

## Equity finance for social enterprises

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### **Biography**

Jim Brown is the principal consultant for Baker Brown Associates, a research and development practice specialising in the social economy. He was the commissioning editor and principal author of *Co-operative Capital*, which explores the development of equity finance for co-operatives.

### **Abstract**

Equity finance is potentially an important source of capital for all enterprises, including social enterprises. Conventional share capital structures, which attribute all the wealth of the enterprise to shareholders, and allocate control on the basis of one-share-one-vote, are clearly inappropriate for social enterprises. This paper explores alternative share capital structures which may be more consistent with the values and principles of social enterprises. The paper starts by explaining why it is important to develop equity structures that allow ethical investors to invest in social enterprises. It adapts Jeff Gates' analysis of ownership rights to identify the design criteria for equity finance that will enable social enterprises to engage with ethical investors in pursuit of a common social purpose.

## Introduction

The Government's support for social enterprise is firmly focused on ending grant dependency within the sector and overcoming what it describes as the sector's cultural aversion to borrowing. It has funded the creation of community development finance institutions to provide loans to social enterprise. The Government has paid less attention to the provision of equity finance, even though the Bank of England reported that the *"lack of access to equity finance is perceived by many in the social enterprise sector as a key barrier to growth and development"*. (Bank of England, 2003, p. 45)

There are several reasons why social enterprises may benefit from equity finance. Early stage growth can be hampered by a lack of capital. Lenders are usually reluctant to lend large amounts of money to enterprises with small reserves of capital and no scope for personal guarantees. Equity finance releases the social enterprise from the obligations of debt that can only be repaid by borrowing again or by making and retaining profits to replace debts. Not-for-profit enterprises that are wholly reliant on debt finance often need to make higher profits than social enterprises where permanent capital is provided by equity investors. The capital repayment cost of short- and medium-term loans is often higher than the interest charges on those loans, placing strains on cashflow. The cost of repeated borrowing can be higher than the cost of raising and servicing permanent equity finance. Investors often accept dividend rates no higher than prevailing interest rates, especially if the social enterprise is pursuing social objectives that are supported by the investor.

Many social enterprises operate in markets where the pursuit of profits is in conflict with their stated social objectives. For instance, the social objective of most housing associations is to provide high-quality, affordable housing to low-income groups. Affordability means low rent levels, which in turn means lower profit margins. But housing associations with high levels of debt have to be highly profitable to service the interest on debt and repay borrowed capital. With equity finance there is usually no obligation to repay shareholders: the capital is permanent not temporary.

Despite the clear benefits of equity finance for social enterprises, its use is controversial because of the potential conflict between shareholder interests and the social objectives of the enterprise. This potential conflict of interest is hinted at in the Government's definition of social enterprise: *"A social enterprise is a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners."* (Department of Trade and Industry, 2002, p.13)

The Government has used this definition to inform the design of Community Interest Companies (CICs), which it describes as the legal format for social enterprises. People establishing CICs will be able to choose between three formats: a company limited by guarantee, a company limited by shares, or a public limited company. The latter two types of CIC can issue shares to investors, but with restricted rights attached to these shares. These restrictions include a cap (upper limit) on the dividends payable to shareholders, limits on shareholder voting rights, and an asset lock that prevents investors sharing any residual assets, beyond the paid-up value of their shares, if the social enterprise is sold or wound up.

It might be thought that such restrictions on the rights of shareholders would be off-putting to investors. But there is evidence that some ethical investors are prepared to accept even greater restrictions on their rights than those which apply to investors in CICs. For instance, in 1990 the Centre for Alternative Technology (CAT) raised £1 million by selling shares to investors who have no voting rights, have never received a dividend and who cannot easily sell their shares. Traidcraft has raised nearly £5 million through four successive share issues over the last twenty years, but up to 2004 had never paid a dividend to shareholders. Until the most recent share issue in 2002, Traidcraft shareholders had no voting rights, and even now voting rights are restricted. Selling shares in Traidcraft has been difficult, although this situation has improved recently with the support of brokers Brewin Dolphin, which operates a matched bargain service in Traidcraft shares.

Both CAT and Traidcraft used the plc format to raise equity finance, designing their own customised package of shareholder rights. An alternative approach is to use the structures provided under the Industrial and Provident Societies (IPS) Acts. This legislation allows bona fide co-operatives to sell shares to their members, up to a maximum value of £20,000 per member. The legislation gives all members one vote, irrespective of the size of their shareholding. IPS shares are usually withdrawable rather than transferable, and receive only a limited dividend. Part of the reserves of most IPS co-operatives is indivisible and must be transferred to another IPS co-operative, or a charity, if the enterprise is wound up. Withdrawable share capital must be treated as a liability, unless the board of directors have discretionary powers to refuse withdrawal, in which case it can be treated as an asset. IPS share capital can be non-withdrawable and transferable, allowing members to sell their shares to a third party, as long as that person qualifies for membership. But in practice, most co-operative societies issue withdrawable capital. The Phone Co-op has received more than £1 million in withdrawable share capital from its customer-members since its launch in 1998.

So far, the amount of capital raised by social enterprises and ethical businesses through the issue of share capital is small, even though some enterprises have raised relatively large sums of money. Triodos Bank helped the Ethical Property Company raise £4.2 million in 2002, and in 2004 it helped Café Direct raise £5 million. Both share launches were heavily over-subscribed. Over the last ten years at least £35 million has been raised by ethical and social enterprises using bond and share issues. But this is less than 1% of the total amount invested in ethical investment funds in the UK, which according to EIRIS stood at £4.3 billion in December 2003 (EIRIS, 2005). Ethical investment is only a tiny part of overall UK institutional investment, which was valued at £1,652 billion in 2002.

The scale of the ethical investment market, and the tiny share of this market invested in social enterprises, gives grounds for believing that there is scope for many more social enterprises to raise permanent capital from ethical investors. Assuming that the ethical investment market continues to grow at 10% per annum for the next ten years, and that social enterprises increase their share of this market to 5% over the same period, then the total investment in social enterprises would stand at £1.2 billion.

In order to achieve this growth in investment in social enterprises, a dedicated infrastructure of investment institutions will have to be constructed, linking

ethical investors to social enterprises. Coupled to this, there is a need to develop the know-how and culture of equity investment in social enterprise. The most important area of know-how is the design of equity finance structures compatible with the values and objectives of social enterprises. The remainder of this paper is devoted to this issue.

### Unpacking ownership rights

In his book *The Ownership Solution*, Jeff Gates (Gates, 1998) dissects the rights of ownership into seven distinct categories: liquidation rights, income rights, appreciation rights, voting rights, transfer rights, information rights and public rights (see Table 1). He describes how these rights can be used as building blocks to design a range of different corporate ownership solutions. The first five rights are crucial elements in the design of equity finance. Liquidation, income and appreciation rights determine financial interests in the enterprise. Voting and transfer rights determine who controls the enterprise. Information and public rights are usually determined by the state and its regulatory bodies, and, therefore, are not an important design factor.

<b>Ownership rights</b>	<b>Description</b>
Liquidation rights	Rights to the residual assets of the enterprise after all other creditors have been paid
Income rights	Rights to receive a dividend or interest payment
Appreciation rights	Rights to any capital gain (or loss) in the value of the investment
Voting rights	Rights to control the affairs of the enterprise using agreed voting principles
Transfer rights	Rights to trade investment with another party, or to withdraw investment from the enterprise
Information rights	Rights to information about the policies, practices and performance of the enterprise
Public rights	Rights of governments on behalf of their citizens to tax and regulate enterprises

### Voting rights

Voting rights have an overriding quality in that they can be used to determine all other ownership rights, with the exception of information and public rights. Consequently, the allocation of voting rights is crucial in determining who controls the enterprise.

It is usual practice in private enterprise to give investors voting rights through the vehicle of ordinary shares. Voting rights are allocated on the basis of one-share-one-vote, which means that if a single person or entity owns the majority of shares they also have the majority of votes. This avaricious approach is often justified on the grounds that ordinary shareholder capital is fully at risk.

In the social enterprise sector, the underlying values and principles determining the allocation of voting rights are far more ambiguous. Some social enterprises, notably co-operatives, have open and democratic membership systems whereby any person who fulfils the requirements of

membership is free to join and is allocated voting rights on a one-member-one-vote basis. Many other social enterprises do not have open membership, especially those that have incorporated using a company limited by guarantee (CLG) format, which, because they do not have shareholders, have to choose to have membership clauses written into their governing document. Other legal formats used to incorporate social enterprises, including formats based on the Industrial and Provident Societies Acts (IPSA) and companies limited by shares (CLS), involve the issue of shares that act as membership tickets, granting the holders rights in the enterprise.

It is because shares often have voting rights automatically attached to them that care needs to be taken when designing equity finance for social enterprises. Voting rights can be tailored to fit the specific requirements of the enterprise. An equally important consideration is who has the right to vote and whether or not there should be more than one class of voting shareholder or member.

There are usually four principal types of stakeholder in any enterprise: workers, customers, suppliers and investors. All four types of stakeholders have a risk relationship with the enterprise: if the enterprise fails they stand to lose out. And all four types of stakeholders are in conflict with each other over the creation and distribution of surplus value. These conflicts are, in theory, resolved by competition in the free market where the laws of supply and demand result in fair transaction prices. A criticism of private enterprise is that ownership and control is usually granted exclusively to investor-shareholders, which creates a fundamental imbalance in the relationships between stakeholders.

Arguably, the function of a social enterprise is to reconcile the competing interests of stakeholders by redressing the power balance through its ownership and control structures. There are a number of ways this can be achieved. The simplest approach is to deny investors any voting rights at all. This means that investors have no powers to protect their interests, which will probably make them more risk averse.

An alternative approach is to restrict equity investment to a single-stakeholder group such as workers, customers or suppliers. Co-operatives using IPSA legal formats are examples of this approach, where members can invest in share capital, normally up to a limit of £20,000. IPSA legislation determines that voting rights are restricted to members on a one-member-one-vote basis, regardless of the size of their individual shareholdings.

A more sophisticated approach involves the development of multi-stakeholder structures, where investors are one of a number of stakeholder groups with their own class of membership and associated ownership rights. This approach is reflected in the CIC regulations, which limit the voting rights of investor-members at general meetings to a maximum of 24% of the votes cast. This is just below the 25% threshold where the power to block constitutional change comes into effect. The CIC regulations also contain measures to protect the financial interests of investors from dilution or alteration by other members. The design of democratic voting rights is far more complicated in a multi-stakeholder ownership structure. Social enterprises developing this type of structure need to protect the rights and interests of all the main stakeholders, not just investors.

## **Transfer rights**

Transfer rights determine who can control the enterprise. They also affect the financial interests of investors. These two factors can be decoupled by not granting investors any voting rights. So, if equity finance carries no voting rights whatsoever, there should be no problem about the transferability of shares between third parties.

But if voting rights are attached to equity then transfer rights might have to be restricted to protect the interests of other members, or to prevent a concentration of power in a single shareholder. For instance, there may be restrictions on the number or proportion of shares held by any single person or entity. Alternatively, voting rights on fully transferable shares could be restricted to issues affecting the rights and interests of investors.

In single-stakeholder enterprises, where investing in share capital is restricted to members who use the services of the enterprise (workers, customers, suppliers), transfer rights are usually withheld to prevent share capital falling into the hands of non-members. This means that the share capital must be withdrawable. But because it can be withdrawn, it is more like temporary capital rather than permanent capital. Enterprises with this type of finance must make provision for the fact that members may withdraw their capital within the terms of the share agreement. The directors of such enterprises must hold discretionary powers to refuse withdrawal if such share capital is to be treated as an asset rather than a liability.

In order for equity finance to be considered permanent capital, the enterprise must be free from any obligation to return that capital to the investor. If the capital is non-withdrawable then it is reasonable for investors to expect to have the right to transfer (sell) their shares to other investors, or to a third party. Enterprises can assist these transfers by acting as brokers between sellers and buyers, or by supporting the development of some form of marketplace for their share capital.

## **Financial interests**

Three main ownership rights determine the financial interests of investors: liquidation rights, income rights, and appreciation rights. Liquidation rights are of fundamental importance because they determine what happens to the residual assets of the enterprise. There is an emerging consensus in the social enterprise sector that at least some of the residual assets should be indivisible. This principle is reflected in the CIC provisions for an asset lock. In the co-operative sector this principle is referred to as common wealth, wealth that belongs to all stakeholders, past, present and future, and which should never be distributed to members.

This restriction on liquidation rights means that members and investors have a vested interest in the survival of the enterprise, or in its merger with, or takeover by other social enterprises. This places even greater importance on transferability of share capital and the development of secondary markets as an exit route for investors.

Appreciation rights are closely connected to transfer rights and liquidation rights. If share capital is withdrawable then appreciation rights are usually restricted or denied. It is common for social enterprises issuing withdrawable

share capital to issue shares that remain at par value. This is especially the case in social enterprises where liquidation rights are restricted by an asset lock, or where at least part of the reserves is indivisible.

Where share capital is transferable between third parties then appreciation rights are, in effect, determined by the market and what buyers are willing to pay for share capital. This in turn is affected by the income rights attached to the share capital, and ultimately, the financial performance of the enterprise. In a secondary market the capital value of shares is strongly influenced by the present and future income flows those shares might generate.

Most social enterprises apply restrictions to income rights, which often take the form of a cap or upper limit on dividends. This type of restriction on income means that share values are unlikely to appreciate. If, instead, income rights are restricted to a maximum proportion of net profits, there is scope for dividend growth, which in turn will lead to an appreciation in the capital value of shares on a secondary market. Of course the whole process can work in reverse. If a social enterprise fails to pay dividends commensurate with its share value then the share value will probably fall.

Appreciation rights can be managed in other ways. The Ethical Property Company bases the value of its shares on the net asset value of the company, which in turn is based on an assessment of the change in value of its properties. But this method still depends on buyers and sellers agreeing to trade at that price. If liquidation rights are restricted and the full net asset value cannot be distributed to shareholders then this method of valuing shares is less useful.

### Designing equity finance for social enterprises

The five ownership rights examined in this paper can be used to design a series of equity finance options for social enterprises. These options range from altruistic to avaricious forms of equity. Between these extremes there are a number of options that will appeal to ethical investors in search of a social return as well as a financial return on their capital. These options focus on three main forms of social ownership – common ownership, single-stakeholder ownership and multi-stakeholder ownership – as well as the CIC regulations for investor share capital. Table 2 shows how these options relate to each other, ranging from those which offer a purely social return, through to those offering only a financial return.

<b>Table 2: Equity finance design options</b>					
Avaricious capital	Multi-stakeholder share capital	Single-stakeholder capital	CIC investor share capital	Common ownership capital bonds	Altruistic capital
<b>Financial return</b>			←————→	<b>Social return</b>	

One of the main problems in designing equity finance for social enterprises is the lack of agreement about the underlying values and principles of this form of enterprise. There is no legal definition of what constitutes a social enterprise or how ownership rights should be allocated. The new CIC regulations provide some guidance, but they also include some restrictions that may prove to be off-putting to both investors and social enterprises.

Table 3 presents proposals for a set of design criteria for equity finance based on the emerging consensus about the most important features of social enterprise. The most critical of these features is that equity finance should be permanent capital for the enterprise. This means it should be transferable, non-withdrawable and tradable. This underlines the importance of developing a secondary market for social enterprise capital.

<b>Table 3: Design criteria for social enterprise equity finance</b>	
<b>Rights</b>	<b>Criteria</b>
Liquidation rights	At least part of the residual assets are indivisible and must be transferred to another social enterprise or charity on liquidation
Income rights	Upper limit on either the proportion of profits distributable to investors, or on the dividend or interest rate payable on shares
Appreciation rights	Share value determined by market
Voting rights	If investors have any voting powers at all, they should be subordinate to the powers of the primary membership, but sufficient to protect their financial interests
Transfer rights	Non-withdrawable. Transferable within certain limits. May be affected by restrictions on voting rights

Table 4 presents a description of avaricious capital, which is also known as ordinary share capital and is the bedrock of capitalism. This type of capital focuses purely on the financial return offered to investors and is not suitable for social enterprises.

<b>Table 4: Avaricious capital (a.k.a. ordinary share capital)</b>	
<b>Rights</b>	<b>Description</b>
Liquidation rights	Residual assets fully divisible amongst shareholders
Income rights	No restrictions or limits on income paid on shares
Appreciation rights	Share value determined by market
Voting rights	One-share-one-vote
Transfer rights	Fully transferable

Table 5 presents a description of altruistic capital, which could also be described as grant finance, except that it does hold out the possibility of some income rights and the refund of capital if the enterprise is wound up. Some social enterprises have raised capital using share capital similar to this, most notably CAT, referred to at the beginning of this paper. This type of capital focuses purely on the social return it offers investors. Social enterprises trying to raise this type of capital must have strong social objectives and must be able to demonstrate the social return on investor capital. It is unlikely that a secondary market could be developed for this type of capital.

<b>Table 5: Altruistic capital</b> (also known as grants)	
<b>Rights</b>	<b>Description</b>
Liquidation rights	Last in line of creditors. Shares refunded at par value. Any residual assets transferred to similar social enterprise or charity
Income rights	None, or very limited
Appreciation rights	None
Voting rights	None
Transfer rights	Non-withdrawable

Table 6 describes an equity finance option for common ownership social enterprises. This type of capital is similar to perpetual or non-redeemable bonds. They are sometimes called junk bonds, especially if the credit rating of the issuer is poor. The attractiveness of such bonds depends entirely on investor confidence in the enterprise's ability to maintain dividend payments.

<b>Table 6: Common ownership capital bonds</b>	
<b>Rights</b>	<b>Description</b>
Liquidation rights	Investors last in line of creditors. Refund of investment at par value with any further residual assets transferred to similar common ownership enterprise or other specified type of organisation
Income rights	Fixed or floating dividend with upper limit
Appreciation rights	Value determined by the market, but usually par value
Voting rights	None
Transfer rights	Fully tradable and non-withdrawable

Table 7 describes investor share capital rights based on the CIC proposals. This type of capital offers investors better rights than common ownership bonds, but the restrictions on income rights mean that capital growth in share value is unlikely. The attractiveness of these shares depends on the ability of the enterprise to maintain dividend payments at forecast levels.

<b>Table 7: CIC investor share capital</b>	
<b>Rights</b>	<b>Description</b>
Liquidation rights	Asset lock. Shares redeemed at paid-up value in the event of liquidation. Residual assets are transferred to another CIC or charity
Income rights	Dividend cap expressed as a percentage of paid up capital determined by the regulator. Fixed or floating rate with provision for paying dividends above the cap if previous dividends have been below the cap
Appreciation rights	Limited by restrictions on income rights and liquidation rights. Probably trade at par value if dividend forecasts are honoured over the medium term
Voting rights	Investor shares limited to 24% of vote at general meetings, with additional rights to protect their shares from variation or change without their consent
Transfer rights	Investor shares are fully transferable and tradable on markets

Single-stakeholder capital presents more of a design challenge because the ordinary members of the enterprise, usually employees or customers, are investors too. If the share capital in such enterprises is to be permanent and non-withdrawable, mechanisms have to be developed that allow members to transfer capital between each other. One way of achieving this might be to create a trust fund that acts as an intermediary between members. Table 8 presents a tentative description of single-stakeholder capital. The income rights of members in single-stakeholder social enterprises are more complex because members occupy two stakeholder roles, typically, employee-investors or customer-investors.

<b>Rights</b>	<b>Description</b>
Liquidation rights	Modified asset lock with part of the reserves held by a trust fund which acts as an intermediary in the transfer of share capital between members
Income rights	Dividends on share capital might be linked to the other income rights of members, for instance, pay bonuses, or dividends based on members' transactions with the enterprise
Appreciation rights	Difficult to finance appreciation rights because of existing demands on reserves to create a trust fund to facilitate transfer rights
Voting rights	One-member-one-vote, regardless of the value of a member's individual shareholding
Transfer rights	Non-withdrawable, transferable capital via a trust fund created by the enterprise specifically for this purpose

Multi-stakeholder ownership provides the greatest level of flexibility in the design of equity finance. Table 9 describes one set of options for such capital. The problems associated with single-stakeholder structures are overcome by having more than one class of membership, with a separate class of investor-member. This arrangement is allowable under the CIC regulations. The main difference between this option and the option described in Table 7 (CIC investor share capital) is that the cap on income rights is based on a proportion of profits rather than an upper limit on the dividend per share. This difference is likely to result in the capital growth of share values on a secondary market if the enterprise is performing strongly, profits are rising and, as a result, dividends are growing too.

<b>Rights</b>	<b>Description</b>
Liquidation rights	Subject to restrictions. At least part of the reserves should be indivisible and form a common wealth fund which cannot be distributed to investors but can be transferred to organisations with the same restrictions
Income rights	Subject to a cap or upper limit on the proportion of profits distributed to investors
Appreciation rights	Share value determined by the market, influenced by the underlying profitability and dividend performance of the enterprise
Voting rights	Investors given sufficient voting rights to protect their financial interests
Transfer rights	Investment should be tradable but non-withdrawable. Trading rights might be restricted to prevent too high a concentration of voting rights with a single investor. The enterprise should retain the right to buy back the investment

## Conclusions

This paper has highlighted a range of options for the design of equity finance in social enterprises, addressing the different motives of ethical investors, ranging from altruistic to more avaricious intentions. At the avaricious end of the scale, the boundary between what constitutes a social enterprise and what constitutes a private enterprise may be blurred, whilst at the altruistic end of the scale the distinctions between a social enterprise and a charity may be minimal. Until there is greater agreement about the values and principles underpinning social enterprise, or a legal definition of this form of enterprise, these ambiguities will persist. The CIC regulations have opened the door to new forms of equity finance for social enterprises. It is important that social enterprises are encouraged to experiment with these forms, in order to discover the best arrangements for encouraging ethical investors to invest in them enterprise. This is as much the responsibility of financial institutions such as CDFIs, venture capital funds and social banks, as it is the responsibility of social enterprises and their advisers.

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