaneously, as such time and money were saved in avoiding excessive travelling. Telephone interviewing produced quality recordings, which facilitated the task of transcribing. Transcription was appropriate in keeping the respondent's words intact and it produced data in the form of text to be analysed (Bryman, 2008: 453).

The interview guide (Appendix) created an order of topic areas, helping the flow of the conversation and providing support and structure for the conduct of the interview as a whole (Ibid: 442). The interview guide provided in the appendix is a sample, since the guide was ameliorated and altered for each individual interview, while following along the structure of the sample.

3.3 Limitations

The limitations of this thesis need to be considered with regards to methodological choices as well as to the overall research design. The nature of qualitative studies can sometimes lead to descriptive reporting of the subject being studied (Bryman, 2008: 387). Yet, this 'emphasis on description' is needed to collect detailed information on the subject (Ibid). In the case of social finance, description is particularly important notably due to the fact that it is a relatively novel field. The complex nature of social finance also bids the need for description to truly analyse the intricacy of the phenomenon.

Additionally, the choice to interview representatives of social finance organisations has increased the issue of a one-sided argument. Indeed, the social

finance sector is relatively new and remains in the hands of those organisations and institutions that work in it. This means that with regards to academic research, there is already dominance in the literature of reports and articles written by these given organisations. However, it is important to say that the respondents provided critical and genuine answers to the questions asked. Given additional time, this thesis could have benefited from a more varied perspective, such as the social enterprise receiving the funding. The approach used to decide what is important and what is not could be criticised for not being systematic enough, leading to overall somewhat subjective results (Bryman, 2008: 391).

Furthermore, the social science nature of this paper brings to light limitations regarding the financial aspect of the paper. The thesis overall may have benefited from greater financial literacy including numerical analysis. The topic of the thesis could have benefited from a longitudinal design if the time and resources had been made available. This idea of a longitudinal study is linked to the limitation regarding financial literacy, which consequently could have yielded interesting revelations regarding the financial sustainability of social finance organisations over time.

Generally the qualitative nature of the thesis and the small sample of interviews can be perceived as limiting the scope of the research (Ibid: 391). Generalisability of the findings in this case will be limited. However, as was mentioned previously, a case study must not be considered as a representative sample but rather a suggestion for further debate. The qualitative nature has yielded interesting and in-depth understanding of the topic. Furthermore, the methodological choices allowed for the research questions to be answered.

4. Analysis

As well as presenting the individual cases in detail, this following part ties together the theory with the empirical data collected during the interviews and will attempt to answer the research question;

What factors explain the emergence and growth of social finance in the UK?

The question has lead to four broad answers, which came to light following interviews, but were already somewhat apparent in the theory:

1. Social finance is driven by the motivation to address some of society's greatest challenges.
2. These challenges will be addressed through investments into social enterprises that will generate both a social and environmental return.
3. Social finance wants to transform the social sector
4. The social finance movement is about building a new market

While the study has focussed on four mains factors, as with all social science papers, there can be no concrete answers, rather these answers must be recognised for making sense of a complex topic by reflecting elements of reality. The interviews were conducted with representatives of leading social finance firms and organisations so as to ask questions to those directly involved in the practice of social finance. These four ideas emerged consistently during the interviews while providing a variety of opinions and angles from which to analyse them.

4.1 Introducing the cases

A total of eight cases were selected for interviewing. All of them are UK based organisations, six are social investment funds and two of them are social finance intermediaries. The latter two do not issue investment transitions. In respect for the respondents as well as for the funds they work with, the names of the individual respondents will remain anonymous. Furthermore some quotes will also remain anonymous. As mentioned in the methods part, the cases were

selected following a snowball sampling approach, as well as purposive sampling. Snowball sampling allowed for a random selection, at the same time purposive sampling was unavoidable, it was important to include the larger actors in the field of social finance. Furthermore, the size of social finance sector is relatively small and the number of cases to choose from was limited. For this reason, it was almost impossible to take on a random sampling approach. Nevertheless, the final cases selected are varied in their role in the social finance sector. The range has allowed for the responses to be nuanced as well as consistent. An interview guide is available as an appendix. The semi-structured nature of the interviews means that the interviews differed to some extent. This interview guide is a combination of questions that were asked during the different interview. The individual cases are presented in alphabetical order along with a brief summary of the organisation.

Bethnal Green Ventures is a start-up support organisation that specialises in technology. They provide funding to start-ups that are addressing societal problems using technology.

Big Issue Invest is the social investment arm of The Big Issue, which is a leading UK organisation that helps prevent homelessness. Big Issue Invest provides loans and investments to charities and social organisations that want to scale up.

Bridges Ventures is a specialist fund manager that aims to achieve social and/or environmental impact as well as financial returns for their investors. They have three funds, two of which are financial-first impact driven, and third is a social sector fund. Within the social sector fund, the interview was predominantly focussed on the social entrepreneur fund.

Bridging to the Future is a business incubator specialised in micro-business and social enterprises. They provide support and investment for start-ups and social businesses that wish to scale-up.

Charity Aid Foundation (CAF) is a charity that provides investment and support to charities.

Nesta is a registered trading charity that provides investments to young and innovative businesses and seeks to improve the environment for early stage ventures.

New Philanthropy Capital is a think tank and consulting firm that offers strategic advice and reviews, impact measurement and grant-making support to charities and social enterprises.

Social Finance is an organisation that provides a range of financial advisory services to help build the social investment market.

4.2 Findings

4.2.1 Tackling societies greatest challenges

The first factor that explains the emergence and raise of social finance in the UK is the attempt at solving some of society's greatest social and environmental issues by using capital to invest in social enterprises (Harij & Hebb, 2010, Weber 2012, Monitor Institute, 2009). While, this declaration is commonly used across the social finance sector, the findings suggest that the extent to which social finance is tackling these issues is in practice limited. Of course, social finance cannot solve all of society's issues and challenges. Nonetheless, an interesting array of answers has emerged regarding selectivity in the attempts at tackling these issues. The majority of the social investment funds interviewed had a set of defined macro-themes incorporated into the organisation, providing a frame delimiting specific areas in which they are aim to provide investment.

The macro-themes were similar across cases. Usually they involved initiatives relating to the UK's ageing population, such as investing in products and services that can promote independent living. Another macro theme was around the issue of education and youth unemployment. Other areas included health care, underserved population, and environmental sustainability. The areas chosen are often reflective of their commercial potential. It was claimed in one interview that they had been "quite deliberate in choosing the thematic areas" (Interview). Effectively, investment decisions are made in areas that will promise to highest level of financial and social success. "There are arguably harder areas", which tend to be avoided by social finance initiatives (Interview). Indeed, there is evidence that social investment is only really present in areas where the rate of

social and financial success is highest. The literature and the findings have made it clear that risk aversion is a high concern for social investors (ClearlySo, 2011). These harder areas are not particularly well suited for investment, although they are generally the areas facing the greatest social issues.

Nevertheless, all of the interviewees were open to discussing the limited appropriateness of social finance, and how it cannot be used to solve all societal issues; "it's really hard to create a tiny little start up that tries to solve a massive problem; you have to pick a very specific problem to start of with. We don't look for start-ups that say we're going to solve climate change" (Interview).

The reality, however, is that a majority of investment proposition are generally not even considered. One respondent stated that they "turn down 90% of [enquiries]. The amount that we turn down is quite high and the majority are turned down because they are too small and a bit too risky" (Interview). The idea of investment readiness is an issue in social finance. The investment propositions that are made to social investment funds cannot be considered, this is generally due to a lack of business knowledge or bad management skills on the social entrepreneur side (CearlySo, 2011: 69). Many social enterprises are just not prepared to take on the amount of capital; "they are people who wish to do good but cannot in a business framework" (Interview). The complexity of skills required in the social finance world that social entrepreneurs often do not possess and that they approach investors before they are ready (Shanmugalingam et al., 2011; Gregory et al., 2012). For this reason, social finance intermediaries are taking on a variety of roles to provide services and support for social enterprises that are looking for investment. Yet, there is still a considerable lack of support for social organisations.

Investing in organisations and enterprises that can contribute to solving society's issues is to a large extent dependent on commercial potential of the area invested in as well as the potential of the enterprise itself. The decision generally is based on enterprises that have the soundest business model and the strongest management team; "whatever is trying to be achieved in terms of impact has to be grounded in a model that can be sustainable and independent from grants and donations. Once we believe that is the case then we look back at the entities which achieve the most impact" (Interview). The results make it clear that it is somewhat of an illusion that traditional business models can solve big problems, for this to

succeeded the right capital structure needs to be applied to the right organisation at the right time, which makes the practice of social finance far more complex than the theory suggests (Hattendorf, 2012: P2). Social and environmental issues are being addressed in a strategic way that limits the scope of social issues being addressed. The goal of making both a social and financial return on investment is at the heart of social finance logic, it is important to analyse independently as it provides further insight into the trade-offs that arise in social finance.

4.2.2 Generating social and financial returns

Social finance by definition is interested in investing in opportunities that can yield both a social and financial return. Yet, the reality of blended-returns reveals that in the case where impact is maximised, there is undoubtedly a trade-off: “organisations are doing work where very commercial organisations wouldn't want to, and there's a reason for that, because it makes less money” (Interview). The low commercial potential in the area of social finance is usually due to the nature or the demand for product or service being provided. The cost of providing it is not always covered by the revenue generated from it. Often the financial benefits of social finance are only apparent in the long run and in the cases where profits are maximised social enterprises are usually non-profit distributing, meaning that individual investors will not make any profits on their investment. The money in this case is reinvested into the organisation.

In that sense, the results also brought attention to the difficulties of convincing individual investors to consider social finance as an alternative. It was claimed in one of the interviews that “unless [investors] are socially motivated or somehow this topic has got onto their radar screens, they are less likely to be reaching out to managers like us” (Interview). In effect, the options for investment in the mainstream market are vast and there are many opportunities for individuals to make money. There is an important distinction to be made between the social finance market and the mainstream market. A respondent made an interesting statement in that regard: “the reality is that the social model doesn't work in the same way as the commercial sector. In the commercial sector a venture capital firm will make ten investments, five or six go bust, two or three

will break even and one hopefully goes gangbusters and basically pays for everything. In social investment, you're not going to get one that pays for the other nine. It doesn't happen. You'll never get a Google or a Facebook" (Interview). Effectively, in social finance, investors need to be prepared to make a trade-off if they seek to make a social impact with their capital and cannot expect to get rich from making investment in social finance (Brown and Swersky: 2012).

Nevertheless, there is a case for social finance when impact is maximised. The trade-off becomes acceptable when this is explicitly the case; "the sector and different organisations are taking quite different approaches. […] In some cases, investors are accepting nothing more than their money back and sometimes even at a small loss" (Interview). Effectively, in the case of impact maximisation "there is a more easily identifiable pool of potential investors. The issue is, at the current stage of market development, they tend to be much smaller therefore the scale of those funds is accordingly much smaller compared to our mainstream market fund" (Interview). Generally, it seems that there is room for trade-offs when impact is factored in and social investment funds are able to take higher risks on innovations with primarily social, rather than financial, returns (Brown and Swersky, 2012: 6). The case of impact maximisation is quite specific even within social finance.

These social investment funds that focus on maximising impact tend to be smaller or exist as add-ons to larger investment funds. For example, one respondent stated that; "we as an organisation are providing growth capital, that's the bulk of what we do. We have now an early stage tech programme which looks at start-ups. But the rest is focused on growth capital for businesses that are established and have demonstrated a proven model, that are looking to scale up" (Interview). The potential for maximised impact is limited to the successful running of the rest of the fund. The findings pointed out that the greatest potential for social impact is generally found in high-risk investment in areas with the greatest social issues. These will generally have the lowest potential for financial reward (ClearlySo, 2011; Brown and Swersky, 2012).

As such, impact maximisation is taken on as a strategy only when there is secured funding for the investment fund. Either along-side more mainstream sustainable growth funds, or along-side trading arms or fee-paying services. This is the case for four out of the eight cases included in this study. Indeed, earnings

and income are important for the running of a social investment fund. Yet, the fact is that running a social investment fund is costly and the revenue generated is not always enough. For example, a respondent stated that their fund “has been able to demonstrate a good track record of investment vis a vis write offs and losses. But we have not made it to a scale that will allow it to cover its losses and operating costs” (Interview). Sacrificing financial returns need also to be considered in this respect. The concept of self-sufficiency as a whole must extend to the social investment funds as well as the social enterprises.

For this reason, in the case where high-risk start-up investments are made, the source of funding is often predominantly philanthropic and the financial trade-off is thus no longer as much of a concern. Bethnal Green Ventures is an organisation that invests in start-ups and is predominantly funded by grants. The interviewee stated that “when you are dealing with stuff that is as early-stage as we are, talking about trade-offs between social and financial returns [...] doesn’t make sense because nobody knows” (Interview with Bethnal Green Ventures). This is generally the reason why this part of the sector is still undeveloped. Another respondent explained that “the reason we don't do early stage investment apart from the one we have right now, is that it is very high risk. 80% of businesses fail in the first 5 years” (Interview). High-risk investments are usually made in the case where they are compensated by the promise of high social returns. In an interview, a respondent made it clear; “for us to take a high financial risk, we can only do it if we see that the organisation has a high social impact. So it's difficult for us to do anything too risky when the impact of the organisation is quite low, because we have made a promise to our investors that overall our portfolio will balance out so that we'll match our risk and impact” (Interview).

Despite the general agreement, that ultimately there is a trade-off between social and financial returns, one respondent stated that ‘if you get it right, your returns should be comparable to any other sort of investment. We just need to understand investment need, structure, risk, different pools of investors etc, which had not been there in parts of the sector traditionally’ (Interview). In order for social finance to be successful a wide range of factors need to be considered simultaneously. This means that in general sense more research needs to be done within the financial organisations as well as in other fields such as academia.

Moreover, there was the only respondent who express concern about the social trade-off; 'I get worried about a very strong profit motive in elements dealing with vulnerable people. History of that has shown that this type of market doesn't work very well because the power comes from the side of the provider rather than from those who need the services' (Interview). Indeed, a critique of social finance is the claim that when business models are being used to replace traditional philanthropic organisations, social enterprises may struggle with running a viable business and staying true to their ideals as a result of competing stakeholder interest (Dixon & Clifford, 2006). The interviewee provided a solution for this; with increased active management in the implementation side; 'it's not about backing them, it's about how are we going to make sure that they implement it effectively. Active vigorous investment is helpful as long someone has got social values down in there too' (Interview). Finding standardised methods for impact measurement and implementing a system for monitoring the sector has a whole must be the next step in the growth of social finance (Tuan, 2008; ClearlySo, 2012). Though standardisation of social finance practices might take away from the organic development, such standardisation is necessary to increase legitimacy, accuracy, transparency and accountability, and ultimately help protect the social enterprises as well as the social mission (Ibid).

4.2.3 Transforming the social sector

Throughout this paper, a lot of focus has been directed towards the social sector. Indeed, one of the justifications for social finance is the idea transforming the social sector in order for it to become more sustainable and ultimately more effective. Investment is being sought in social enterprises in the hope that they uncover or create new opportunities through a process of exploration, innovation, experimentation, and resource mobilization (Dees: 26). A respondent explained that "grant funders have been starting to think of news ways of spending their money. They felt that they had funded so many projects for three or five years which had come to an end. […] Often a project couldn't continue after the grant funding" (Interview). As such, the emergence of social finance was founded upon the question; "How do we invest better in charity and social enterprises?"

(Interview). Ultimately, "social entrepreneurship was the idea of taking the best of what investing can do and try and make a social outcome out of it" (Interview).

Addressing social issues by investing capital into the third sector has been a real driving force in the emergence of social finance. The idea of recycling capital and reinvesting it back into the mission were common themes during the interviews. An interviewee stated that their "investment approach shows that there are some issues that can be addressed with private capital and if you can show that you can also make a financial return out of it, then hopefully there is generally more capital that can be deployed to solving these issues" (Interview). Indeed, the aim of making funding toward to social sector more financially sustainable can be linked to the emergence of social finance. The demand for social capital in this sense was as much driven by social enterprises as it has been by grant funders (ClearlySo, 2011; Brown and Swersky, 2012). A respondent spoke of social finance as "alternative to grant funding, because if its investment it's probably a more sustainable project if they can see a revenue from it. It's a more sustainable way of using money than just giving grants" (Interview). As such, the interviews made it clear that the quest for financial sustainability has contributed to the emergence of social finance.

Nevertheless, this notion of financial sustainability is equally the result of severe cuts in grant funding. A respondent made the claim that "grant funding is getting smaller and smaller, and statutory funding is also getting harder to get", believing that "social organisations are having to become a bit more social enterprise like, so actually make some money, trade etc' (Interview). For many social sector organisations, social finance is the only option as well as being a new opportunity; 'as we have seen the market can move quickly and many charities are struggling to gain the funding they previously relied on. Hence everyone realises the need to become more sustainable' (Interview). There was opportunity for investment within this changing sector, which undoubtedly is a contributing factor to the emergence of social finance.

As such, social finance has taken on the task to 'show that you can preserve the capital by way of investments, you can then actually recycle the capital because it could be repaid with a bit of return and then that capital could then be redeployed and have additional impact' (Interview). Building a track record of this is the next step in the growth of social finance. This can be done by

developing its commercial potential: “if we can demonstrate that a particular learning technology is helping raise attainment it will help its commercial prospects. If we can find the techno that allows people to live at home while actually demonstrating the quality of life improvements, it we will be their commercial interest, because there is a large population that would rather live at home than in an old people's home” (Interview). The commerciality of social finance lies in investment that supports the production and distribution of product or services that are in demand. Interest in the innovative and commercial appeal of social entrepreneurship continuously contributes to the growth of social finance (Dees, 2007; Defourny, 2001).

Again, the results also pointed to the fact that social finance isn’t appropriate in all situations; “we don’t think that investment is the model for all the issues that society faces but there are certainly a lot of them that could take advantage of the entrepreneurial spirit to provide solutions for” (Interview). Moreover, every respondent claimed that social finance could not fully replace grant funding. A respondent was able to get to the bottom of this. He believes that the true questions to be asked are: “does a social enterprise have the management capacity to take on investment to expand in a way that is strong but sustainable? Does it understand what investment involve?” (Interview). Investment readiness, however, must not be the only concern prior to investment. The respondent states that “there is another element which is what fundamental approach to meeting this need” and which begs the question “does it require a radically different sort of organisation from the one that is out there at the moment?’ (Interview).

Indeed, while the issue is often related to investment readiness and the focus is on how to make existing organisations ready for investment, in other words “financially, structurally, operationally ready to take on big chunks of investment” (Interview). This idea of whether investing into existing organisations is necessarily the best approach was a unique result. The respondent explained that “one needs to step right back and think about quite different ways of answering the question: How do we address this need?” (Interview). At the current stage of social finance development where capital is being invested in existing organisations, this statement does not reflect a widespread initiative and was mentioned only in one interview. The reason for this is linked to the costs associated with looking at all the different ways to address a specific need. The

respondent claimed that “it is both time consuming and risky, but if you get it right it becomes something much more transformative than investing in an existing charity or enterprise” (Interview). This finding demonstrates how the possibilities associated to social finance are still not being fully tapped into. Risk mitigation is a factor that is preventing social finance from realising its potentials.

4.2.4 Building a social finance market

“The social investment market is developing at a pace. With the launch of Big Society Capital [...], increasing interest from commercial and other investors, and a growing demand for capital from social organisations, there are reasons to be cautiously confident” (Brown and Swersky, 2012: 1). This statement is the first of an article titled ‘The First Billion’, commissioned by Big Society Capital to forecast the demand for social investment and assess its future. It was made clear in each of the interviews that the growing social finance market was something to strive towards. One respondent stated that “if one could develop an asset class and proven model capable of investing in social enterprises and at the very least, preserve capital, deliver social value, its potentially become very interesting” (Interview).

Big Society Capital, which is planning on investing a considerable amount of money into the sector, was mentioned in the majority of the interviews. The establishment of Big Society Capital is making the prospect of an emerging marketplace a reality (Gregory et al, 2012: 3-4). Big Society Capital is contributing to the market by funding social investment funds and “developing their capacity to provide social sector organisations with access to new, appropriate and affordable sources of finance to increase their social impact” (Big Society Capital).

Nevertheless, the term *cautiously confident* is relevant to the discussion. During the interview the topic of the launch of Big Society Capital, respondents while generally having positive outlook to BSC were also aware of the need for caution in the distribution of the capital. One respondent was aware that the amount of capital available is larger than what has been invested so far; “BSC is doing fund of fund investing’ and it's got a big pot of money, arguably not too big,

if it is all poured into the market tomorrow, there would be an overweight of capital supply compared to demand" (Interview). Another respondent emphasised the need for increasing responsible investment practices; "there are challenges, when large amounts of money come into a sector there is a risk that the money is invested poorly and there is a learning curve. There can be too many people chasing too few good deals and pricing is affected. So there are issues" (Interview). Indeed, actors in social finance in their aim to achieve financial sustainability must be cautious about potential waste.

The topic of risk capital and equity investment, notably in relation to start-ups and early-stage enterprises, was also regularly mentioned. It was generally agreed that the social finance sector needs increased efforts to build up this area; "The arrival of BSC is going to create an awful lot of investment opportunities for young early stage organisations […]. There isn't a track record of this type of investment in the UK. We need to demonstrate that it is viable" (Interview). The opportunity for increased levels of social impact in this area is generally higher, yet few investment funds are willing to take on the risk (ClearlySo, 2011).

Furthermore, the idea that the market was still far from being established was also recognised during the interviews. The respondents emphasised the lack of a social finance track record. The idea of 'proving oneself' was mentioned a number of times, referring to the need to demonstrate that social finance can be successful; "like any emerging sector you need to prove yourself. We still have a lot of awareness raising to do and we need to market ourselves to a broader range of investors" (Interview). Indeed, social finance has not been around for very long. An interviewee claimed that 'you tend to need to wait at least 10 years to get any real idea. […] There is insufficient evidence' (Interview). We are still in the early days of social finance; the desire to demonstrate the potential of social is a strong factor contributing to the explanation of the continuous growth of social finance in the UK.

5. Concluding remarks

While the social finance movement in the UK is still relatively small, there is no doubt that its development as a market is underway. The launch of Big Society Capital has made it clear that this market-building process is underway (Brown and Swersky, 2012). Nevertheless, at the current stage of the social finance market, further development is needed regarding the strengthening of infrastructure, in addition to social investment funds, there is great need for social finance intermediaries that can provide services beyond the issuing of capital, such as business support and mentoring.

The findings and the literature have suggested that the area of social finance dealing with start-ups is largely underdeveloped. It is in this area that there is the greatest untapped potential. Social entrepreneurship brings creativity and resourcefulness into the equation; these ideas if provided with the right amount of support could transform the delivery of social services (Dees, 2007). Increasing investment in start-ups implies an increase in equity investment. As such, social investments funds must be prepared to take higher risks. The findings have also suggested evidence that this area is growing.

While there is evidence of opportunity in social finance, the study has also brought to light the fact that in practice making a social impact while generating financial return is not as straight forward as the theory may have suggested (Harij & Hebb, 2010, Weber 2012, Monitor Institute, 2009). Emerson's blended value proposition (2003), which claims that social, environmental and financial returns are interconnected, may be correct to some extent. The results show there is evidence of a negative correlation between the social and environmental returns on one side, and the financial returns on the other. The social finance experts that were interviewed all agreed that more time is needed to prove whether or not a blended-value is possible. At the moment, the track record is too limited to provide any secured answers. Indeed, social finance practices have not been around long enough to demonstrate the truth behind such claims.

Greater transparency of the cost-benefits of social finance could help to avoid having unrealistic expectations that could be detrimental in the long run (Tuan, 2001: 24). Indeed, if social finance is to successfully address some of

society’s greatest issues, efforts need to concentrate on how such a market could be managed. Evaluating and monitoring existing social finance practices, by collecting impact and outcome data, could provide a better idea of what has or hasn’t been successful (Ibid). Additionally, in order for the social finance market to be fully established, greater effort must be made regarding the use of common language and measures, which are still all too relative to context. Such practices remain in the hands of each individual organisation.

For this reason, academia must play a greater role in the field of social finance, as it will provide additional critique, which is currently lacking in the literature available. Indeed, current literature on social finance, while being of high quality, is perhaps too one-sided. An increase of academic research will spark debate and ask the questions that will help increase the legitimacy of social finance. Indeed ‘the point is to use these tensions to create a debate and think about what’s right for social investment’ (Interview).

Finally, while the thesis portrays the social finance movement as significant, it is important to remember that the actual size of it is actually small in comparison to the mainstream market or the third sector. Nevertheless, it is significant in its own right. Social finance could represent a real change in the field of welfare management. The question is: ‘if social finance is successful, could social entrepreneurship create a social impact in arenas where government has been inefficient?’ (Dees, 2007: 24). The findings revealed that this idea of effectively delivering public services was a genuine effort, though never intended as a replacement for governmental provisions. Cautious confidence is the correct attitude towards social finance in the UK, however it is important to remain critical. Social finance may be a new and innovative way of tackling social problems, however until this has been proven, one must not be too quick to replace traditional welfare models.

The emergence and growth of social finance in the UK can be explained by a number of factors. Social finance is, as much about the desire to move away from the use of voluntary capital deemed wasteful to working investment capital, as it is about finding new ways of addressing social and environmental issues using this capital. Social finance offers a new perspective on the management of welfare, provoking a discussion on the traditional roles of philanthropy, mainstream finance and the public sector, and how these are changing.

Executive Summary

Social finance is the notion of actively, purposefully and deliberately seeking social and environmental impact on investment, whereby social investors intentionally apply financial tools, instruments, and strategies to enable capital to achieve a social, environmental as well as a financial return (Harij & Hebb, 2010, Weber 2012, Monitor Institute, 2009). It is the belief that social finance may be a solution to addressing some of societies greatest challenges in an efficient and innovative way. Social finance may generate a financial return, but the social returns are 'defined as a priori and are not an incidental side effect of a commercial deal' (Brown and Swersky, 2012: 3).

This thesis is a study into the factors that explain the emergence and growth of social finance in the UK. A series of interviews were conducted with leading experts in the field. The outcome was a qualitative debate on the strength and weaknesses of social finance. These representatives of leading social finance organisations were asked questions during a semi-structured interview about the running of their fund or organisations, as well as about their general opinions on social finance theory and practice. Today, the scale of social finance in the UK is relatively small, but there is evidence of a steady growth during the last decade (Brown and Swersky, 2012).

Generally speaking, social finance is a way of providing capital to socially driven organisations and enterprises as an alternative way to grant funding in the hopes of giving them greater financial sustainability and the opportunity to keep their projects running in the long-term. Social investment funds are expert institutions in the field of social finance and play the role of providing capital by investing into social enterprises and businesses. They vary in their mission from profit maximising mainstream investment that is socially driven, to non-profit distributing with a goal to maximise impact. There is no monolithic approach to how social finance should be carried out. Social investment funds make use of traditional financial instruments, such as debt and equity investment.

The theory highlights concerns regarding three topics. One is regarding the high level of risk and uncertainty associated with social finance. This has lead to a large number of investment proposition being made to enterprises that already

have a sound business model and proof of income (ClearlySo, 2011). Indeed, the social sector offers many opportunities for social impact, but there is a shortage of projects that are ready to take on investment capital (Gregory et al, 2012). Another concern is the lack of a standardised method for impact measurement, which means that social investment is lagging with regards to the accuracy of social returns (Tuan, 2008). Finally, there is also concern regarding the possible trade-off between social and financial returns, which simultaneously are sought out in social finance. The cost of social finance is higher than mainstream investment, and requires a complexity of skills, including social analysis as part of the management of funds (ClearlySo, 2011).

Following the conduct of interviews, the findings brought to light four broad factors that explain the emergence and growth of social finance in UK. The discussions built upon these four factors are not deliberate ways of undermining the legitimacy of social finance, rather they provide a critical and honest discussion about the intricacy and complexity of the application of social finance in practice.

The first explaining factor is the attempt to solve some of society's greatest social and environmental issues. The study elaborates and looks more closely into what issues are being focused on. The findings suggest that actors in social finance have a strategic approach to investment, choosing areas that have the highest commercial potential. Nevertheless, the existence of investment funds seeking to maximise impact, while limited, provides evidence that social finance is remaining true to its goal of tackling social and environmental issues.

The second explaining factor is the pursuit for blended returns on investment. Social finance is at the heart of an inter-disciplinary debate on the legitimacy of blended-value returns, whereby financial, social and environmental success is manageable and accessible simultaneously (Emerson, 2003). Evidence shows that there is somewhat of a negative correlation between social and financial returns. The cost associated to creating social impact ultimately affects the level of financial returns. Nevertheless, the results suggest that social finance organisation wanting to demonstrate that it is possible. The growth of social finance can be linked to the goal of developing a proven track record of successful investments.

The third factor is the goal of transformation of the social sector. Social finance is the idea transforming the social sector in order for it to become more sustainable and ultimately more effective. Investment is being sought in social enterprises in the hope that they uncover or create new opportunities through a process of exploration, innovation, experimentation, and resource mobilization (Dees: 26). At the same time, social enterprises and charities are looking for new sources of funding since the overall decrease in access to grant funding.

Finally, the fourth factor explaining the growth of social finance is the motivation to create a new market. Building a track record, proving that successful outcomes can arise from social finance, and making social finance an asset class in its own right, are have been driving forces of the social finance movement.

To conclude, what this study has demonstrated is that the social finance market in the UK is growing in size and in number of actors involved. There is a clear support from government, who plans on investing a large some of capital into social finance intermediaries with the launch of Big Society capital. However, the factors that explain the emergence and growth of social finance need additional research. In particular, the case for blended-returns needs more time in order for it to be fully demonstrated. Finally, there is clear need to the involvement of academia to increase in the field of social finance, which for the moment somewhat lacks in critical discussion.

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Appendix - Interview Guide

1. In a few words, could you tell me a bit about your organisation?
2. Could you tell me a bit about how came into existence?
3. Could you tell me a bit about your different investment funds? Services that you offer?
4. How is the organization funded?
5. Could you tell about a current project you are working on?
6. What are your criteria when making an investment?
7. Why is it important that they have evidence of at least one year of income?
8. What kind of relationship do you have with the businesses? For how long are you in contact with them?
9. What kind of returns do you expect? Equity, financial returns, board representation?
10. You mention that it is important to invest in order to create new funds, could explain that further?
11. Could you tell me more about the growing demand for impact investment?
12. What are the biggest challenges for social businesses when looking for funding?
13. How do you measure impact? Why is impact measurement important?
14. What would a social finance market mean for the UK?
15. Could you tell me more about the importance of making partnerships with other actors such as social venture intermediaries and other investors?
16. In what way is the UK a pioneer for social finance?
17. Would you say that social finance is something particularly important today?
18. What issues and compromises arise in impact investment that may not in traditional finance?
19. Would do you say to the claim that there are trade-offs between social impact and financial returns?
20. What is your opinion on the effect impact investment may be having on the third sector or charities?
21. What are the next steps for social finance?