GDN's Next Horizons Essay Contest 2014*

THE FUTURE OF DEVELOPMENT ASSISTANCE

Supported by the Bill and Melinda Gates Foundation

CATALYSING INVESTMENT IN SOCIAL ENTERPRISE: THE SEE FUND

Abstract

Social enterprises are an important tool for human development. Social enterprises have designed innovative (and profitable) ways of delivering a whole range of development initiatives including affordable education in Kenyan slums, reducing child mortality in Ugandan villages and improving food security in Rwanda. While investors have shown growing interest in supporting social enterprises to achieve greater impact, the flow of investment is hampered by a lack of exit opportunities. The Social Enterprise Exit (SEE) Fund can change this. The SEE Fund could be created by international development institutions such as the IFC, USAID and private foundations. The mandate of the SEE Fund would be to take minority stakes in successful social enterprises, providing an exit opportunity to the founders and early investors. This would positively impact human development outcomes in three main ways. Firstly, it would release existing capital to be reinvested in other social enterprises needing growth capital. Secondly, it would attract more capital into social enterprises. Thirdly, it would attract a wider pool of entrepreneurial talent to create and to grow successful social enterprises. The SEE Fund could also catalyse change in the impact investment sector more broadly, proving the viability of a liquid secondary market. The long-term consequence could be a sustained increase in investment flowing into social enterprises, improving the lives of millions of the world's poor.

Authors

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**The GDN Next Horizon Essay Contest was launched globally by the Global Development Network (GDN) in 2014, with the support of the Bill & Melinda Gates Foundation. The contest invited contributions related to the future of development assistance to inform the ongoing discourse on development assistance with fresh thinking, and revamp policy debates with new voices. This essay is one of 13 winning entries selected by a high-profile Jury of aid policy makers, experts and practitioners chaired by Nancy Birdsall.*

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INTRODUCTION

The SEE Fund as a New Financial Tool for International Development

Social enterprises are an important tool for international development. However, currently their ability to operate at scale is hampered by a dysfunctional social finance capital market. We propose that the international development community could catalyze the growth of social enterprises by setting up a Social Enterprise Exit (SEE) Fund. The SEE Fund would take minority equity stakes in successful later-stage social enterprises, increasing the ability of founders and early investors to exit and reapply their talents and money to other social enterprises.

This essay makes the case for the SEE Fund as an innovative financial tool for international development in the following ways:

- **Section 1 examines the potential for impact:** we show how social enterprises have a proven ability to meet basic human development goals including quality primary education and improved health outcomes, while being financially sustainable.
- **Section 2 identifies a problem**: we look at evidence of a lack of exit opportunities for social enterprises, and analyse how this restricts the flow of both financial and human capital into social enterprises.
- **Section 3 explains our solution**: we demonstrate how the SEE fund can address the exit problem, leading the way towards a liquid and well-functioning capital market for social enterprises.

The SEE Fund has the potential to be catalytic in creating a secondary market for investment in social enterprises. We argue that the SEE Fund, if properly implemented, could result in widespread positive impacts for disadvantaged people in the poorest economies.

SECTION ONE

THE POTENTIAL FOR IMPACT:

Social Enterprises Can Improve the Lives of the World's Poorest

Social enterprises are an important tool in international development. As Margolis and Walsh point out, "Manifest human misery and undeniable corporate ingenuity should remind us that our central challenge may lie in blending the two."[1] This section explains how social enterprises work to further human development. We also look at how social enterprises currently access finance, as a starting point for analyzing the (dis)functionality of social finance markets in Section Two.

1.1 What is a Social Enterprise?

There are many definitions of social entrepreneurship (as a phenomenon) and social enterprises (as entities). We follow Seelos and Mair's definition: "Social entrepreneurship combines the resourcefulness of traditional entrepreneurship with a mission to change society."[2] For the purpose of this essay, we will define social enterprises[3] as having two key characteristics:

1. **For profit**. "In SE…social value creation appears to be the primary objective, while economic value creation is often a by-product that allows the organization to achieve sustainability or self-sufficiency."[4]
2. **A primary goal of meeting basic needs** (e.g., education, health, water, sanitation, livelihoods). "Social entrepreneurship creates new models for the provision of products and services that cater directly to basic human needs that remain unsatisfied by current economic or social institutions."[5]

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[1] Seelos and Mair (2005)
[2] Seelos and Mair (2005)
[3] Our definition excludes certain entities that may otherwise be thought of as social enterprises. Firstly, we are excluding non-profit organisations because they cannot legally issue equity, thus there is no scope for a traditional exit. Secondly, we are excluding profitable entities that do social good in developed economies and, therefore, do not target the poorest of the world's poor. We are also excluding environmentally focussed social enterprises unless they are addressing environmental issues in tandem with basic human needs.
[4] Seelos and Mair (2005)
[5] ibid

1.2 What Impact do Social Enterprises have on Human Development?

Social enterprises have the potential to deliver significant development impact on a large scale. To illustrate this, we briefly discuss three successful social enterprises operating in East Africa.

In the education sector, Bridge International Academies is delivering low-cost private education to poor communities in Kenya. Since opening their first academy in 2009, they have enrolled over 95,000 students, charging an average of US$ 5 per month.[6] Their students are performing better on average than children in government schools.[7] Bridge International Academies has plans to deliver high-quality primary education to 10 million children a year by 2025. This will make a significant dent in the 57 million children that were not attending primary school in 2011.[8]

In the health sector, Living Goods employs a network of Avon-style sales ladies to sell basic health and wellbeing items door-to-door in their local communities. In Uganda, their workforce of over 1,000 women provides healthcare advice on pregnancy, malaria and malnutrition. The Poverty Action Lab at Massachusetts Institute of Technology has recently completed a randomized control trial of Living Good's work in Uganda. They found a 25 per cent reduction in under-five mortality in areas where Living Goods operates[9] – a significant contribution to Millennium Development Goal 4: reducing child mortality by two thirds between 1990 and 2015. "The results indicate that entrepreneurial models of community health service delivery can result in a sustainable and effective reduction in under-five mortality."[10]

Sanergy is a for-profit social enterprise that provides toilets in Nairobi's slums, creating jobs while also improving sanitation. Their network of 455 micro-franchised 'Fresh Life' toilets is serviced regularly, with waste being removed and then turned into fertilizer and energy. Currently Sanergy has 18,000 people using its toilets daily,[11] greatly enhancing sanitation services in Nairobi's slums.

1.3 How are Social Enterprises Currently Funded?

In order to understand why fresh thinking is needed in the funding of social enterprises, we need to first understand how social enterprises are currently funded. As explained in the Harvard Business Review, "Many social enterprises survive only through the largesse of

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[6] Bridge International Academies Website, (2014)
[7] ibid
[8] Millennium Development Goals Website, (2014)
[9] Bjorkman-Nykvist, Guariso, Svensson and Yangizawa-Drott (2014)
[10] ibid
[11] Sanergy website, (2014)

government subsidies, charitable foundations, and a handful of high-net-worth individuals who will make donations or accept lower financial returns on their investments in social projects."[12]

Currently, there are some particularly innovative social enterprises that have managed to access capital from a wide range of sources. For example, Kenyan based social enterprise, Sanergy, has received grant funding,[13] raised debt through the crowdfunding platform, Kiva,[14] and raised equity from impact investors.[15]

For the purposes of this essay, we will focus on equity investments. Typically, equity investors seek a return on their investment, either through receiving dividends or selling their stake in the business. In traditional capital markets, equity investors have a number of exit routes, including initial public offerings (IPOs) or selling the business to another business or financial investor. As we will show in Section Two, the exit options for equity investors in social enterprises are limited.

Who Makes Equity Investments in Social Enterprises?

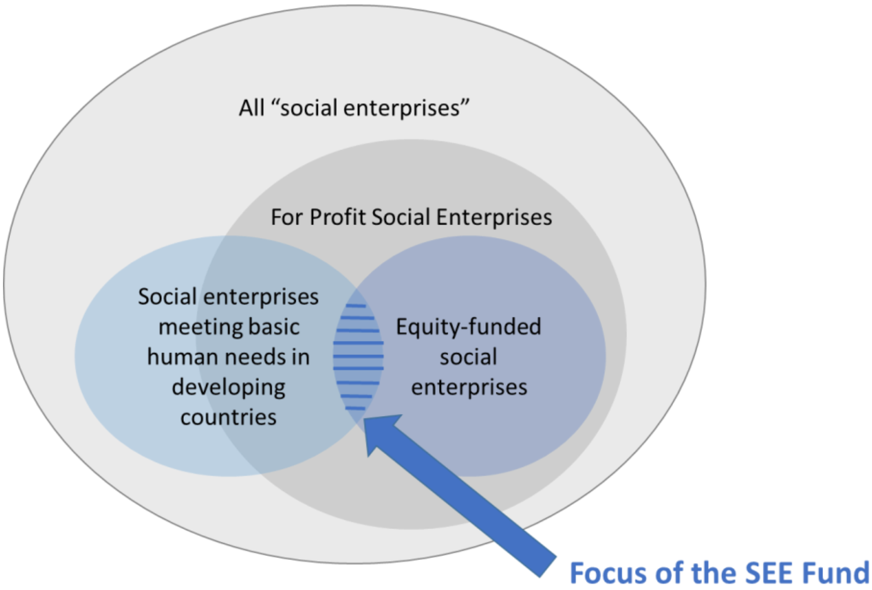
At an early stage, equity investment typically comes from the social entrepreneur, largely in the form of sweat equity, and potentially seed capital from friends, family and angel investors. As the social enterprise begins to build a track record, the main source of equity investment comes from impact investors, including impact investment funds, foundations and high-net-worth individuals. Big Society Capital defines impact investing as follows:

> "The provision of finance to organizations with the explicit expectation of a social, as well as a financial, return (…) the key criteria that define social investment are:
>
> (1) That the social returns (...) are clearly defined a priori and are not an incidental side-effect of a commercial deal
> (2) That the investor expects a financial return. To draw a clear distinction between social investment and variants of philanthropy, we advocate for social investments to include only finance that is anticipated to deliver at least a 0% return (i.e., repayment of capital)."[16]

For the purpose of this essay, we will focus on a specific area of development finance: equity investments in for-profit social enterprises meeting basic needs in developing countries (Figure 1).

[12] Bugg-Levine, Kogut, and Kulatilaka (2012)
[13] USAID Website, (15th February, 2013)
[14] Kiva Website (30th August, 2013)
[15] Sanergy website (19th April, 2013)
[16] Brown and Swersky (2012)

Figure 1: Focus Area of the SEE Fund



SECTION TWO

THE PROBLEM:

A Lack of Exit Opportunities Stunts the Growth of Social Enterprises

In Section One we established that social enterprises are an important engine for human development for poor people in developing countries. In this section we discuss how a lack of exit opportunities is suppressing investment in social enterprises. A recent report by the Boston Consulting Group (BCG) and Big Society Capital highlights the problem: "social investors are in critical need of a market making facility that guarantees them liquidity, an exit option, if they need to cash out on their social investments."[17] Nicholls (2012) further elaborates on the problem in his forthcoming article 'Filling the Funding Gap': "the novelty of the [social finance] marketplace and absence of developed secondary markets means that exit routes are untested or unavailable."

This section is broken into two parts: firstly we look at evidence of a lack of exit opportunities (Section 2.1) and secondly we examine how a lack of exit opportunities stunts the growth of social enterprises (section 2.2).

[17] Brown and Swersky (2012)

2.1 Evidence of a Lack of Exit Opportunities Stunting Investment

Two recent large-scale surveys of impact investors found that a lack of exit opportunities is a major barrier to further investments.

The JP Morgan and Global Impact Investor Network's (GIIN) Fourth Annual Impact Investor Survey[18] includes responses from 125 impact investors with total committed capital of US$ 10.6 billion in 2013. When asked to rank the biggest challenges to the growth of impact investing, the third biggest challenge was 'difficulty in exiting investments' (see Figure 2). When asked to identify the contributors of risk to their portfolio, impact investors ranked 'liquidity and exit risk' as the second biggest risk factor (see Figure 3).

Figure 2: Challenges to the growth of the impact investing industry today[19]

n = 125; Respondents ranked top three

Rank	Score	Available answer choices
1	165	Shortage of high quality investment opportunities with track record
2	161	Lack of appropriate capital across the risk/return spectrum
3	98	Difficulty exiting investments
4	82	Lack of innovative deal/fund structures to accommodate investors' or portfolio companies' needs
5	80	Lack of common way to talk about impact investing
6	73	Lack of research and data on products and performance
7	49	Lack of investment professionals with relevant skill sets
8	42	Inadequate impact measurement practice

Source: GIIN, J.P. Morgan. See scoring methodology in the Methodological and Analytical Notes section on page 3.

Figure 3: Contributors of risk to impact investment portfolios[20]

n=125

Rank	Score	
1	253	Business model execution & management risk
2	118	Liquidity & exit risk
3	104	Market demand & competition risk
4	93	Country & currency risks
5	83	Macroeconomic risk
6	73	Financing risk
7	26	Perception & reputational risk

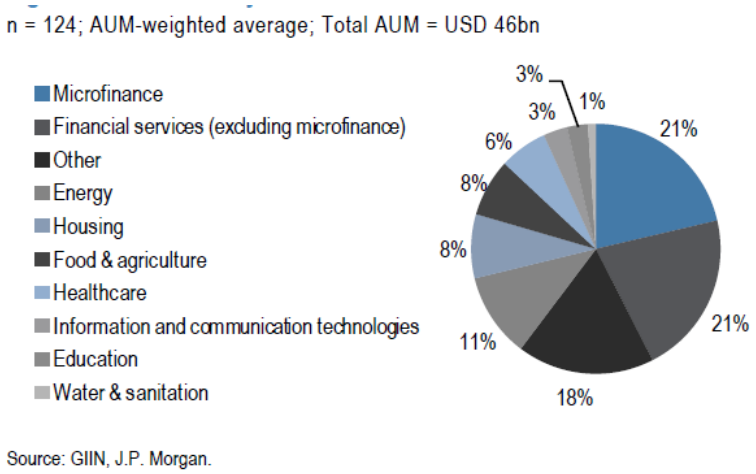
Source: GIIN, J.P. Morgan.

Alongside the exit problem, we acknowledge that other factors are also limiting the growth of impact investing and need to be addressed in tandem with the exit problem. As will be explained in Section 3.1 below, there are already a number of initiatives designed to address the leading risk – 'business model execution and management risk' – through initiatives such as fellowship programs, technical assistance and training.

[18] Saltuk (2014)
[19] Saltuk (2014)
[20] ibid

Sectors where there are successful exits also benefit from extra investment as impact investors feel more confident about the prospects of achieving a return. This plays out clearly in the financial services and microfinance sectors. Exits in the sector include Banco Compartamos[21] in Mexico and SKS Microfinance in India. According to the Impact Investor Survey, 42 per cent of total assets under management (AUM) are in the microfinance and financial services sector (see Figure 4).[22]

Figure 4: Total AUM by Sector[23]

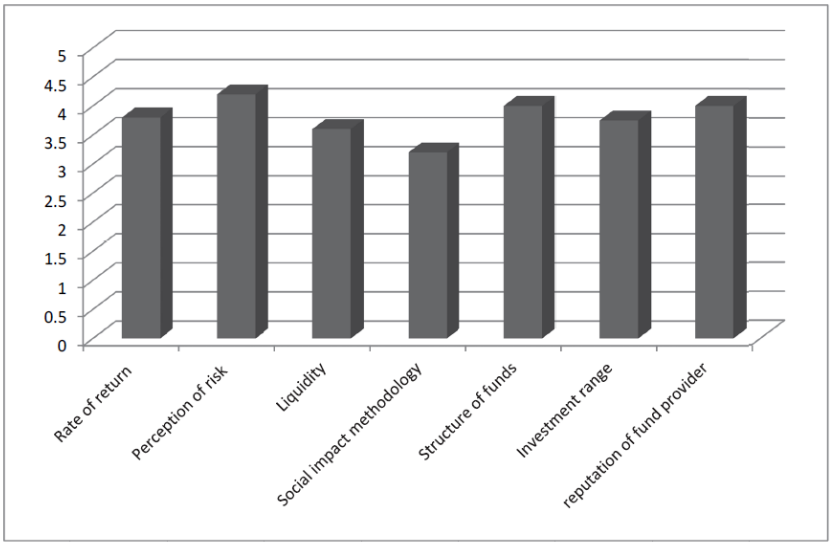


The second large-scale survey is the 2011 ClearlySo report on 'Investor Perspectives on Social Enterprise Financing', conducted among 55 impact investors in the UK, including charitable foundations, pension funds, investment banks and social financial intermediaries. Most potential investors cited lack of exit as a barrier to impact investments. In particular, private equity houses said they need "an obvious market to sell this enterprise to either up or down the value chain, ideally within 4-6 years of purchasing" for social enterprises to "stand a chance of gaining investment".[24]

Similarly, charitable foundations need good exit options. When ranking the features of an appealing investment, charitable foundations ranked liquidity over social impact methodology[25] (see figure 5). "Liquidity here is high reflecting the foundations' need for an exit strategy – if their money is to be recycled, it needs to be able to be released."[26]

[21] Rhyne and Guimon (2007)
[22] Saltuk (2014)
[23] Saltuk (2014)
[24] Hill (2011)
[25] ibid
[26] ibid

Figure 5: Charitable Foundations' rankings of vehicle features[27]



2.2 The Problems Caused by a Lack of Exit Opportunities

The lack of exit opportunities identified in Section 2.1 limits the growth of social enterprises in two main ways:

- **Lack of financial capital:** investors are hesitant to invest in a social enterprise if they are not clear how it could be returned in the future. Lack of access to financial capital limits the ability of social enterprises to improve and scale their social impact
- **Lack of human capital:** when social enterprises lack access to financial capital, it can make it hard to attract and retain the right human capital.

2.2.1 Lack of Exit Limits flow of Financial Capital

A lack of exit opportunities results in impact investors limiting their investment in social enterprises, instead focusing on publically traded companies that meet their definition of having social impact. When impact investors do invest in social enterprises, they often look to other forms of financing such as debt. However, debt is often unsuitable for early stage social enterprises that have unpredictable cash flows. Equity is more suitable for start-ups due to the flexibility it provides, as evidenced by the wide use of equity in commercial starts-ups.

The lack of successful exits also makes valuing social enterprises difficult as there are few reference points for valuation.[28] This increases the time and money required to complete transactions, distracting social entrepreneurs from running their social enterprise.

[27] Hill (2011)

2.2.2 Lack of Exit Limits Flow of Human Capital

In traditional capital markets, exit is important in attracting human capital. However, in social capital markets, a lack of exit makes it difficult to:

- **Attract talented entrepreneurs**. Most entrepreneurs are prepared to live frugally to launch a commercial venture because there are clearly defined paths to exit. In contrast, most aspiring social entrepreneurs know that they will likely have to support themselves with little chance of financial gain. Unfortunately, this limits social entrepreneurship to those with access to financial support (e.g. personal savings or capital from friends and family). In this way, lack of exit and its pursuant financial rewards limits the pool of social entrepreneurs greatly.
- **Retain early-stage staff with equity stakes.** Early-stage ventures often do not have the money to pay market salaries. Mainstream start-ups overcome this by offering early-stage staff equity stakes. But given the lack of exits in social enterprises, equity stakes have little value (or at least a very uncertain value), thus limiting the ability of early stage social enterprises to attract and retain quality staff.
- **Transition effectively from start-up mode to a more mature corporate company**. Exit allows founders to transition out and professional managers to take the business to the next stage of development.

In a Harvard Business Review Blog entitled 'to grow, social enterprise must play by business rules', Alan Hirzel explains how many social enterprises hit a road block in their growth.

> *"Founding CEOs realize—or fail to realize—that their maniacal energy and personal devotion can only take their enterprises so far (…) They need new executive talent, infusions of capital, and systems capable of supporting an expanding organization. For-profit companies in the same situation can turn to a robust venture capital community that is focused on providing the management, financing and strategy that innovative companies need to scale up quickly. Yet those resources don't exist in the social enterprise market—even though the need is essentially the same."*[29]

He concludes that "we can't ask social enterprises to have a big impact if they can't get the resources they need to grow bigger."[30] Exit provides an important path for social enterprises to access the resources they need to grow bigger, including talented staff and capital. Therefore exit is critical for fuelling the growth of a sector that has shown great potential to achieve sustainable human development.

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[28] Nicholls and Patton (2013)
[29] Hirzel **(**2013)
[30] ibid

SECTION THREE

A SOLUTION: INTERNATIONAL AID BACKED SEE FUND

The Social Enterprise Exit (SEE) Fund is a new development finance tool that will unlock growth in social enterprises in developing countries. The aim of the Fund is to buy minority equity stakes in successful social enterprises, allowing entrepreneurs and early-stage investors to exit. The longer term aim of the SEE Fund is to catalyze the development of a liquid equity market for social enterprises, unlocking huge social impact.

This section explains how the SEE Fund will work:

- Section 3.1 articulates the gap filled by the SEE Fund in the social finance market
- Section 3.2 explains the mechanics of the fund
- Section 3.3 identifies the impact of the fund on human development goals
- Section 3.4 analyses the potential long term impact of the fund on the social finance market more broadly
- Section 3.5 outlines next steps for implementing the fund

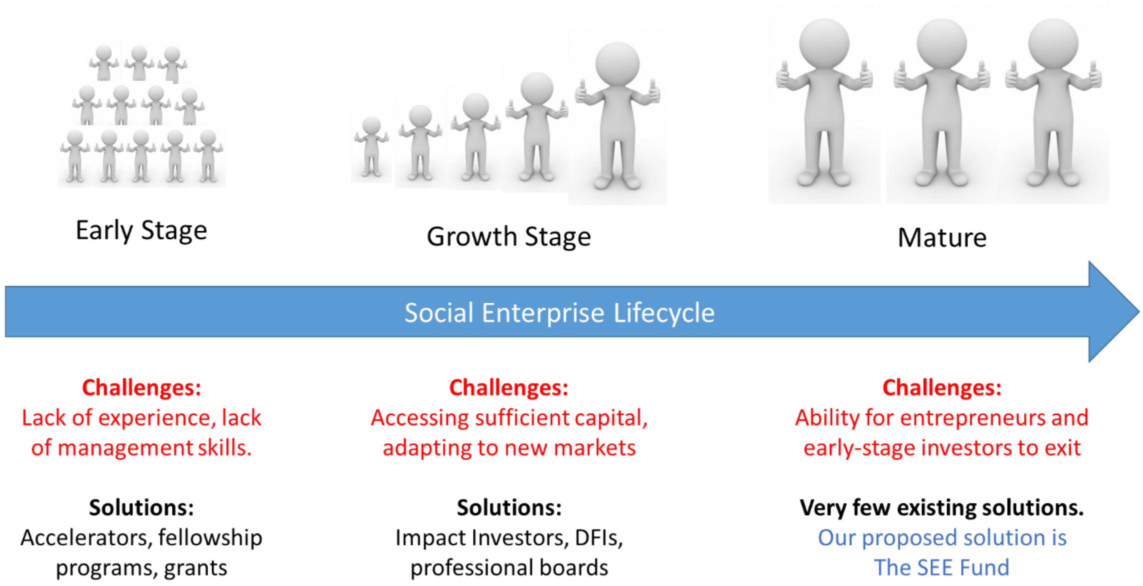
A recent Harvard Business Review article entitled 'A New Approach to Funding Social Enterprises' identified the power of new financial tools: "With the right financial innovations, [social] enterprises can access a much deeper pool of capital than was previously available to them, allowing them to greatly extend their social reach."[31]

3.1 The Gap Filled by the SEE Fund

We noted in Section 2.1 that there are a number of barriers to the financing of social enterprises at different stages in their lifecycle (see Figure 6). So why have we chosen to address the exit problem in particular? We believe that there are existing tools that address other barriers to the growth of social enterprises, but there are limited existing solutions to the exit problem.

[31] Bugg-Levine, Kogut, and Kulatilaka (2012)

Figure 6: Social Enterprise Lifecycle



Early stage social enterprises have support to develop management capability from accelerator programs (such as Village Capital Competitions) and fellowships specifically for social entrepreneurs (such as Ashoka). On the funding side, there are many grant-making organizations targeted at early-stage social enterprises.

Growth-stage social enterprises are the most attractive to Development Finance Institutions (DFIs) and impact investors as they have a track record but still have significant need for growth capital. On the capacity building side, there are a number of international conferences (AECF, Skoll World Forum) where growth stage enterprises can learn from their peers and attract more funding.

However, there is little support for later-stage or mature social enterprises. There have been initiatives to launch social stock exchanges in both the UK and Asia, however, neither exchange is liquid. For example, the Social Stock Exchange in the UK currently only has 12 listings.[32] While some more commercially-oriented social enterprises may be able to attract private investors at exit, many cannot. The SEE Fund will target social enterprises that are profitable and have a large social impact but do not attract the attention of traditional investors either due to a lack of exit opportunities for the secondary investor, social objectives that may constrain growth in profits or other perceived investment risks. We believe the development finance community needs to apply fresh thinking to support the development of a complete social finance market. We believe the SEE Fund is an important innovation to fill this gap in the social finance market.

[32] Social Investment Exchange (2014)

3.2 How it Could Work

The Fund requires a clearly defined investment mandate combined with appropriate structuring to ensure its success.

Investment Mandate

The goal of the Fund is to provide exit opportunities for mature social enterprises that currently lack commercial appeal for traditional investors, but that are delivering a significant social impact. We recommend that the SEE Fund uses the following two criteria to select investments:

1. Track record of social impact, with evidence of direct improvement on the lives (health, education, income) of the poor in developing countries.
2. Annual revenues in excess of US$ 3 million and either be profitable or have a clear path to profitability

The first criterion ensures that the social impact is central to the investment decision. The revenue threshold of US$ 3 million is open to debate and has been set with the aim of ensuring that only enterprises of a certain scale are investable. Ideally, the Fund would invest in profitable social enterprises to ensure that the Fund targets more mature and proven entities. However, we believe that the Fund should have the flexibility to invest in loss-making enterprises, provided that the enterprise has a clear, demonstrable path to profitability. This would be particularly relevant for social enterprises that are profitable at a unit level, but are spending their profits to increase growth.

Minority Stakes

The Fund would be limited to taking minority positions in its investee companies.[33] The Fund is expected to make a large number of investments across different developing economies and a wide range of industries. As such, the Fund is unlikely to have the capacity to actively manage all of its investments. By taking minority positions, the Fund allows active investors to drive the growth of the business.

Size of the Fund

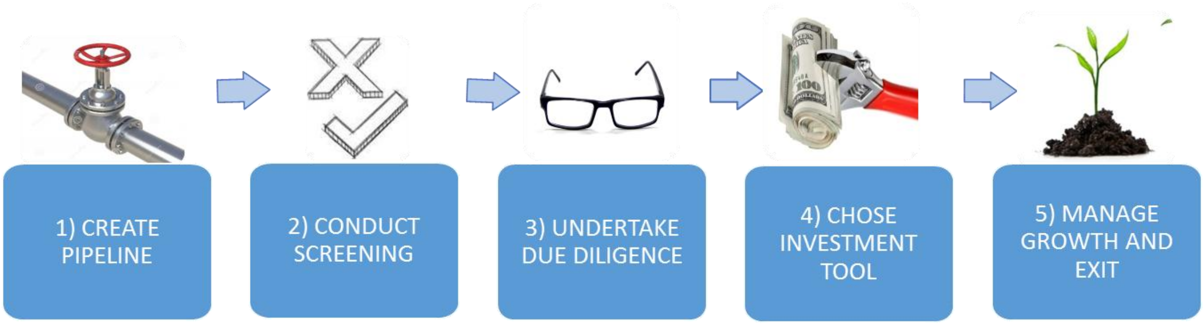
We recommend that initial commitments of US$ 200 to 500 million be made to the SEE Fund, with approximately US$ 40 to 100 million called per year for five years. We anticipate the Fund would complete five to ten deals per year with this level of funding,

[33] We considered limiting the recommended investment size to 20% in order to reduce accounting and reporting complexity (as the IFC does), but on balance believe that restricting investments to this size would severely limit the flexibility of the Fund to facilitate exits. We believe setting the investment limit at 49% should be sufficient to create liquidity in the market.

Five Step Process for Any Given Social Enterprise

The SEE Fund would manage its investments in social enterprises through a five-step process, as illustrated in Figure 7.

Figure 7: The SEE Fund Investment Process



We will now examine each of the five steps in turn to understand how the SEE fund could work in more detail.

1) Pipeline: the SEE Fund would scope out a pipeline of potential social enterprises needing to exit. The SEE Fund is likely to have a high profile in the impact investment industry and is envisaged to be funded by well-known development financial institutions (DFIs) and foundations. Through these networks, the SEE Fund should have good access to deal flow.

2) Screening: applications would be screened to see if they meet the investment criteria. Applicants need to show evidence of their social impact and their financial profitability. The SEE Fund would evaluate the other exit opportunities available to the social enterprise to ensure they are not crowding out investment.

3) Due diligence: social enterprises that pass the initial screen will progress to full due diligence. This includes examining their track record of social impact and their financial performance to date. The SEE Fund would scrutinize future plans, looking at potential for further scaling of social impact, with a particular focus on any intended changes to the board or management at exit.

There is the potential for investors seeking to exit to view the Fund as a soft target given its investment mandate and large portfolio. To mitigate this risk, the Fund will need to build a rigorous due diligence process. Unlike investments for growth equity, where the company needs the capital by a certain date to execute on its business plan, secondary buyouts have less impact on the company itself. This means that the Fund should have sufficient time to undertake careful due diligence on its investments.

4) Choose an investment tool: if the social enterprise is deemed appropriate for investment by the SEE Fund, the fourth step is to choose an investment tool. We believe the SEE Fund should use two different financial tools to facilitate exit:

- **Equity:** when the founders and early stage investors want to exit the social enterprise, the SEE Fund can buy their shares. The equity purchase could either be in a single event, or spread over instalments contingent on achieving certain social impact or financial goals.
- **Debt:** when the founders want to regain ownership in their enterprise, but do not have sufficient capital, the SEE Fund can lend the business money to buy out early stage investors. This would be dependent on the ability of the enterprise to service the debt from its cash flows.

5) Manage growth and exit: A key consideration for the Fund is how to address future capital requirements for the social enterprises in its portfolio. We believe the Fund should have the option (but not the obligation) to provide capital pro rata with its shareholding so as to not restrict the fundraising ability of the social enterprise.

One may think that exiting an exit fund defeats the purpose of the fund in the first place. On the contrary, the SEE Fund is intended as a temporary fund to spur the development of a liquid secondary market for social investments. It is hard to anticipate how long the Fund will need to run for – so at this stage we recommend an evergreen fund, which means funds received from exit are recycled. As a liquid secondary market for investment in social enterprises develops, the Fund should look to sell down its equity investments and return the capital to the funders of the SEE Fund.

The key consideration at exit is to protect the social impact. Nicholls and Schwartz (2012) explain how the main difference between traditional and social equity investments is in governance mechanisms to protect the social impact: "These might restrict the freedom of the Board in some way in order to ensure the continuation of the social mission, or provide for a certain percentage of any surpluses to be invested socially or retained by the company, or a myriad of other socially oriented limitations such as the 'golden share' that prevents take over."

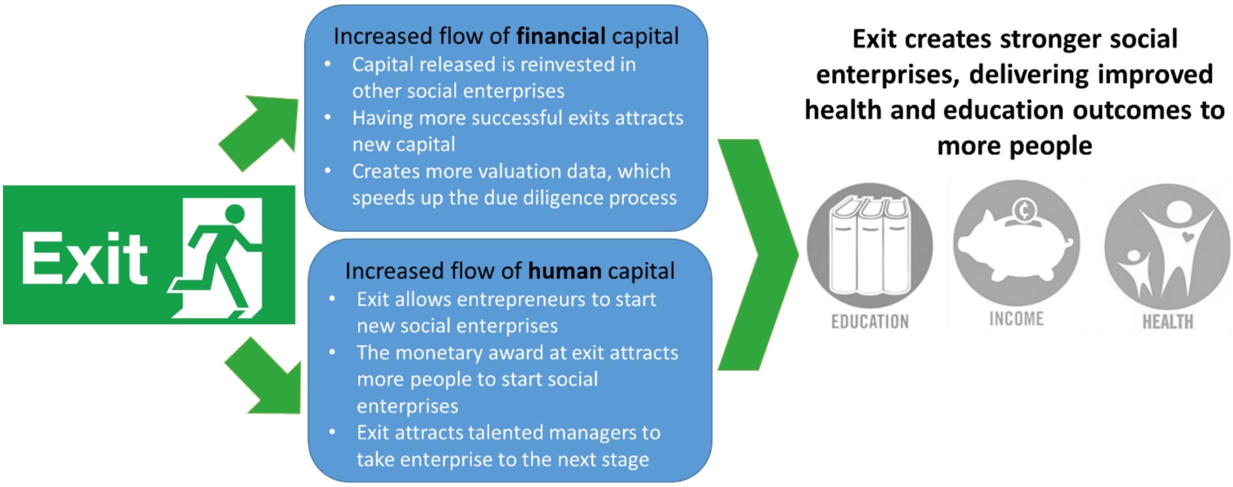
3.3 The Impact of the Fund on Human Development Goals

Given the aim of the Fund is to catalyze human development, it is important to understand how buying minority equity stakes in later-stage social enterprises can impact human development goals. The SEE Fund can have a positive impact on human development goals in two ways:

- Attracting more money into social enterprises
- Attracting more talented staff into social enterprises

With more money and better staff, social enterprises can improve and expand their social impact to more people. The flow from exit to impact is illustrated in the Figure 8.

Figure 8: The Flow from Exit to Impact



For many socially oriented investment funds, there is a stigma around using capital to purchase existing shares in companies, as the direct impact of the capital is not easily measurable. The Fund seeks to fill this gap in capital markets for social enterprises. From the Fund's perspective, capital is only allocated to social enterprises that have a successful track record of social impact, while other investors take the early-stage risks.

For every dollar released at exit, a portion will arguably be reinvested in social enterprises. Reinvestment rate data is difficult to find for impact investment funds, in part due to the lack of exits. However, given that impact investors are seeking a social impact, we believe that the churn into other asset classes is likely to be low. Therefore, we assume that a high proportion of funds paid by the Fund to exiting impact investors are reinvested in other social enterprises.

In addition to increasing the flow of financial capital to social enterprises, the SEE Fund will also increase the human capital available for social enterprises. In a 2011 Forbes interview, Kevin Jones, the founder of the Social Capital Markets Conference (SOCAP), was asked what change he hoped for in the social enterprise industry: "In five years, I think there will be cadres of social entrepreneurs on their second, third or even fourth start-ups, who have learned how to grow businesses, how to listen to, and respond to, the market and work with customers, vendors and investors on the essential elements of behavior change we need in order to respond to the challenges of the world."[34] The SEE Fund should help this

[34] Kanani (2011)

vision to become a reality: providing an exit path for social entrepreneurs allows them to start-up their next social venture.

3.4 Longer term prospects

In the longer term, the SEE Fund can act as an important catalyst in developing a more liquid market for social investment.

Exits Play an Important Informational Role in Creating a Liquid Social Finance Market

Valuing any business is hard. However, mainstream finance has developed methods to value businesses based on predictions of their future cash flows, and based on comparisons to similar companies that have achieved successful exits.

> *"It is well understood that in order to function effectively, capital markets require high levels of accurate, transparent, comparable and relevant data to price allocation options effectively and reduce transactions costs. Over many years, accounting standards have developed to support capital allocation decisions in mainstream finance, but in social finance the process of institutionalizing standard* (...) *is still at an early stage."*[35]

The SEE Fund will have to work carefully to value all businesses before it invests. As the Fund grows, the investment team will be able to build an effective cross-sectoral valuation approach for social enterprises. These valuations play an important informational role that is the cornerstone of any well-functioning capital market.

Having a More Liquid Social Finance Market Starts a Virtuous Cycle of Investment

Creating a more liquid social finance market will attract new investors. The more investors, the more liquid the market becomes; it is a virtuous cycle. The longer term goal is to make socially responsible investments a component of mainstream investment portfolios. For example, over US$ 32 trillion of assets are held by pension funds globally.[36] If an allocation of even one or two percent was made towards social investments, this would provide a huge influx of capital. Pension funds are generally passive investors and so are more attracted to stable and mature investments. There is still significant growth required in the size and professionalization of social enterprises in order for mainstream investors to invest.[37] However, one of the key hurdles that the SEE Fund can overcome is demonstrating the viability of secondary investment.

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[35] Nicholls and Patton (2013)
[36] Towers Watson (2014)
[37] Nicholls (2010)

3.5 Next Steps in Establishing the SEE Fund

To establish the SEE Fund, the international development finance community would need to take the following three steps.

1. **Rally investors:** firstly, someone from the international development finance community needs to take the lead in rallying potential investors to fund the SEE Fund. Once they have attracted sufficient interest (say 5-10 funders willing to each commit at least US$ 50 million to seed the fund) they should call interested parties to a conference to discuss the structure and mandate of the Fund.

2. **Agree on a mandate and Fund structure:** at the conference, interested parties need to confirm which social enterprises to target. For example, will the Fund target social enterprises in least developed countries only? Will the Fund be limited to social enterprises in certain sectors like health and education? Funders will also need to agree on the structure of the Fund. For example, is a 49 per cent cap on ownership stake appropriate? Is it feasible to invest US$ 100 million each year? The end goal of this conference should be an agreement to launch the Fund, including a commitment from each party of how much capital they will contribute to the SEE Fund.

3. **Hire a Fund Manager:** Once the Fund structure is agreed, the final step in launching the Fund is to recruit a Fund Manager to lead the SEE Fund. Ideally the Fund Manager will combine an impressive track record in the international finance industry, with on-the-ground experience with social enterprises. The Fund Manager will be tasked with employing an investment team to start creating an investment pipeline.

If there was sufficient commitment for establishing the SEE Fund from the international development finance committee, we envisage that the SEE Fund could make its first exit investment within two years.

CONCLUSION

Given the first wave of equity investments in social enterprises began nearly a decade ago, the SEE Fund is a much needed financial tool to enable the growth of the social enterprise sector. Social enterprises have proven their ability to have a social impact through profitable business models. This has allowed a nascent market for social finance to emerge. In order for the market for social finance to be completed, the exit problem needs to be addressed. If this can be achieved, and more financial and human capital can be attracted to social enterprises, the impact on human development could be huge.

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