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Equity Capital in the Social & Solidarity Economy

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Equity Capital in the Social & Solidarity Economy

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1. Introduction

Equity investments play a vital role in fostering the growth of the social and solidarity finance market and effectively addressing social and environmental challenges on a larger scale. According to research conducted in the UK(1), the demand for equity funding in the social enterprise sector is estimated to be three times greater than the current available supply.

Equity capital refers to external investment capital contributed by the company's owners. Unlike debt financing, equity capital does not have a fixed repayment requirement and remains invested in the company indefinitely. Investors in equity capital receive returns through regular dividend payments and/or the potential growth in company valuation, resulting in an increase in the value of their ownership stake.

Such a funding approach would allow for larger investments, facilitating scalability, and attracting private capital. Consequently, there has been an increasing focus on equity financing as a means to reduce the reliance on grants and debt funding for social enterprises since 2000.

Nevertheless, numerous obstacles hinder the success of this type of funding. Many actors in the social and solidarity economy still perceive a lack of access to equity finance as a significant obstacle to growth and development. The primary challenges include low demand and inadequate awareness and readiness among potential recipients and insufficient supply due to inflexible return expectations on the limited partner side. Additionally, early-stage ventures often face difficulties in obtaining loan funding due to the high risk involved or the absence of sufficient cash flows to cover interest payments.

(1) Shift, CAF Venturesome, & UnLtd. (2020). *Beyond Demand. The social sector's need for patient, risk-bearing capital.*

2. Equity financing in Europe

2.1 Types of equity

Equity capital refers to the funds raised by a company through the sale of shares or ownership interests in the business. It represents the portion of a company's funding that is provided by its shareholders in exchange for ownership rights and potential returns on their investment.

Equity investors become co-owners of an enterprise and aim for a return on their investment by future dividend payments and an increase in the valuation of their shares (usually either/or). As co-owners, their investment enables them to exercise voting rights and a certain influence on the development of the venture.

Different forms of equity capital exist and are being used in the social finance field. They are identical to traditional equity funding in their role as financial tools but are usually tailored to the specific context and needs of social enterprises. The most common ones in the social and solidarity economy are:

- **Bootstrapping**: Bootstrapping refers to the practice of starting and growing a company using personal resources, creativity, and unconventional methods, rather than relying on external funding or financial support. It involves self-funding and operating with limited financial resources to build and expand the business.
- **Business Angels**: Private individuals, known as business angels, provide support to startups by offering equity capital and sharing their expertise, along with providing access to potential customers or suppliers. Business angels often operate within networks that facilitate co-investments, enabling collaboration and pooling of resources for startup investments.

- **Venture capital**: Venture capital is a type of equity financing provided by specialised firms or investors to early-stage companies with high growth potential. In exchange for capital, venture capitalists often acquire a percentage of ownership and may provide guidance and expertise.
- **Private equity / Growth equity**: Private or growth equity refers to a form of investment where capital is provided to privately held companies that have demonstrated a certain level of success and are in a growth phase. Private equity firms invest in these companies in exchange for an ownership stake, with the aim of accelerating their growth and increasing their value.
- **Quasi-equity/Equity-like/Mezzanine capital**: Quasi-equity, also known as mezzanine equity or mezzanine financing, is a hybrid form of financing that combines elements of both debt and equity with regard to risk, governance participation and interest in benefits. Mezzanine investors usually have no stake in the business (because the enterprise cannot or does not want to give up equity) and the mezzanine tranche sits between traditional debt and pure equity in terms of risk and return characteristics. Quasi-equity typically addresses the challenges of giving up ownership when issuing classic equity as well as the requirement of fixed repayment schedules demanded by traditional debt funders. Examples for quasi-equity instruments in the social and solidarity economy are subordinated debt, participatory loan or convertible bonds.
- **Catalytic capital**: This refers to a type of investment that is strategically deployed to unlock additional financing and to address market failures. It plays a critical role in driving social change by catalysing and leveraging other sources of capital. Examples of catalytic capital include guarantees, social impact bonds, blended finance structures, and mission-driven investments.

Different stages of development of an enterprise require different equity instruments. Along the life cycle of a social enterprise, most companies start activities with equity provided by the funders and their personal network as well as bootstrapping. After proof of market of the product or service, usually more investment is needed to introduce the company's offer to a wider group of customers. Business angels and venture capital funds often provide the funding needed for this stage. Growth equity investors will then provide larger amounts of investment needed for scaling-up organisations:

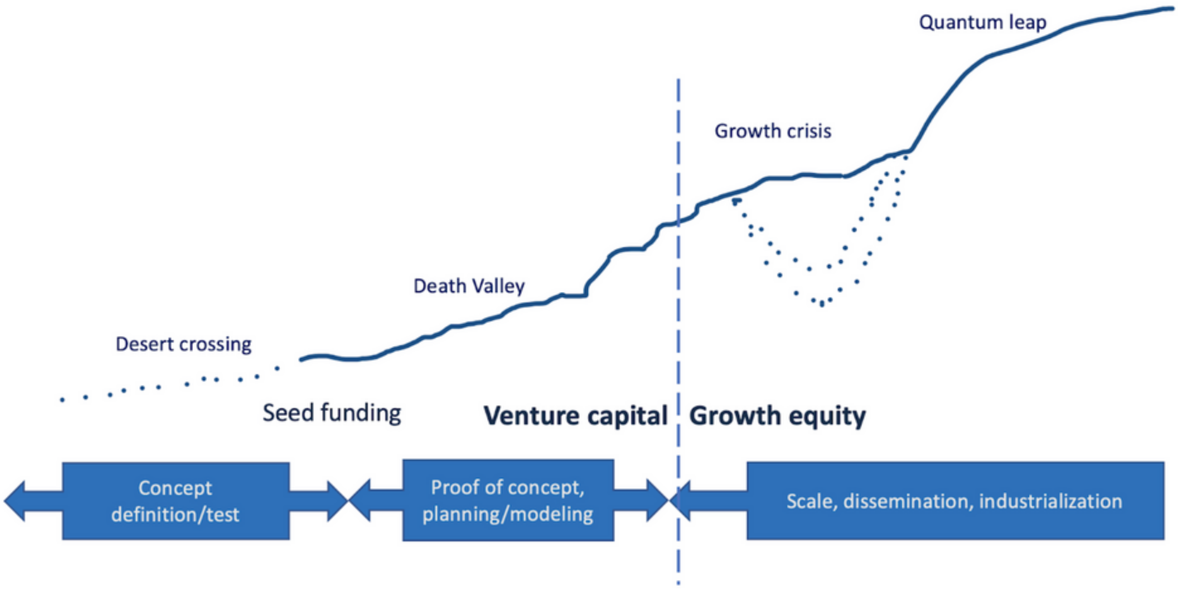

Figure 1: Equity funding needs along the enterprise life cycle
Source: Own illustration

Equity Capital in the Social & Solidarity Economy

Advantages of equity finance for an enterprise	Disadvantages of equity finance for an enterprise
No Debt Repayment: Unlike debt financing, equity financing does not require regular interest payments or a fixed repayment schedule. This relieves the company from the pressure of making regular payments, especially during challenging times.	Dilution of Ownership: When new equity is issued, existing shareholders' ownership stake in the company is diluted. This means that existing shareholders have a smaller percentage of ownership and control over the company.
Long-Term Capital: Equity capital provides long-term funding, which is particularly beneficial for companies with high capital requirements, such as those involved in research and development or capital-intensive industries.	Loss of Decision-Making Control: Equity investors may have the right to participate in major decisions and voting rights, especially preferred shareholders or venture capitalists. This may result in a loss of control for the company's founders or existing shareholders.
Shared Risk: By bringing in equity investors, the risk is shared among shareholders. If the company faces financial difficulties, shareholders bear the risk of potential losses, reducing the burden on the company itself.	Cost of Equity: Equity financing can be more expensive in the long run compared to debt financing. Shareholders expect a return on their investment, either through dividends or capital appreciation, which can be costly for the company.
Access to Expertise: Equity investors often bring industry expertise, connections, and valuable advice to the company. They can provide strategic guidance, open doors to new opportunities, and help the company grow and succeed.	Information Disclosure: Companies that issue equity may need to disclose certain information to shareholders and potential investors, which could be sensitive or competitive in nature. This may limit the company's ability to keep certain information confidential.

Table 1: Advantages and disadvantages of equity finance

Source: Own illustration

2.2. Equity funding for social enterprises in Europe

According to a study published by the European Commission in 2020, European investors currently provide equity funding amounting to €225 million per year, provided by funds, crowdfunding platforms, various ethical banks and cooperatives(2). The estimated demand for equity funding, however, is much larger. Based on country-specific variables and the level of commercial maturity of the organisations, the annual funding gap for equity in social enterprises in Europe ranges from €230 million to €605 million.

It is important to note that there are significant geographical disparities in the adoption of this financing instrument throughout Europe, reflecting the diverse and heterogeneous market. In certain countries like Albania, Iceland, Montenegro, North Macedonia, and Serbia, no active equity investors do exist at the moment. Italy, France, Germany, Belgium, and the Netherlands have emerged as the leading contributors of equity funding to social enterprises in terms of absolute amounts. When considering per capita figures, Belgium, Luxembourg, Italy, and Denmark emerge as the countries with the highest concentration of equity investments.

(2) Spiess-Knafl, W., & Scheck, B. (2020). *Social enterprise finance market Analysis and recommendations for delivery options*. European Commission, Directorate General for Employment, Social Affairs and Inclusion.

3. Supply-side of equity investments

3.1 Landscape of equity investors in Europe

Although rather fragmented and relatively small, some equity investors have emerged in Europe across the different life-cycle stages and needs of social enterprises:

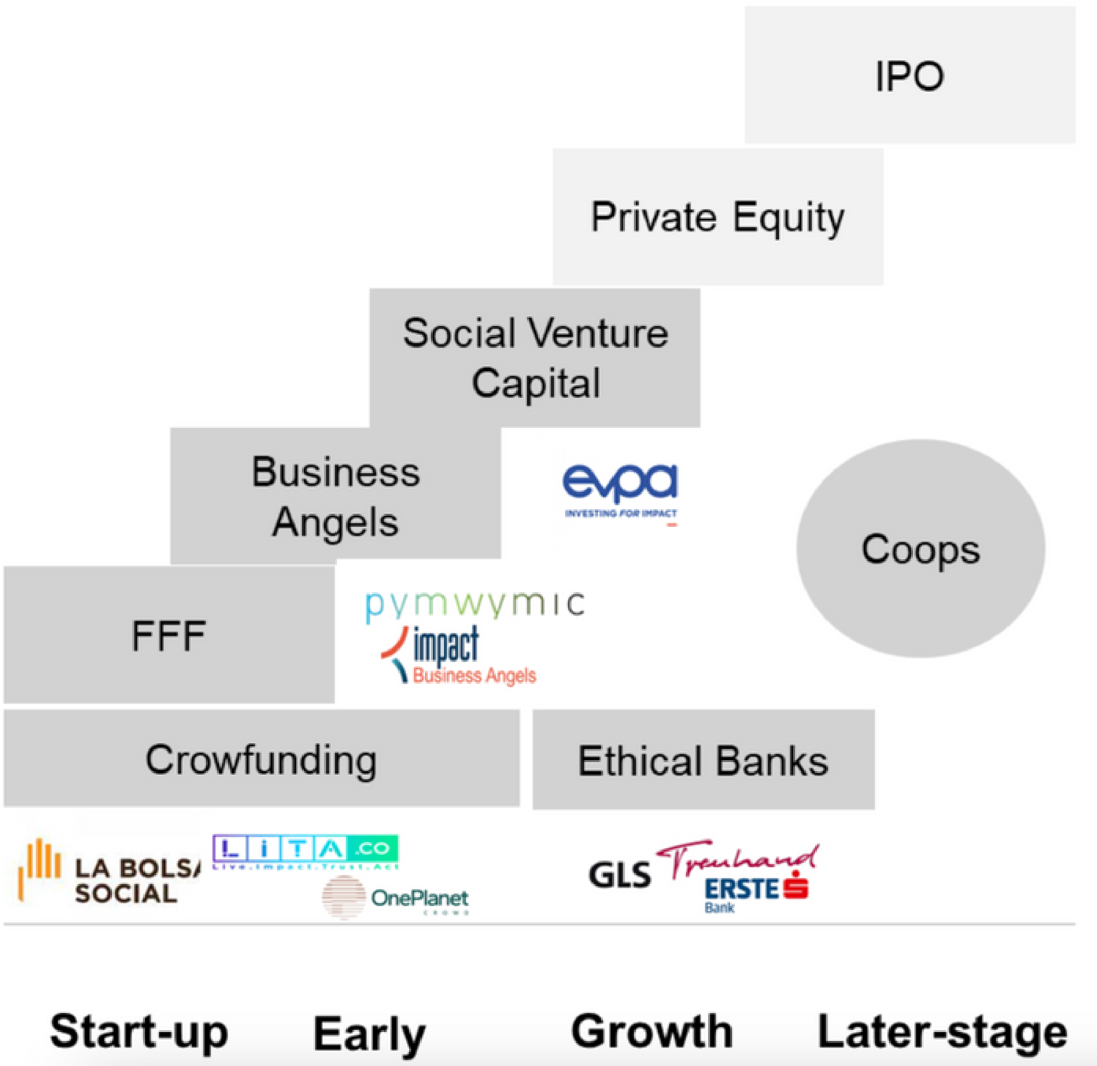

Figure 2: Landscape of equity investors in Europe
Source: Own illustration

It is important to notice that in markets where cooperatives have a strong and active community, a substantial portion of equity capital often arises from capital increases, which are typically contributed directly by worker-members instead of allocating profits to reserves, as commonly practised. However, the role and impact of social finance within the cooperative sector have not been extensively researched, requiring further analysis to gain a deeper understanding of the range, instruments, potential, and specific requirements of these stakeholders.

3.2 Challenges on the supply-side

It is important to note that in markets where cooperatives have a strong and active community, a substantial portion of equity capital often arises from capital increases, which are typically contributed directly by worker-members instead of allocating profits to reserves, as commonly practised. However, the role and impact of social finance within the cooperative sector have not been extensively researched, requiring further analysis to gain a deeper understanding of the range, instruments, potential, and specific requirements of these stakeholders.

Fundraising for equity vehicles across all types of investors remains a large challenge for providers.

Private investors still play a big role in many European regions. They are usually quite fast in their decision-making processes but the investment sizes are comparatively small and will not suffice to cover all equity funding needs.

Institutional investors usually aim for a minimum investment of €50 million per investment that is still difficult to absorb for most social finance asset managers. In addition, the fund model of private institutional investors requires a funding structure and return rate that aligns closely with mainstream private equity. Furthermore, the funding needs of social enterprises, particularly the young ones showing reasonable growth, raise questions about plumbing issues and the risk-return model. Given the transaction costs involved, the fund cannot be too large. Consequently, the amounts raised are not significant enough to attract investors. In general, there exists a cognitive dissonance between public attention and the money being rerouted. Despite the increased awareness and focus on certain issues, the actual redirection of funds may not be as substantial as expected. However, it is worth noting that there are some exceptions to the aforementioned challenges, particularly within the regulatory framework of solidarity finance.

Public investors such as the European Investment Fund (EIF) provide some possibilities, for example through the Social Impact Accelerator(3) and its successor. Nevertheless, the overall funding amount remains rather limited. There is, however, an increased awareness and involvement at the national or regional level across Europe that might lead to additional funding opportunities in the short-term.

Independent of the origins of funds, asset managers struggle in general with small fund sizes that render the sustainability of their business model challenging. Smaller funds generate less management fee for the fund management while at the same time smaller investment sizes entail higher transaction and follow-up costs for the investment managers.

Lastly, the lack of secondary markets and limited exit scenarios render equity investments less attractive. Investors can currently choose between a repurchase of the shares by the entrepreneur(s), secondary sales (which become more and more frequent) or mergers and acquisitions by strategic investors.

(3) https://www.eif.org/what_we_do/equity/sia/index.htm

4. Demand-side of equity investments

4.1 Landscape and needs of enterprises

In general, the need for and the ability to take on equity funding as a social or solidarity enterprise are determined by a variety of influencing factors.

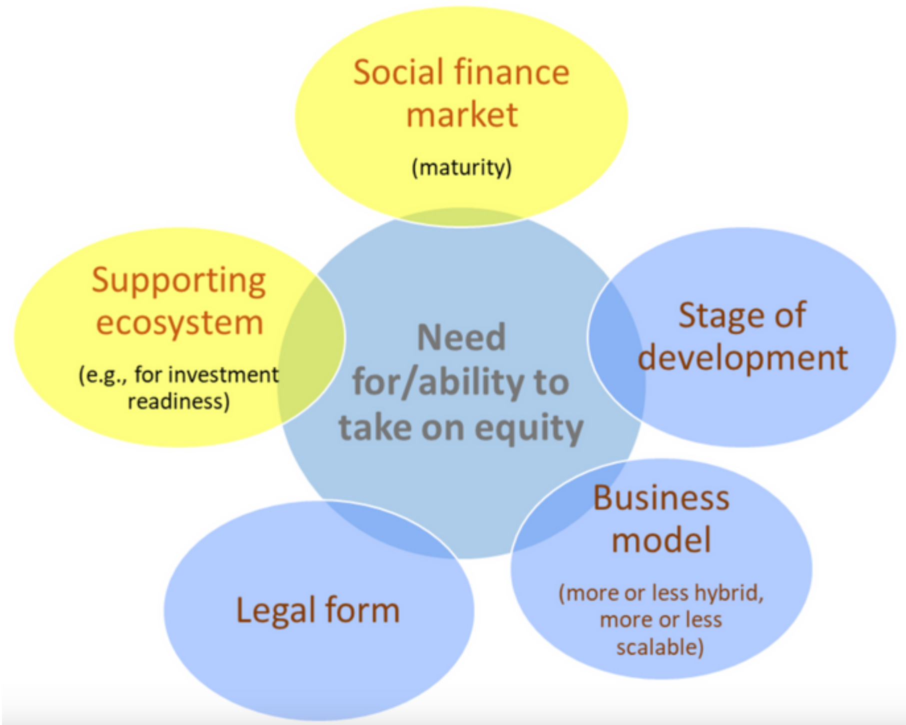

Figure 3: Determining factors for taking on equity funding

Source: Own illustration

Recent reports still share consensus around the market gap social enterprises are faced with when it comes to accessing finance, be it debt or equity(4).

Moreover, debt funding is still overwhelming in a social enterprise's financial strategy. In a compiled updated vision on 28 EU countries, the study "Social enterprises and their ecosystems in Europe"(5) states that demand for equity capital is still quite low. However, it remains unclear to date if the demand for equity is low or the resource too scarce or both(6).

While a French study(7) underlines the need for more patient capital citing that 30% of respondents suffer from a financial structure qualified as precarious, namely low equity and high indebtedness, a German level study(8) highlights both a very low demand for equity and a very poor success rate for equity candidates. Research undertaken by Shift, CAF Venturesome, UnLtd and Esmée Fairbairn Foundation in 2020, has published the following insights: Almost one in five (18%) social enterprises require equity-like funding to support their operations and growth. Only a third (33%) of those social enterprises are actively engaged in the process of raising such funding, which is three times less than the total number in need. One of the primary barriers identified is the low awareness and understanding of patient, risk-bearing capital among social enterprises. This lack of awareness hinders their ability to access the necessary funding for their ventures.

(4) European Commission. (2020). *Impact of the European Commission's Social Business Initiative (SBI) and its follow-up actions.*
(5) European Commission. (2020). *Social enterprises and their ecosystems in Europe. Comparative Synthesis Report.*
(6) Shift, CAF Venturesome, & UnLtd. (2020). *Beyond Demand. The social sector's need for patient, risk-bearing capital.*
(7) Le financement des entreprises de l'Économie Sociale et Solidaire, rapport de la commission présidée par Frédéric Tiberghien, avril 2017, https://www.ess-france.org/rapport-sur-le-financement-des-entreprises-de-l-economie-sociale-et-solidaire
(8) Deutscher Social Entrepreneurship Monitor 2020/21, https://www.send-ev.de/wp-content/uploads/2021/03/DSEM-2020-21.pdf

These studies are the only ones on the topic currently available. They are not very recent and they might not be entirely transferable to other European countries due to the rich tradition of social finance in the UK.

4.2 Challenges on the demand-side

Challenges on the demand side of equity financing for social enterprises include a lack of awareness and understanding among potential investors and therefore a lack of supply.

Another challenge is the lack of investment readiness and a certain level of reluctance among social enterprises themselves to pursue equity financing. Additionally, comparatively high pricing of equity investments poses a challenge for social enterprises seeking funding. This challenge will vary substantially according to the stage of development and business model of the social enterprise (is it for instance beyond seed funding and easily scalable, access to equity should be easier).

The heterogeneous legal structures of social enterprises also contribute to the challenges in equity financing, as different legal frameworks may affect the availability and feasibility of such funding(9). The needs for and ability to raise risk bearing and patient capital vary inevitably depending on the social finance market they grow in and the level of support brought by the ecosystem. Non-profit and cooperatives remain poorly funded in some regions, and the current development trend of impact funds on the supply side targets mostly for-profit entities, with a broader spectrum including impact-driven enterprises (further away from social economy type approach).

(9) The above-mentioned study "Social enterprises and their ecosystems in Europe" (European Commission, 2020, 2021) clearly highlights the very high heterogeneity within EU of both supply and demand side of "repayable financial resources" (equity included) for social enterprises.

Valuation considerations present another obstacle, as determining the value of social enterprises can be complex and may affect investment decisions. Finally, the focus on the lockstep model, where financial returns are aligned with social impact, can be a challenge to balance and thus further complicate the equity investment approach for social enterprise not fitting in this frame.

5. Investments in listed equities

Recently, investments in listed equities have become discussed as an emerging topic within the social finance field. However, it is challenging to replicate impact investment practices from other asset classes in public markets due to their unique characteristics and dynamics. In public markets, shares in listed companies primarily involve secondary trading between different investors, which typically does not directly impact the company's access to capital.

Furthermore, the comparative influence of a single investor in public markets is generally more limited than in private markets, where individual investors can have a more significant impact on the company's operations and decision-making. Lastly, the attribution of impact to specific investors in listed companies is often extremely difficult, making it challenging to determine the direct contribution of a particular investor to the company's overall impact. Consequently, investments in listed companies generally do not have a substantial impact on the enterprise's overall social or environmental outcomes.

Nevertheless, investments in listed equities can involve various approaches, each with its own strategy and investment intent.

- A clear problem statement is essential in the fund/portfolio prospectus, providing a concise description of the issues the investment aims to address.
- Articulating a clear theory of change is crucial, encompassing considerations such as market capitalization, diversification, objectives, returns, beneficiaries, and shareholder rights.
- Portfolio design and selection involve screening through an impact thesis lens, both at the portfolio level and the enterprise level, to determine the composition of the investments.
- Engagement strategies are employed to guide the interactions and priorities for engagement, based on the theory of change.
- Assessing the effectiveness of engagement is a critical component, evaluating the outcomes and impact of the engagement activities.
- Definition of milestones and criteria for escalation and exit are established to monitor progress and determine appropriate actions within the investment portfolio.
- Performance measurement is conducted to track the success and impact of the investments, ensuring alignment with the intended objectives and desired outcomes.

6. Recommendations and trends

Going forward, we observe the following trends in the equity finance market:

- Larger investment vehicles are emerging with the objective of achieving fund volumes of at least €100 million. This is aimed at reducing transaction costs associated with investment activities(10).
- As a result, there is a natural increase in transaction sizes as these larger investment vehicles come into play.
- There is a growing availability of mezzanine products and equity-like instruments that provide more flexibility in financing options for businesses.

In order to further develop the market, we would see potential areas of improvement and support through some of these approaches:

- Although not currently available, the introduction of equity guarantees could have a significant impact on the investment landscape de-risking private capital and thus crowding-in investors.
- Along the same lines, although with less leverage, incorporating first-loss pieces in investment structures has the potential to attract additional capital to support social finance initiatives.
- Equity fund-of-fund models have the potential to absorb more capital thus attracting institutional investors and encouraging their participation in the social finance market.
- The cost structure could be improved by exploring hybrid fund models that combine debt and equity, catering to different types of enterprises.

(10) The EaSI Transaction Cost support programme from the European Commission specifically seeks to tackle this challenge. Further information to be found here: https://ec.europa.eu/social/main.jsp?catId=629&langId=en&callId=518&furtherCalls=yes

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Its objective is to support the exchange of experiences and promote cooperation between social economy and social finance practitioners.

Each FEBEA member is integrated in the SSE Sector in its country, focusing on mobilising savings and equity from responsible citizens and using these funds to finance sustainable development and local communities. FEBEA is member of GECES, the European Commission's expert Group on Social Economy and Social Entrepreneurship and of Social Economy Europe, the main European network of social economy practitioners.

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