New facilities, new funding

A proposed financing model from Scope

New Philanthropy Capital

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Summary

- Scope has developed an interesting model using loans to finance the redevelopment of its Grangewood facilities.
- This model combines a bank loan with a blended loan and donation product aimed at donors.
- Social investment and loans offer charities a way to pay for expensive redevelopment projects efficiently and quickly.
- Charities rarely consider these options. Scope should be applauded for using instruments that are not commonplace in the charity sector.
- Donors should also consider contributing via loan instruments.
- In the Scope model, donor contributions are leveraged and can be recycled into other projects in future.

Introduction

Scope has an ambitious vision of a world where disabled people have the same opportunities to fulfill their life ambitions as non-disabled people. This includes, as adults, living in pleasant surroundings with people of their choosing. Scope is frustrated that, having provided an education to children and young people at its schools that enables them to maximise their potential, this effort is often lost when they become young adults and are transferred to unsuitable residential care. Therapies and support are not maintained, and the young people lose their hard-won capabilities. In the worst cases, young adults find themselves in residential facilities for older people, cut off from friends and peers.

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The challenge for Scope

Scope has a portfolio of adult facilities, many of which are not up to date and are not what it would like to provide for its residents in 2010. Many of these facilities are large and institutional, and in old buildings that are hard to maintain and keep current. What Scope's residents want are a variety of options, including shared houses with four to five residents, that are just like normal homes but adapted to their needs. Alternatively, Scope residents might want to live alone but with the necessary support close to hand. In any type of facility, Scope would provide care and support that would help adults maintain and develop their skills and abilities, and to live as full a life as possible.

The challenge for Scope is:

- **to develop new facilities for the young people graduating from its schools.** Insufficient places exist for young people seeking appropriate accommodation, as NPC concluded in its report, *Rights of passage;* and
- **to replace its out-of-date facilities with improved ones**, moving its current adult residents across to the new homes once they are developed.

The funding puzzle

To fundraise for capital appeals is enormously time consuming and runs the risk of cannibalising the charity's other donations. Alternative models that accelerate the process of replacing unsuitable buildings are therefore needed.

Using loans is one way to achieve this. They work when:

- there is an income stream that is sufficient to repay the loan and interest; or
- the sale of unneeded buildings can be used to repay the loan and interest.

However, there is not always enough income or value in the assets to cover all the interest or repayments required of a commercial loan. The key question is: **how can a charity fund new buildings when the commercial sums do not add up, without resorting to straight donations?**

Scope's proposed solution

Scope has developed a financing model that it hopes will address this challenge. At the centre of its model is a '*venture philanthropy*' product targeted at private donors and grant-making trusts. This involves an interesting hybrid: combining a zero-interest loan with a donation into a single philanthropic unit. Together with an interest-bearing loan, Scope believes it will meet the costs of redeveloping its residential facilities.

Scope has launched a pilot project at its Grangewood home to test the model. Scope hopes to fund three new specially adapted homes to replace the existing out-of-date accommodation at Grangewood using this model. If the pilot is successful, the model will be rolled out across the UK to redevelop Scope's other residential facilities in need of modernisation.

About this report

This report has been commissioned by Scope, a charity that supports disabled people and their families. NPC has endeavoured to maintain its independence when researching this report.

This report is divided into three main sections. The first part gives some background about the use of loans and other types of non-grant finance to meet charities' and social enterprises' funding needs. It is not intended to be a comprehensive guide to social investment but instead meant to give an idea of the funding environment in which Scope's model fits.

The second section examines Scope's financing model in more detail, including the different types and layers of finance involved and the hybrid philanthropy model.

Finally the third section explores whether donors should fund Scope's model. It examines the advantages for donors, as well as the risks and drawbacks. It also examines how other charities have financed similar redevelopment projects and the different models, instruments and funders they have used.

Background to social investment

The UK charity sector and its funders have an overwhelming preference for financing charities using grants. In 2007/2008, the sector received nearly £15bn in donations and grants from individuals, grant-makers, government and businesses—about 40% of total sector income.[1]

Yet the spectrum of financing options for charities is much broader: there is a whole range of non-grant finance available to charities too. Sometimes collectively termed social investments, they all require the charity to repay at least some of the funding provided, as well as generating social or environmental benefits.

Social investment can take a myriad of forms, including secured and unsecured loans; bonds; 'patient' capital (ie, long-term loans, often with favourable terms for the organisation receiving the funding); equity or quasi-equity. It also includes providing charities with standby or overdraft facilities, or underwriting particular projects.

Charities can also take out loans, overdrafts and mortgages with commercial banks. These are not generally regarded as social investments, however, as the social impact created is incidental, rather than deliberate.

Despite these many possibilities, charities and funders have in the past been reluctant to take them up. Although not accurately known, some have estimated the size of the social investment marketplace at just £1bn, far below the equivalent figure for grants and donations.[2]

Part of the explanation for why the social investment marketplace has historically been small may be the lack of understanding among charities of the available options. This is the experience of Social Investment Business (SIB), a social investor that manages several government funds offering loans to charities. NPC's contact at SIB indicated that charities would first aim to secure grants to fund a project but, if they failed, would look to borrow an interest-bearing loan, rather than other lower-cost options from social investors. NPC was not able to test this independently; it is a surprising observation.

This has begun to change. Charities have become more open to non-grant finance, with many now prepared to take mortgages from commercial lenders to purchase buildings. At the same time, the concept of 'social investment' is beginning to pierce the consciousness of more funders and investors looking at using social investment instruments either as a way to achieve greater social impact or as a way to diversify their financial investment portfolio, or both.

Opportunities for social investment

There are many instances where charities are using traditional fundraising to pay for costs that might be funded more efficiently through non-grant finance. This is particularly the case with charities' capital costs, where expenditure on a new building or on increased capacity, say, provides an asset or an income stream against which loans can be secured and/or repaid.

Venturesome—a social investment practitioner—suggested in its 2008 report that non-grant finance can be used by charities for several purposes (listed in order of risk):

- hard development capital, eg, a bridging loan to purchase a building;
- 'closed' working capital, eg, to tide an organisation over before a committed grant is paid;
- 'open' working capital, eg, to tide an organisation over to meet unfunded costs;
- soft development capital, eg, supporting start-up costs or periods of big growth.[3]

Advantages over fundraising

Grant funding is a valuable resource in great demand. However, the level and number of grants and donations available to charities is finite—particularly the availability of unrestricted funding. The priority therefore should be to use grants to meet costs that cannot be funded by alternative mechanisms. For example, ongoing or revenue expenditure not funded by state contracts, such as service provision, research, campaigning, and overheads—none of which are suitable for non-grant finance—will need donation funding.

[1] Clark, J., Kane, D., Wilding, K. and Wilton, J. (2010), *The UK civil society almanac 2010*, NCVO.

[2] Note, in particular, Venturesome's concerns about the lack of robust evidence backing up this figure in Goodall, E. and Kingston, J. (2009), *Access to capital: A briefing paper,* Venturesome.

[3] Mitchell, L., Kingston J. and Goodall, E. (2008), *Financing civil society: A practitioner's view of the UK social investment market,* Venturesome.

For charities' capital needs, however, non-grant finance is often a more efficient way of meeting them than fundraising. Donations are often thought of as 'free' money, but this is not the case. All fundraising has costs: NCVO has calculated that voluntary organisations' fundraising and publicity costs represent 8% of total expenditure. This figure rises to 10% for larger organisations.[1] These costs are comparable to those of loans from some specialist providers or even some commercial lenders.

Social investment can also relieve pressure on charities' cash flow. Fundraising costs are often paid upfront and charities with low levels of working capital may find these difficult to cover, especially when the returns are not guaranteed. With loans, interest only accrues once the loan is drawn down—hopefully once a revenue stream has been established.

Fundraising alone for a project can also prove problematic if large amounts of money need to be raised over a relatively short period of time—for example, for a new building where costs are negotiated based on their taking place within a certain time period. In these instances, fundraising alone can take prohibitively long.

Combining grants with social investment

That is not to say, however, that grants and donations have no role in financing parts of projects funded primarily from social investment. Often charities cannot afford to repay the full amount of the capital required, either from its operating surplus or from the sale of assets. NPC's conversations with charities found that none had been able to develop a financing model for capital developments that did not include a small non-repayable element.

Grants can also be a helpful supplement to projects that increase charities' capacity by helping them capitalise on their expansion. For example, Martha Trust—a charity that provides life-long residential care for people with complex needs - received nearly £58,000 as a grant in addition to the £637,000 loan it received from Futurebuilders to expand facilities at one of its residential homes.[2] This grant partly paid the salary of a new Service Development Officer whose role has been to ensure places in the new extension would be filled quickly, maximising fee income (see case study below).

Who makes social investments?

There is growing range of investors prepared to supply charities with non-grant finance. These include specialist providers, such as Venturesome or Bridges Ventures, as well as banks that understand charities, eg, Unity Trust, Charity Bank or Triodos.

Trusts and foundations have started to explore social investment. Grant-makers such as the Tudor Trust and the Esmée Fairbairn Foundation now offer charities loans from the income allocated to grant-making. Others, such as the Joseph Rowntree Charitable Trust, looking to better align their financial investments, have begun making social investments from their endowment.[3]

There are also several government-backed funds, for example Communitybuilders and the Social Enterprise Investment Fund, offering a range of loan products. One of these funds, the Modernisation Fund (now closed) offered charities 0% loans to help them weather the economic downturn.

In addition to these sector-based initiatives, some financial investors—such as pension funds and other institutional investors—are beginning to look at opportunities to combine financial return with social impact. Although the numbers are still small, a few investors have started to recognise charities and social enterprises as an underdeveloped area with potential for growth.[4]

Balancing social and financial returns

Social investment aims to produce both financial and social returns. But the range of returns varies considerably between investment and this needs to be balanced according to the motivations and priorities of the investor.

For some investors—sometimes termed **finance-first investors**—their main motivation is financial, meaning that receiving a market rate of return is a priority. This does not necessarily mean that they sacrifice the social impact of their investment but it does narrow the market in which they are prepared to invest. Only social investments such as BlueOrchard—a fund that invests in micro-finance initiatives in developing countries with a targeted return of 15%[5]—will be considered worthwhile.

[1] Clark, J., Kane, D., Wilding, K. and Wilton, J. (2010), *The UK civil society almanac 2010*, NCVO.

[2] Futurebuilders website, http://www.futurebuilders-england.org.uk/investments-made/case-studies/martha-trust-providing-a-home-for-people-with-disabilities/ [accessed 24 May 2010]

[3] Nissan, S. and Bolton, M. (2008), *Mission possible: Emerging opportunities for mission-connected investment*.

[4] Bridges Ventures, Parthenon Group, and Global Impact Investing Network (2010), *Investing for Impact: Case studies across asset classes*.

[5] Nissan, S. and Bolton, M. (2008), *Mission possible: Emerging opportunities for mission-connected investment.*

Finance-first investors also include trusts and foundations looking to better align the investment of their endowment with their grant-making activities. For example, in 2008, the Joseph Rowntree Charitable Trust had around 13% of its investments in social ventures.[1] It also includes some funds of specialist social investment organisations, such as Bridges Ventures.

For other investors—sometime termed **impact-first investors**—generating a high social impact is their primary motivation. While they may receive a handsome financial return on their investment, they may be prepared to accept below-market financial returns.

In some cases, some impact-first investors may even sacrifice their financial returns so that more attractive rates can be offered to investors demanding higher returns. The pay-off for impact-first investors is that they are able to leverage their own funds in order to achieve more social impact than they could achieve alone.

This has similarities to Scope's hybrid philanthropy product. Donors are trading a financial return, in the form of interest, for a social one, ie, the benefits people with complex disabilities gain from living in appropriate housing.

Some commentators have pointed to the potential of the global financial crisis to accelerate the trend towards social investment by challenging established ideas about mainstream investments and boosting the appeal of social investment as an alternative.[2]

For further analysis of the trends, readers may want to consult the Monitor Institute.[3]

Opportunities for donors for social investment in charities

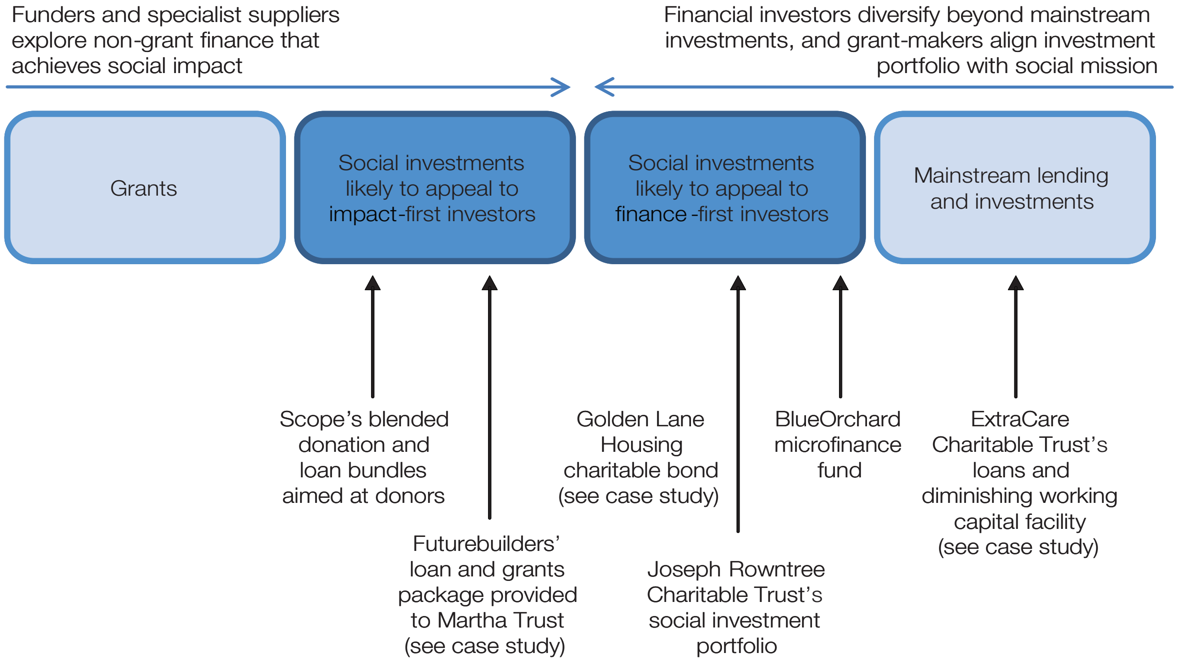
A recent report from Venturesome commented on the small number of social investments aimed at donors: *"Very few philanthropists are engaged in social investment, indeed there are limited opportunities for them to do so. There are even fewer opportunities for the general public to get involved – aside from putting funds on deposit with specialist banks."*

This chimes with NPC's findings: NPC found only a few examples of charities, including Golden Lane Housing's charitable bonds in 2003/2004 (see case study below), actively offering donors the opportunity to give loans either to complement donations or as an alternative to donations.

Instead NPC's conversations with charities suggest that, when donors have become involved, this is often an ad hoc arrangement. For example, Golden Lane Housing has partnered with a philanthropist who rents properties to people with learning disabilities, as an ethical investment. Golden Lane Housing manages the properties and takes a share of the rent in return.

One interesting organisation operating in this space is CityLife, which currently offers 0% bonds to donors. Around 80% of funds raised are then loaned to registered social landlords for five years at a commercial rate of interest (generally around 4.5%). The remaining 20% is made as a donation to a specified charity that has been involved in marketing the bond to its donors. Bond holders are then repaid their original investment at the end of five years from the interest generated on the loan.

Diagram 1: Motivations for social investment



[1] Nissan, S. and Bolton, M. (2008), *Mission possible: Emerging opportunities for mission-connected investment*.

[2] Bridges Ventures, Parthenon Group, and Global Impact Investing Network (2010), *Investing for Impact: Case studies across asset classes*.

[3] Freireich, J. and Fulton, K. (2009), *Investing for social & environmental impact (executive summary)*, Monitor Institute.

Generally, however, social investment opportunities in charities for donors are few and far between. A crucial reason for this, though, is that few donors are interested in taking these opportunities up.

Barriers to greater social investment by donors

Commentators have identified many barriers that explain this lack of take-up. A key reason often identified is that many donors perceive their philanthropically minded grants and donations as entirely separate from their other investments, which they see as driven by an entirely different, and perhaps opposing, motivation: a desire to see financial returns.

Overcoming this is a considerable challenge, as the experience of Golden Lane Housing shows. It found that many donors struggled to get to grips with the idea of receiving their money back on a charitable project. Since they could usually afford to lose the money, and it was going to a good cause, some simply were not interested in having it paid back, let alone with interest.

This, too, is something that came up in Scope's initial conversations with potential investors. Many felt embarrassed about the idea of making a profit from a charity. Scope's decision not to offer donors interest-bearing loans was influenced by this; zero-interest loans were seen by donors as far more in keeping with their ideas of philanthropy.

This is linked to a more general perception that loans and other forms of non-grant finance are somehow 'uncharitable' and so not something that charities should take on. This is something ExtraCare Charitable Trust has found when fundraising for its retirement villages: donors are sometimes reluctant to give because the Trust's reliance on loan finance means that it is not seen as a 'proper' charity.

Scope's financing model: what is it?

Scope has launched a pilot project to update the facilities at its Grangewood home, which currently accommodates 15 people, but is no longer appropriate to their needs. Scope wants to sell the old building and replace it with three new homes on land it already owns, each housing five residents. The total building costs of this project are £1.8m.

Scope has identified that the funding for this project needs to come from three sources:

1. **an interest-bearing loan** that is repayable from operating cash flow;
2. **a loan the charity could repay from the sale of the old home**, but on which there is no regular cash flow to pay interest; and
3. **donations** that would cover the gap between the full cost of Scope's plans, and what the charity can raise from loans.

'Layering' the finance from the three sources this way will meet the full costs of the project. This layered model has similarities to the structure of some venture capital deals where different types of finance bring investors different financial returns. This is the same with Scope's model: the financial returns decrease as you move down the three layers.

But Scope would argue that the social returns increase; the bottom layer is effectively leveraging funds into a project so that it is completed rapidly. It is also enabling Scope to minimise the calls on its supporters for donations.

1. Interest-bearing loan

This 'layer' of funding can be raised from a commercial bank or from a bank that understands charities.

The size of the interest-bearing loan depends on the funds available to pay for the residents' housing costs. Currently, total fee income (paid for by the local authority) for the residents comes to £915k per year. Total support and care costs amount to £810k, leaving £105k as the total annual housing allocation for 15 residents.[1]

Based on these figures, Scope is seeking a loan of £750k to be repaid over 10-15 years, and is expecting to pay interest at around 6%.

Scope is in advanced discussions with two banks about this loan. The banks will need to be satisfied with the credit risk before approving the loan, but so far the signs are promising.

2. Loan repaid from sale of old building

Scope plans to raise this tranche in the form of a 0% loan borrowed from donors and grant-making trusts. The loan will be repaid to them within three years, once the old facility has been sold.

Scope believes it can sell the old building for £1m. Based on this, it is looking to raise £700k in the form of 0% loans.

An alternative would be for Scope to offer donors an interest-bearing loan for the same period. The amount raised would be lower to allow for interest payments, while still keeping within the £700k limit. At 4% over three years (which is comparable to building society bonds), for example, the loan amount would be £620,000.

An interest-bearing loan might be more attractive to grant-making trusts worried about generating income for future grant-making. But this needs to be balanced against the possibility that an interest-bearing loan might put off some donors, embarrassed to accept a financial return on a charitable project.

Another downside of an interest-bearing loan is that the gap between the full cost of Scope's plans and the amount it can raise from loans widens. The charity would therefore need to find more donations to cover the shortfall. Using the 4% interest loan example, this would result in Scope finding a further £430k in donations. If the loan paid interest at 6% (comparable to a specialised charity lender), the donation amount would rise to about £465k.

3. Donations

The remaining funds would be raised via donations and grants from grant-making trusts and donors. Assuming £700k is raised from the zero-interest loan layer, Scope is aiming to raise £280k in donations.

Scope believes that the donations will be supplemented by an extra £70k in Gift Aid. But it is difficult to estimate exactly how much Gift Aid will accrue to donations. Donors who already have a foundation, or a charities account deducted from gross income (eg, payroll giving arrangements, CAF accounts), will not qualify for additional tax relief and such donations are not eligible for Gift Aid for Scope. So we should assume that only a small proportion of the donations will result in a Gift Aid effect.

It is worth stressing that the donation element is a crucial 'layer' of the financing model. Scope cannot afford to take out a commercial loan on the entire cost of the project as the operating surplus is not enough to cover repayments. Without the grant funding, the project will not proceed. This is similar to the experience of the charities we interviewed: none had developed a model without a donation or grant element to supplement non-grant finance.

Table 1 summarises how the £1.8m building costs of the Grangewood pilot project will be met.

Table 1: Funding of new facility

Instrument	Supplier	Amount	How serviced
1. Interest-bearing loan charging 6% interest repayable over 10–15 years	High street or charity bank	£750,000	From operating surplus
2. 0% interest loan repayable within three years	Donors	£700,000	From sale of old property after transfer of residents to new property
3. Donations, supplemented by Gift Aid	Donors	£350,000	Not repaid
Total		**£1,800,000**	

[1] These figures all assume a 'void' of 1.5 residents, ie, that there will be an average of only 13.5 residents living in the three new homes.

Blending loans and donations from donors

Scope intends that both the 0% loan and the donations (ie, layers 2 and 3) will be funded by donors. It has therefore decided to combine the two into a single '*venture philanthropy*' product.

This product divides the combined £1.05m of the 0% loan and donations into 100 philanthropy units. Each unit consists of a £2,800 donation and a £7,000 0% loan. The 0% loan will either be returned directly to the donor, or donors can choose for Scope to recycle it back into its other projects on their behalf.

Each unit therefore has a cost of £9,800 and donors can purchase one or several units.[1] We say 'initial' cost because the loan element of the unit, as well as the tax relief that the donor can claim on the donation element, means that the eventual cost of each unit is £1,750.

Table 2: How the costs to the donor work

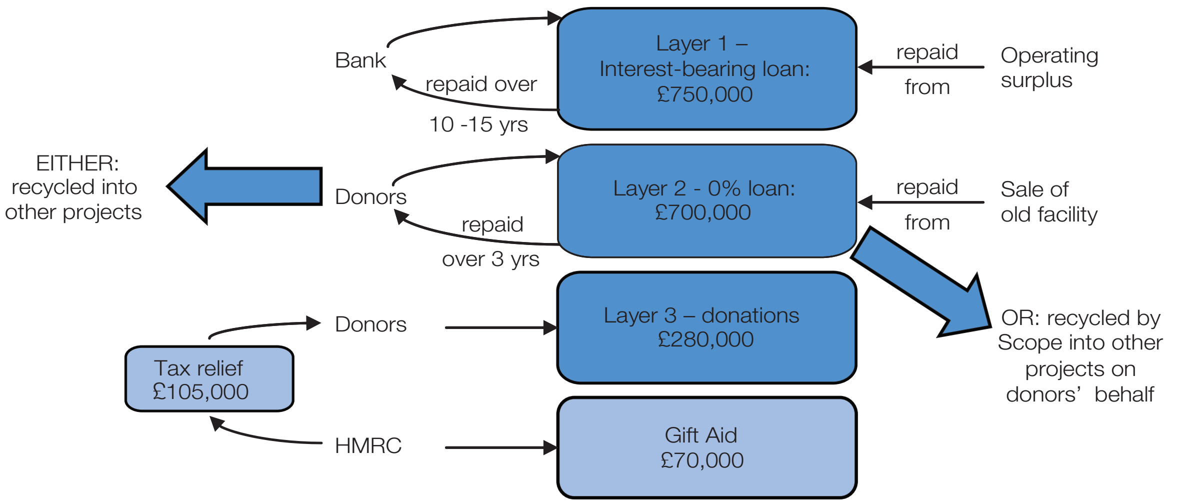
Cost	£
Philanthropy unit	9,800
Minus loan repayments	-7,000
Minus tax relief of donation[2]	-1,050
Total cost to donor	**£1,750**

Other options for donors

Although Scope anticipates demand for the philanthropy product, donors can choose to fund either the donation or loan element alone. At the same time, Scope is looking for grant-making trusts with a special interest in loan finance who may want to finance just the loan element, and it is talking to several grant-making trusts. Although this should not come from the income-generating part of a grant-making trust's endowment, foundations may consider allocating a portion of their assets to recyclable investments which produce below-market returns.

Diagram 2 summarises Scope's model overall.

Diagram 2: Scope's funding model



[1] 100 units of £9,800 amounts to £980k, leaving a shortfall of £70k on the £105k needed from donors. Scope believes this will be met by Gift Aid.

[2] Scope is assuming that its donors will all pay the highest rate of tax. They can therefore claim 30% gross donation back from HMRC.

Should donors fund Scope's model?

Scope is facing the considerable challenge of providing appropriate supported accommodation for its beneficiaries. This need is an urgent one that must be addressed quickly. Scope's pilot at Grangewood proposes one solution to financing this kind of project. This layered model uses financial instruments that are not commonplace for charities, in particular blending a 0% loan and donation into a single unit aimed at donors. During its research, NPC did not become aware of other charities offering this product.

The lack of a tried-and-tested model means there are uncertainties, not least whether donors and other funders are going to take up Scope's offering. Some funders might be nervous about taking part in such a new concept. However, NPC believes that in principle the model is sensible, notwithstanding some risks (analysed later), as it offers the donor attractive features, such as **leverage** and ability to **recycle** the funds—discussed in more detail below.

But first, donors should ask themselves how they view the donation, in particular the 0% loan component:

- Is the funding part of their giving 'pot'?
- Can they afford to lose the money if it is not repaid?
- How does the donor intend to use the funds once repaid? Recycled into other donations, or needed for the donor's own expenses?

If the donor can only spare the funds temporarily and needs the money back, he or she may be better off seeking a commercial return elsewhere that would compensate for inflation and cost of capital incurred for the duration of the loan.

If the donor can spare the funds temporarily, but intends to give the funds away elsewhere when returned, then the donor may be less sensitive about protecting the value of the loan.

Some donors may see the loan as a donation, and prefer Scope to recycle the funds itself on their behalf.

The market for this kind of product among donors has not been fully scoped out and lack of familiarity with social investments could be a barrier. Scope's decision that Grangewood should be a pilot project is therefore a sensible one. Scope should test with donors their appetite and motivation for the loan component of the project, as well as issues such as donor attitudes to risk and whether a zero interest rate is tolerated.

What are the benefits and advantages?

Leverage

As noted above, the eventual cost of purchasing one philanthropy unit is £1,750 (see Table 2). But each unit is worth much more—£18,000—to Scope, meaning that donors' contributions are highly leveraged.

Here is the value of each unit to Scope:

Table 3: Value of philanthropy unit to Scope

Value to Scope	£
Gross donation	2,800
Gift Aid	700
0% loan	7,000
Commercial loan	7,500
Total value to Scope	**18,000**

The 0% loan element is part of the leverage as it is then recycled back to the donor, or back to Scope.

The Gift Aid element will vary, however, depending on the donor's tax position and whether he or she is funding this from his or her own foundation.

The commercial loan is also included in the leverage calculation. Although the commercial loan is not directly linked to the number of donors purchasing the philanthropy units, its availability is likely to be contingent on Scope raising the rest of the finance from donors and funders. The project cannot proceed unless all of the financing is in place.

Each unit is therefore highly leveraged, providing an attractive £10 of value to the charity for each £1 cost to the donor.

Recyclable

From donors' point of view, the model is efficient. Scope's plans to repay a sizeable portion of donors' contributions allows this money to be 'recycled' into other projects. This means that donors interested in supporting Scope from their current giving 'pot' need not sacrifice their funding to another charity in order to do so.

Alternatively, if donors do not need the money back to support other projects, Scope is willing to recycle the money on their behalf, putting it towards other of its projects supporting people with complex needs.

This recycling means that the same money can go much further.

Replicability

For some donors, the opportunity to be part of an exciting and pioneering new venture will be appealing. If Scope can demonstrate that the model works and is sustainable, it plans to roll it out across the UK. This pilot project therefore has the potential to transform the lives of residents living in other facilities, as well as Grangewood.

This model could also benefit other charities wanting to build or refurbish residential care facilities. Funding these expensive projects is a challenge for many charities, and developing a workable model that could be replicated and would allow charities to access capital affordably and efficiently has the potential to transform the lives of thousands of people living in residential care.

What are the risks and drawbacks?

Scope does not have sufficient financial experience to take on a loan

A concern raised by funders in NPC's report, *Granting success*, is that many charities do not have the necessary skills or knowledge to take on a loan. There is a danger, for example, that if a charity is not able to plan the repayments correctly, it may realise it cannot afford them only after taking out a loan.[1]

Scope, however, has a track record of successfully managing and repaying loans on its books. In 2007, it took a small commercial mortgage, which so far has been successfully repaid. In 2009, it received a £5.2m loan from Futurebuilders to develop some of its residential facilities for young people. Again, all repayments are being met.

Scope's experience with Futurebuilders also demonstrates that the charity is able to use loan finance to accelerate development of its residential facilities. However, since the fund is limited and has now closed, it is not scalable without wider sources of investment.

Project risk

There are always risks associated with development projects which could compromise funding arrangements: the project goes over budget; the project takes longer than expected; the contractor fails to complete the project. Any charity undertaking capital projects faces these risks: the difference here is that the charity has undertaken to repay sums to commercial lenders and donor lenders, and may be unable to do so.

Scope cannot sell the old residential home

Scope plans to repay 0% loans to donors from the sale of the existing outdated residential home. If Scope cannot sell the property, or if it can only sell it at a reduced price, there is a chance that Scope will be unable to make these repayments.

However, Scope believes it can sell the property for around £1m. With total loans predicted to amount to £700,000, this gives the charity a comfortable buffer: the property can be sold for a figure some way below the asking price and still cover the repayments.

Interest rates, cost of capital, and inflation

The cost to the donor of funding the project is not limited to just the donation element of the funding provided. At zero interest, the donor will be exposed to the risk of inflation reducing the value of the loan element when returned.

Related to this is the opportunity cost of the interest that the donor would have received on the £7,000 loan had he or she invested it elsewhere. If the donor invested the funds, could he or she generate a higher return and then donate more to Scope? £10,000 currently deposited in a three-year Nationwide bond would earn 4% per annum, which, compounded over the period, would result in over nearly £11,500 returned to depositors. However, an extra £1,500 in three years' time is arguably not as valuable to a charity as a lower contribution now, which can speed up an important project.

[1] Brick, P., Kail, A., Järvinen, J. and Fiennes, T. (2009), *Granting success: Lessons from funders and charities*, New Philanthropy Capital.

The loan does not qualify for tax relief

The loan element of the funding is not tax efficient: Scope can only claim Gift Aid on the donation portion of the funding provided, not the 0% loan. This was flagged up by the donor we interviewed as a downside that would weigh quite heavily in a decision between giving a charity a grant and a loan.

Furthermore, if the donor wished to convert the loan into a grant, the process involved to make it eligible for Gift Aid and tax relief is convoluted: the donor would have to be repaid the loan and then subsequently gift the money to the charity as a separate donation.

Scope does not attract enough donors to fund the philanthropic element

Scope does not have an existing cohort of wealthy donors and will have to attract new ones: a challenge for any charity. This product is quite complicated—its sophistication may attract new donors wanting something flexible and innovative. Other donors may be put off by the complexity or reject it through incomprehension. Scope should test this as it puts the case to donors.

Not finding sufficient donors could risk endangering the entire project since, as noted above, a combination of grants and 0% loans are necessary if the development project is to be affordable.

In the event of not recruiting enough donors interested in funding the blended units, Scope has contingency plans in place to access other fundraising income and loans from other sources. One way the charity might do this is by fundraising for the remaining donations and borrowing more money from a commercial lender to cover the 0% loan element. Repayment of the interest on this would be covered either from the sale of the existing facility, or from donations. The Grangewood project is therefore likely to go ahead even under these circumstances.

What would be less certain in such a situation is whether the pilot project would be rolled out across the charity's other residential homes. If the pilot project showed that not enough donors were interested in the product—for whatever reason—it is unlikely that it will be expanded.

Scope's operating surplus diminishes due to a squeeze on revenue and costs

Scope plans to make repayments on the £750,000 commercial loan from operating surplus generated from the fees received for the new residential homes. These fees will be paid by Essex County Council on behalf of residents.

If fees do not increase year-on-year at the same rate as the charity's support and care costs for residents, or if not all places in the new homes are filled, then the charity's operating surplus will be reduced. If this reduction is considerable, the charity may find it hard to service repayments.

Although this is a key concern for the charity, it should not affect donors financially. Donors' loans are tied up with the sale of the old facility, not the operating surplus of the new one. Also, this risk is greatest several years into the project, at which point donors' loans will have already been repaid.

That said, a squeeze of this sort is likely to affect the social impact and overall success of the project. Any reduction in operating surplus will have a knock-on effect on the range and quality of any extra services funded by this surplus.

The sustainability of the project will also be in serious question if the operating surplus is stretched or if, in a worst-case scenario, Scope has to step in and fund repayments using its reserves or using donations. In such a situation, it is unlikely that the model would be replicated across Scope's other residential homes.

Scope has already taken a number of steps to mitigate this risk:

- The model assumes cost inflation of 2% but a fee inflation of 1.5%.
- The model has a void ratio built in, ie, Scope has assumed that it must cover the costs of 15 residents at Grangewood but has assumed that it will only receive fees for 13.5 residents.
- Scope is already negotiating with Essex County Council about future fee increases.

The pilot project does not bring benefits for residents

NPC does not believe this is a significant risk. Evidence—such as NPC's research into young disabled people undergoing transition to adulthood and adult services—demonstrates the considerable need for services providing appropriate residential care that helps people with disabilities live more independently.[1]

[1] McGrath, A. and Yeowart, C. (2009), *Rights of passage: Supporting disabled young people through the transition to adulthood*, New Philanthropy Capital.

What are the alternatives?

NPC interviewed three charities with experience of non-grant finance, including social investment, to pay for buildings or redevelopment projects.

Like Scope, all three charities rely on fees and contracts for the majority of their income and receive relatively little in the way of grants or donations. They have low levels of reserves and working capital.

All three have used non-grant finance in different ways, either in terms of different instruments or in terms of different suppliers. With each charity, NPC was interested to find out:

- what models were used to fund the project;
- the part played by non-grant finance, in particular what instrument was used and on what terms; and
- whether the model worked, the benefits, disadvantages and risks of their approach.

Commercial loans: ExtraCare Charitable Trust

ExtraCare Charitable Trust provides housing, social- and health-care services for older people through its eight retirement villages and 21 smaller housing schemes. The charity has an ambitious programme to expand its villages and, with each providing housing for around 300 people and costing upwards of £25m to build and develop, it has substantial capital needs.

ExtraCare's first villages were on a relatively small scale—for between 50-150 residents—and were built in partnership with housing associations. This was a fairly low-risk model for the charity, limited to a fundraising appeal for £0.5m that supplemented a commercial loan taken on by the housing association.

Although this partnership model worked well financially for the charity, it found it could not scale up villages as rapidly as it wanted, to meet growing demand. The charity also wanted to move beyond just providing housing and began developing a well-being and activity programme that required more communal space and facilities. ExtraCare therefore decided to begin building villages on its own.

This decision opened the charity up to far greater financial risk: compared to a £0.5m charitable appeal, a recently completed village in Birmingham for 260 residents cost nearly £40m to develop.

Historically, the bulk of the development costs were met from commercial loans taken out against future rental income. However, a model using 100% rented accommodation did not reflect the wider housing market among older people, where 75% owned their own home and only 25% rented. In order to better reflect older people's preferences, ExtraCare decided to sell around 120 of the new homes in the Birmingham village. This raised an additional £25m, and had the added advantage of reducing the charity's dependency on the subsidy from the Homes and Communities Agency on affordable rented accommodation. ExtraCare then took out a smaller mortgage from a mainstream lender at commercial rates of interest on the remaining rented accommodation.

With a multi-stranded funding model and different drawdown times, the charity has also negotiated a £70m fund from Lloyds TSB to provide working capital over the period of development. This is a diminishing facility: the working capital loan is replaced by a loan covered by rental income streams once a village is completed. The facility is therefore progressively exhausted as villages are completed.

This multi-stranded model works well for ExtraCare. In particular, using commercial loans and a working capital fund addresses one of its most pressing concerns: speed. With ten people vying for each residential place, the charity is keen to build villages as quickly as possible. According to David Campey, ExtraCare's director, it would take many years to raise enough for one village from fundraising alone. Using commercial loans, the charity can complete villages more quickly.

That said, ExtraCare believes it could build villages more rapidly by using specialist lenders instead of commercial ones. Negotiating with commercial banks involves significant legal costs and charges and they tend to be cautious given the charity's multi-stranded funding model and its exposure to property sales. A specialist lender might be less sensitive to this financial risk given the social impact created by the villages, which include reducing isolation and improving well-being among older people. A specialist lender might also be able to lend to ExtraCare on more favourable terms. But the scale at which specialist lenders are currently operating is well below ExtraCare's capital needs.

While non-grant finance enables ExtraCare to access non-grant funding relatively quickly, it cannot cover the full capital costs as the charity's rental income is not sufficient to cover the repayments. So all of its villages need some grant funding to make up the difference. For example, for the Birmingham village, ExtraCare raised an extra £3.5m in grants from a combination of a charitable appeal, its own reserves, and statutory grants (for example, from the Department of Health and the Homes and Communities Agencies).

However, the charity finds raising these funds from donors is often difficult. David Campey pinpoints the problem as donors' perceptions that charities with loans on their books are somehow not properly charitable. Overcoming this attitude, he believes, is a major challenge for charities with high capital needs.

Charitable bonds: Golden Lane Housing

Golden Lane Housing (GLH) is a charitable subsidiary of the national learning disabilities charity, Royal Mencap Society, that was set up in 1997 to address the chronic housing shortage facing people with learning disabilities. GLH was established as a separate charity to the main charity partly to isolate the risk associated with taking on non-grant finance.

One of GLH's key services is providing people with learning disabilities with supported housing. A typical housing unit costs around £150,000 to build. Of that, £50,000 is paid for by grants from a mixture of statutory authorities and funders. Where families are able to, or want to, contribute, they do so using an equity arrangement, ie, the family owns a proportion of the property purchased. The remaining £100,000 is financed using a mortgage from a high street bank at commercial interest rates, and repaid from future rental income.

This model works, but GLH is keen to diversify its funding, in particular to reduce its reliance on expensive borrowing from commercial lenders. It has therefore experimented with different funding models.

In 2003, GLH partnered with the ethical investment bank Triodos to develop a charitable bond as a public offering, which enabled the charity to market the bond to the public. Each bond has a nominal value of £100 and pays interest of RPI plus 1% (capped at 6.5%) over the course of ten years. Because the concept was innovative, it was therefore untested, meaning GLH had no particular expectations as to how the bond would sell. It hoped to raise £4m so that it could halve the amount borrowed from the bank to £50,000 for each housing unit.

When the bond issue closed, GLH had raised £1.9m. The majority of investors were not originally known to the charity; instead they were contacts and customers of Triodos Bank. Whilst the majority of these investors were small-scale investors, they were familiar with and understood the concept of investing for a social and financial return. As such, they were a unique pool of sophisticated social investors that responded well to the offering.

Some investors were already connected with the charity's cause; many families of people with learning difficulties purchased bonds. But the total amount raised was less than expected. The direct correlation between poverty and disability means that many families were not experienced investors and treated the bond as a donation, ie, they gave only as much as they could afford to give.

Mid- and high-value donors were also somewhat reticent, this being the first such approach of its kind they had received. Many were unfamiliar with the concept of social investment and found it hard to grasp: some saw the bond merely as a more complicated way of making a donation. And, since they tended to be fairly well off, they questioned why they would want the money returned. There was also a perception that buying bonds to fund property acquisition was a way of helping a charity become wealthy through the accumulation of more assets. This even though GLH considers its properties more as liabilities than as assets. This is because of GLH's intention to provide a home in perpetuity for its learning disabled tenants brings costs to the charity of maintaining them over the long term.

GLH also marketed the bond to small organisations, such as churches or local charities, that might have a small surplus to invest in a good cause, and it had some success here.

Of the larger grant-giving organisations, the Esmée Fairbairn Foundation invested but GLH were surprised that not more trusts and foundations were interested: at the time, many did not seem set up to make social investments. Few conventional professional financial advisors felt able to recommend the investment to their clients because the return offered was simply not big enough.

Although the amount raised was less than GLH had predicted, the bond still allowed the charity to halve commercial borrowing on around 40 properties, and it will be doing something similar again.

GLH has also explored other models for funding supported housing. One project in the pipeline is in Cornwall where, in the wake of a horrific abuse scandal at a local residential hospital, there is great demand for housing, further exacerbated by high house prices. The charity has plans to build a block of nine flats to either rent or sell on to people with learning disabilities or their families who have, or can access, capital. GLH has secured an option on the land needed for the flats and is exploring fixed-price contracts for the development. There has been considerable local interest including informal pledges to buy three of the flats. It is a sign of the difficulties charities face accessing capital that, despite these good prospects, GLH has so far been unable to secure the rest of the financing on the reasonable terms needed to fund the project.

Loans from specialist lenders: Martha Trust

Martha Trust provides life-long residential care for adults and young people with physical and multiple learning disabilities, initially at its two residential homes in Deal, Kent. In 2005, it acquired a third home—Mary House—for eight residents in Hastings, East Sussex.

In 2007, the charity decided to expand the facilities provided at Mary House by adding a new four-bedroom annex and a hydrotherapy pool to the existing buildings. These plans made economic sense as well as being good for residents: for Martha Trust, a residential home with 12 residents is more efficient and can achieve economies of scale that cannot be realised by an eight-bed facility.

The total costs of expansion were £1.8m. However, the charity's funding model made the project difficult to finance. The charity's main source of income is from the fees it receives from local authorities. It has only a small donor base providing donations and grants; in 2008, voluntary income made up just 5% of total income. The charity had a small operating surplus and almost no free reserves to use as working capital.

Martha Trust approached Futurebuilders for a loan to fund part of the expansion. The charity had previously taken out a loan with Charity Bank and the two providers together agreed to provide Martha Trust with a loan of £1.2m. The loan is to be repaid from the charity's future operating surplus over a period of 25 years at a fixed interest rate of 6%, although the charity may refinance before then in order to take advantage of lower interest rates offered by alternative providers.

Futurebuilders also provided Martha Trust with a grant, part of which was used to recruit a Service Development Officer to negotiate with local authorities and ensure that places in the new extension would be filled quickly, maximising fee income.

The remaining £0.6m was fundraised from a mixture of individuals and grant-making trusts. Because of its small supporter base, this was a sizeable challenge. But the charity found that, once the Futurebuilders funding had been secured, fundraising became a lot easier. According to Barry O'Sullivan, the trusts and major donors manager, the Futurebuilders loan "acted like a gold standard, engendering confidence that we were competent and well run".

The charity believes the Futurebuilders loan had a further advantage: the application process was extremely rigorous and required robust financial projections and exact costings, as well as detailed fundraising plans. The application process therefore helped the charity think through its plans in a structured way, and built confidence among staff and funders that the project would be successful.

Conclusions

Scope's blended financing model, if successful, will help Scope to meet the pressing needs of its beneficiaries: developing appropriately adapted residential facilities that allow independent living for residents.

However, despite some recent growth, non-grant finance and social investment are still only used in the charitable sector on a very small scale. Grants and donations are still the primary, and probably preferred, way of meeting charities' financing needs.

In such an environment, Scope should be applauded for taking a different approach and piloting a model that uses financial instruments – especially the hybrid philanthropy product – that are still not commonplace in the sector.

The advantages to Scope of using non-grant finance are:

- speed: it is quicker to borrow funds than to rely on a lengthy fundraising appeal;
- amount: larger sums can be raised via Scope's hybrid philanthropy product than through fundraising alone;
- allocation of resources: valuable unrestricted donations can be used for the charity's other needs; and
- sustainability: if the model works it can be replicated across Scope's other facilities in need of renovation.

Scope's model looks sensible but since the Grangewood pilot project is the first time it is being tested, uncertainties remain and its success cannot be guaranteed. The biggest risk is that donors may not be sufficiently familiar or comfortable with charities using non-grant finance to take up Scope's offering.

This apprehension is understandable but social investment, including Scope's hybrid model, should be seen as a legitimate and alternative form of philanthropy to grants and donations.

It is therefore something that donors should consider seriously. Especially in the current low-interest and low-inflation environment, Scope's model has the potential to make donors' money work harder, since:

- contributions will be highly leveraged at a ratio of ten to one; and
- donors can reinvest the repaid 0% loan in other projects (either with another organisation or within Scope).

Scope 'soft' launched this product at the beginning of April and it has already 'sold' nine units worth £88.2k. In addition, Scope has raised £23k in straight donations. Given that this funding had all been from donors who had previously not given to Scope, this is an encouraging start.

If the Grangewood pilot is successful and can be shown to work, it has the potential to transform the living arrangements of all Scope's residents currently living in out-of-date accommodation.

It could also bring wider benefits: if proved to work, it could act as a model that could be replicated by other charities facing similar challenges to Scope. It may also encourage charities to consider financing options open to them beyond grants, allowing them to meet the needs of their beneficiaries more swiftly and more efficiently.

New
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New Philanthropy Capital (NPC) is a consultancy and think tank dedicated to helping funders and charities to achieve a greater impact.

We provide independent research, tools and advice for funders and charities, and shape the debate about what makes charities effective.

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- For funders, this means understanding what makes charities effective and supporting their endeavours to become effective. It includes using evidence of charities' results to make funding decisions and to measure their own impact.

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