

Fatal Attraction

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The government is keen to attract investors for social enterprise, but it appears there has been a subtle shift in the kind of investor it is looking for. Where once it courted funders who were interested in a "blended financial and social return", it now seeks "profit-maximising investors" - a different beast altogether.

This change in emphasis was signalled in the Office of the Third Sector (OTS) consultation document, published last month, on creating a risk capital fund for small social enterprises looking to grow their business. This will be a joint venture, with City investors providing half of the proposed £20m fund.

One of its main objectives will be to "demonstrate that there are a meaningful number of investors interested in making a profit-maximising investment in the area of social enterprise". This is at odds with the government's own definition of social enterprise as "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".

The document does not say how an investor might make a profit-maximising investment in a social enterprise, but it does insist that any investments made by the fund would have to be in the form of "equity or quasi-equity". This rules out investment in most social enterprises, which are charities and companies limited by guarantee, and are unable to accept equity investment.

It also rules out investment in community interest companies, which are subject to asset locks and dividend caps, making profit-maximising returns impossible. Asset locks prevent shareholders from benefiting from any increase in the capital value of the enterprise. Dividends are capped at a maximum of the Bank of England base lending rate plus 5%, which currently works out at a maximum rate of return of 10.75%. This compares poorly with the rates of return achieved by conventional venture capital funds, which are typically 20% a year and more.

The fund is also unlikely to invest in industrial and provident societies, where a ceiling of £20,000 on individual equity stakes would limit attractiveness. This would leave just a handful of social enterprise plcs, such as Cafédirect and the Ethical Property Company, able to accept investment from the fund.

But an even more significant problem is the lack of a coherent exit strategy that would enable the proposed fund to cash in its investment. While the consultation document acknowledges that the quick exit strategies of conventional fund managers might not be the best model for social enterprise, it is vague about the alternative. None of the options it lists address the fact that profit-maximising investors usually want their share of any growth in the capital value of the enterprise. Equity that cannot be freely sold at full market valuation is never going to be attractive to profit-maximising investors. The notion that social enterprises might be forced by their profit-maximising shareholders to sell out to rival social enterprises, or go private, will be unacceptable to many in the sector.

Why has the government abandoned the blended approach? It might be that the OTS is intent on developing "different ways of structuring investment" in social enterprises that would satisfy the needs of profit-maximising investors, while still maintaining that social enterprises are businesses "with primarily social objectives".

Different ways of structuring investments could mean establishing private partnership projects that allow profit-maximising investors to invest in social enterprises. These joint ventures would be branded as social enterprises, but run as profit-maximising subsidiaries, with the justification that at least some of the profits would end up with the parent social enterprises. But this would just create a Trojan horse for private capital, allowing the City further into the domain of public service delivery.

A shift towards profit-maximising would raise a fundamental question: how are social enterprises any different from the private sector? The solution lies in ethical investors prepared to accept lower financial returns when these are blended with social value, in the same way that ethical consumers are willing to pay a higher price for fair trade products. Ethical investors have already invested more than £50m in UK social enterprises, two-thirds in the last five years. It is to them, rather than the City, that government should turn.