



The Case of Romania

Building the Social Investment Industry in Central and Eastern Europe

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BUILDING THE SOCIAL INVESTMENT INDUSTRY IN CENTRAL AND EASTERN EUROPE: THE CASE OF ROMANIA

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Preface

THE GROWTH OF THE SOCIAL ENTERPRISE SECTOR¹ IN THE PAST TWO DECADES IS DUE TO ITS SUCCESS IN ADDRESSING ENTRENCHED SOCIAL AND ECONOMIC PROBLEMS.

The persistent problems of unemployment, poverty, social exclusion, poor social services, and environmental degradation—even in fast-growing emerging market economies—call for new, innovative solutions. Neither pure market-based nor pure public sector approaches have effectively confronted these problems. The former has tended to approach them as a side activity usually addressed through corporate social responsibility programs, whereas the latter has tended to create programs with an over-emphasis on subsidizing services for a set number of beneficiaries rather than improving the root causes of poverty and exclusion.

Social enterprises offer a hybrid response to these complex social problems. They are uniquely qualified to address the barriers that prevent disenfranchised and poor communities from accessing employment and services. These companies create jobs and placement opportunities for at-risk youth, women and people with disabilities, providing them with the hard and soft skill training, job preparation, and accompaniment needed to enter the labor force and embark in a long-term career of dignified employment. They develop business models that improve product quality, increase sales volumes, streamline production processes and provide market access, significantly

increasing the income streams of small producers and artisans. Social enterprises provide affordable high quality services in education, health care, renewable energy, as well as water and sanitation for communities that are off the grid, isolated and often invisible to the rest of society. They use technology and innovative paying schemes to make these services accessible and sustainable in the end.

Despite the success and growth of social enterprises in the last decade and the increased recognition on the part of both the public and private sectors of their importance, there is still very little available capital for these companies to grow and thrive. Social enterprises lack the financial history and do not meet the criteria required by traditional commercial banks and other financial institutions. Early stage enterprises are even less eligible, given their unproven business models and lack of consistent cash flow. There is an urgent need to close this capital gap and to develop financial instruments designed to meet the patient capital needs of social enterprises. Social enterprises need access to low interest and long-term loans to invest in infrastructure and for working capital needs. They need quasi-equity and less risk averse financing to grow their teams and operational systems. Without these mechanisms, social enterprises will continue to rely on inflexible and unreliable project-based grant funding, preventing them from growing and realizing their fullest potential.

¹ Social enterprises are businesses created to further a social goal in a financial sustainable way. They use entrepreneurial solutions to solve critical social problems including reducing high poverty levels and unemployment, especially among disadvantaged groups. Social enterprises apply business principles and practices, and reinvest their financial returns, to achieve their social ends. These enterprises engage in a broad spectrum of activities including community development, employment and livelihoods, education, conservation and environmental protection, financial services, health and universal rights. In addition, they target a wide range of marginalized or excluded communities including at-risk youth and mothers, ethnic communities, people with disabilities, small producers and artisans, migrants and refugees and low-income communities.

In order to understand this phenomenon and to be able to develop valid and realistic recommendations for fostering capital for social enterprises, NESsT set out to conduct a region-wide study assessing the Romanian and Central and Eastern Europe (CEE) state of social enterprise financing. The objectives of the research were to: (1) assess the loan products currently available to social enterprises in Romania and CEE and their capacity to meet the investment needs of social enterprises in the region; (2) make recommendations on new loans and other types of investment instruments needed by these social enterprises to align with latest worldwide trends; and (3) identify partnerships and a call to action needed to implement these recommendations.

Methodology

NESsT engaged with various stakeholders to conduct this research—social enterprises, donors, investors, corporations and government agencies—conducting a series of interviews in order to map the ecosystem, discover best practices and share lessons learned, and document conclusions and recommendations. The NESsT team created a detailed research framework, highlighting the key criteria to consider when analyzing loan products. These criteria helped assess which loan products are available and which would have to be developed. NESsT analyzed general information about the products, the stage at which they are used, the main institutions offering them, their geographical focus, their due diligence processes, and support



Social enterprises, such as Mai Bine in Iași, Romania, are developing innovative models to help to solve complex social problems in their communities, including unemployment and social exclusion.

provided to borrowers, such as monitoring and post-investment services. NESsT also evaluated the main investment criteria required by these entities including interest rate, time horizon, as well as social and financial return expectations. On the demand side, NESsT assessed the need for debt financing among social enterprises, the amounts, their use, preferred conditions and general attitudes towards this instrument.

The findings from the research indicate that there is a huge need to build on the loan products that are already in existence in the region by creating instruments that respond to the needs of social

enterprises. They also indicate that the time is ripe for this to happen, as different stakeholders expressed their interest to work together to implement the study's recommendations and to leverage the commitment of the European Union (EU) in this area, as well as to learn from global best practices. The study indicates the tremendous opportunity that currently exists to work together to provide social enterprises with access to the most appropriate financial instruments needed to grow their businesses and ultimately their systemic impact.

About NESsT

NESsT has been working for 20 years to provide dignified employment to lift people out of poverty in emerging markets. NESsT achieves its mission by raising philanthropic capital to invest in and develop social enterprises that create employment and viable income opportunities for the poorest communities facing isolation, discrimination, lack of job skills and poor education.

NESsT uses an engaged investment approach to accelerate the growth of social enterprises that offer access to dignified employment. In selecting these enterprises, NESsT places less importance on the legal form of the enterprise—nonprofit, cooperative, for profit—and looks for the intent or purpose as the most important element. In other words, does the social enterprise practice what it preaches? Does it try to balance the social, financial and environmental bottom line in its everyday running of the business in order to

solve a critical social issue? Setting a broad definition such as this is especially helpful in emerging countries where the sector is still very small, as it provides the space for the sector to grow and include many types of enterprises whose main purposes are to create social impact through a sustainable business model.

Once NESsT completes its due diligence, it invites social enterprises to join its portfolio. By committing to these enterprises for five to seven years, NESsT supports them through the tough transition of moving from start-up to fully scaling businesses. During this time, NESsT provides several rounds of patient capital investments and connects the enterprises with other co-investors. Its team also offers one-on-one business development support to help them consolidate and grow their businesses, and leverages the expertise of more than 200 mentors for specialized support. NESsT contributes to strengthening the ecosystem, working with other stakeholders to ensure that its grantees and the entrepreneurs it supports are equipped with the tools and resources needed to thrive and maximize their impact.

To date, NESsT has trained more than 2,300 people in social enterprise in Romania. It has invited 21 social enterprises to enter its portfolio providing them with an average of four years of support and investing over US\$1 million in capacity building and direct funding. Close to 1,700 marginalized individuals have attained employment or income opportunities and almost 20,000 have experienced an improved quality of life.

NESsT GLOBAL IMPACT TO DATE

Since 1997, NESsT has invested in and supported social enterprises in emerging market countries.



167
social enterprises
supported



\$11.5 million
invested



31,000+
economic
opportunities
created since 2008



509,000+
lives improved



44%
social enterprises
break even by year 2
in the NESsT portfolio



19%
revenue growth of
social enterprises in the
NESsT portfolio in 2015

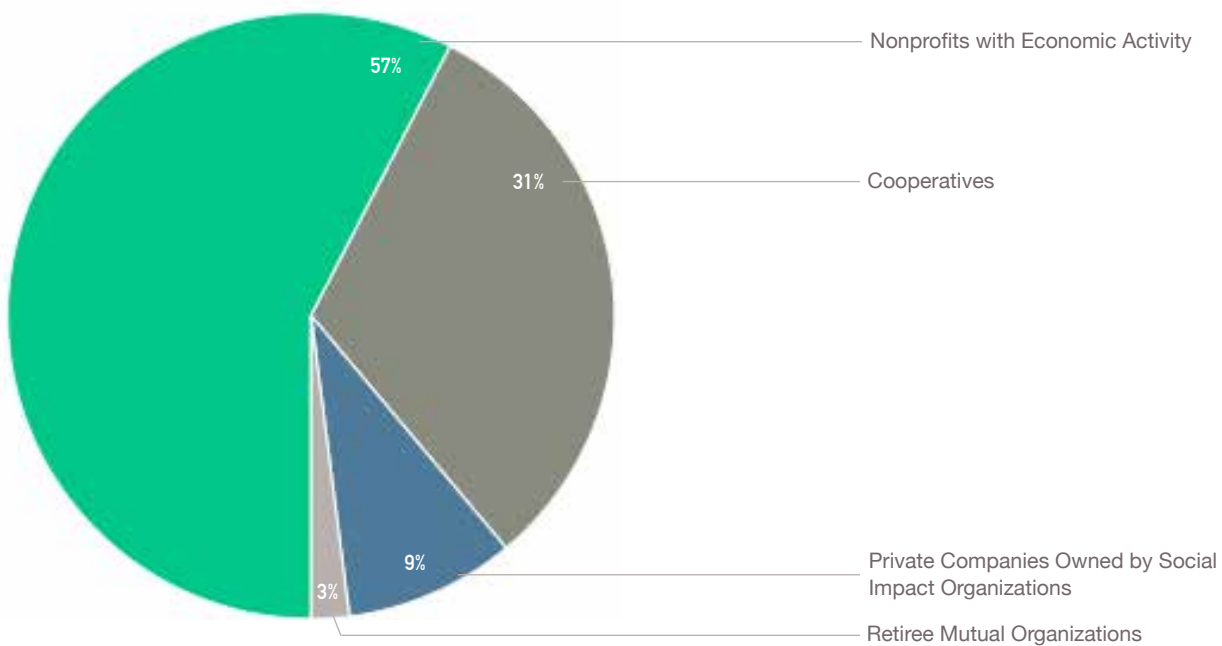
Social Enterprise in Romania

According to Eurostat, Romania is among the European countries with the highest poverty rate, with 39.5% of the population at risk of social exclusion in 2014 and 25.4% at risk of poverty. Due to the high unemployment rate among youth (21.7%), the significantly higher percentage of youth neither in employment nor in education and training (18.1%) compared to the EU28 average (12%) and the growing aging population (17% of the population aged 65+), Romania will most likely experience deeper social problems and higher inequalities in the coming years.

Romania is the European Union (EU) country with the lowest level of access to financial services. According to the World Bank, only 60% of the population has a bank account (35% in rural areas), compared with the Euro zone average of close to 95%.² The same is true for social enterprises—less than 2% accessed financing support in 2015.³

One of the most complete reports providing statistically relevant data is the Social Economy Atlas,⁴ published in 2014 by the Social Economy Institute. The report confirms that the number of social enterprises provided by the National of Statistic Institute in 2012 is accurate.

Table 1: Social Economy Organizations in Romania



Source: Barna, *Social Economy Atlas, Romania 2014*.

² Demirguc-Kunt, Klapper, Singer, and Van Oudheusden, *The Global Findex Database 2014: Measuring Financial Inclusion around the World*.

³ Ministry of European Funds, Romania, *Ex-ante assessment for financial instruments for SMEs in the 2014-2020 programming period*.

⁴ Barna, *Social Economy Atlas, Romania 2014*.

Approximately 91% of social enterprise employees work full time. Organizations have staff of one to 60 employees, with an average of nine per organization. On the revenue side, the gaps are even bigger—the average annual revenue is €420,000, with the highest at €4.7 million and the lowest at €1,200. More than half reported profits, although social enterprises often assign grants, donations and subsidies as revenues. This makes it difficult to estimate to what extent these are truly economic profits based on sales revenue only.

Until recently, there was no clear definition of social enterprise in Romania. This changed when a new law regulating the social economy defined the term and articulated a common understanding of the concept. This represents a great step forward, as the lack of a clear legal and regulatory framework was often cited as a challenge by most sector stakeholders in the past.

The above-mentioned 219/2015 law and its norms cover the following key areas:

- Defines the social economy and clarifies two concepts—social enterprise and insertion social enterprise. As long as it is certified as such by the local labor agencies, any legal body can be a social enterprise. In order to be certified, a social enterprise must respect:
 - A set of principles, defined as (1) an independent legal body with priority given to the social mission as opposed to profits, (2) joint responsibility, (3) alignment with the interests of the local communities, (4) democratic control, (5) profits allocated to the social missions, (6) voluntary and free association, and
- Legal criteria, defined as (1) social or community driven, (2) at least 90% of profits invested in the social mission, (3) transmits all its assets, in case of liquidation, to another SE, (4) equitable salary levels, with 1 to 8 the maximum accepted differences among employees. Social enterprises can be nonprofit or for-profit in form.
- Sets up a certification process that provides a social enterprise label that is valid for three to five years and is also applicable to the enterprises' products and services. It also sets up a National Register for Social Enterprises, aimed at gathering and providing access to data and statistics. The label brings a set of obligations for social enterprises, requiring them to submit financial, legal and social impact reports. They are also subject to annual controls to assess if the social enterprise complies with the criteria to preserve the label. Social enterprises employing at least 30% marginalized persons and already defined as such by the new law may ask the Social Economy Department—a structure within the local labor agency—for the social label. The social label, valid for three years, is different from the social enterprise label, and it's aimed at emphasizing the job generation aspect of the impact. See Box 1 (page 10) for the NESsT perspective on social labels.
- Describes the state mechanisms to incentivize and support the development of social enterprises

BOX 1: NESST POSITION ON SOCIAL ENTERPRISE LABELS

NESST believes that supporting legislation that simplifies the establishment, implementation and reporting of social enterprise activity would go very far to foster their growth. Some countries in Europe are implementing “B-corporation” certification, a certification process which recognizes entities focused on social and environmental impact. Certifying social enterprises could potentially position them to leverage funding, including qualifying them for public procurement opportunities. In NESST’s opinion, this should be one of the main goals of the Romanian label.

However, while labels can be very useful in raising the visibility and promoting the concept and models of social enterprise, labels should be demanded and appreciated by customers. Such consciousness and demand from the market does not seem to exist in most of Europe yet (certainly not in CEE), therefore obtaining the label might not bring market advantage and differentiation to social enterprises currently. On top of this, the existence of two labels—the social enterprise and the social one—might generate confusion among both practitioners and the general public. Also, caution is required when linking the label to the definition, as it seems to be the case now in Romania, since it is not desirable early in the development of the sector, to reduce the social enterprise sector to only those organization that have obtained the label.

Labeling brings up the huge issue of social impact, since granting the label would depend very much on the social enterprise’s ability to demonstrate social impact. This is a topic of debate in the field: what is considered social impact, what indicators should be used, and how should that impact be monitored. If social impact can be achieved only in the long run, it could be extremely difficult to determine compliance beforehand. If obtaining a label is connected to achievement of social impact, the field might have to contend with shorter-term outputs or outcomes. It is a global trend that impact measurement and reporting is becoming more standardized. Social enterprises and social investors are looking for common indicators and reporting formats to understand performance and impact better and to be able to make comparisons. These standardization efforts could help

raise awareness and understanding, but need to be treated with caution so as not to homogenize a very diverse sector. Perhaps a quality assurance label (depending on business performance and social impact standards), which social enterprises can apply for voluntarily, could be beneficial in further developing the field and providing credibility to funders and customers.

Public procurement government agencies can use their project approval and procurement powers to support social enterprises, and also establish or subsidize financing mechanisms specifically for them. At the moment there are few social enterprises that are able to participate in public procurement, as public authorities are unreliable clients, and they often do not have the public procurement procedures that would open bidding processes to organizations, including social enterprises. So in this sense the labeling effort could be strengthened by the reform of public procurement procedures, which could in the future give preference to labeled social enterprises in some industries. Many believe the European Commission will push for simplification, inclusion of social enterprise and a universal use of new procedures across Europe, as they see public sector markets as an opportunity to boost social enterprises. Best practices in Sweden and Belgium give preference to social enterprises in certain public contracting cases. They reserve some contracts, take social impact into account when selecting among bidders, or encourage social enterprises to establish partnerships with other bidders, allowing them easier access to public contracts. In Hungary, for example, regulations prescribe that social impact considerations should be taken into account when procuring services or products for the public sector, but the attempt fails in the implementation phase, as these considerations do not actually appear in the tender announcements. Therefore public procurement reform (regulation and implementation) is a key measure. Existing possibilities offered by the current public procurement rules need to be better understood and exploited by countries. Social enterprises suffer from the lack of understanding on behalf of their local authorities of the existing EU procurement guidelines, and this is one of the reasons why implementation is lagging behind.

Source: Etchart and Comolli, *Social Enterprise in Emerging Market Countries: No Free Ride*.

(i.e. tax incentives, right to use the local public real estate facilities, support in promoting their products/services, state aid mechanisms, counseling from public agencies).

In 2015, NESsT published a Romanian Country Report based on the outcomes of extensive research, carried out within a flagship multi-disciplinary, multi-method international research project on social enterprise funded by the European Commission (SEFORIS). The report highlights the findings on the status of social entrepreneurship in the country.

As described in the report,⁵ the European Social Fund had a significant impact on social enterprise growth in Romania. The availability of large EU grants has led many nonprofits to develop social economy projects and create—not develop—social enterprises. Unfortunately, most of the EU funding leads to a proliferation of projects promoting the concept of social enterprise through activities such as creating websites, physical or online resource centers, conferences and information campaigns. As far as fostering social enterprises themselves, the way the funding is structured does not allow them to go through a process of business model validation leading to growth and sustainability. The funding is focused on short-term job creation and other short-term activities (i.e. workshops) during the period of the funding cycle, but not for the longer term type of investment that social enterprises need to enhance their marketing, sales, human resources and overall operations. Nor does EU funding

BOX 2: TRADE-OFFS BETWEEN REGULATION AND FOSTERING SOCIAL ENTERPRISE

The Case of EU Policies

1. Only available for larger and stronger organizations
2. Risk averse, while at the same time not requiring sound business plan which could mitigate risks
3. Provide false incentives and encourage project-based short-term thinking that does not lead to sustainability of enterprise activities
4. Focus on meeting administrative goals, rather than achieving social impact
5. Inadequate screening of applicants which leads to disbursing funds to organizations with no experience or content, causing long-term damage on the growth of the sector
6. Provide little or no funding to support organizations, and other intermediaries committed to building the sector no long-term capacity building nor technical assistance.
7. Require co-financing not provided or delayed at national level
8. Call for tenders often suspended at national level and disbursements delayed causing cash flow problems and even bankruptcy

Source: Varga and Etchart, *Trade-Offs Between Regulation and Fostering Social Enterprise: the Case of EU Policies*.

⁵ Etchart, Iancu, Rosandic, Mocanu and Paclea, *The State of Social Entrepreneurship in Romania, SEFORIS Country Report*.

provide the kind of patient financing that would permit these enterprises to be positioned for growth.

Box 2 (see page 11) provides a comprehensive summary of why EU funding does not lead to sustainable social enterprise and impact.

Most of the outcomes of the 2015 research continue to remain valid today:

1. Despite the awareness raised, the sector is still in an early stage of development.
2. It is still difficult to get objective, accurate and up-to-date statistical data on the number of social enterprises, jobs created and sustained, and environmental impact.
3. An increase in relevant training programs for social entrepreneurs is required to ensure success.
4. Major challenges are: (1) access to finance, (2) access to markets (i.e. they are small and fragmented, with limited marketing capacities), (e) access to talent, and (4) operating in a risk adverse environment, with limited room to fail, leading the social enterprises to incur and manage the excessive costs of innovation, including the generation and piloting of new ideas or products. In the absence of their own resources, many to-be-entrepreneurs simply give up.
5. Monitoring impact seems to be perceived as only an external request and the number of people employed is the most commonly tracked indicators.
6. A complex ecosystem exists with a multitude of stakeholders, including the following:
 - Policymakers: Directorate for Social Inclusion Programs at the Ministry of Labor, Family, Social Protection and Elderly, National Agency for Workforce, Ministry of Economy, Commerce and Business, Ministry of Agriculture and Rural Development, Ministry of Justice, Commerce National Office, etc.
 - Public bodies implementing policies, like social enterprise certification and labeling (i.e. local labor organizations, with special social enterprise departments)
 - Private structures: Romanian Chamber of Commerce, Commercial organizations, Industry Associations
 - Support organizations (i.e. incubators, accelerators, capacity builders, online platforms, mentors, exchanges, good practice sharing)
 - Social enterprises support networks (i.e. the Institute for Social Economy)
 - Universities and research organizations
 - Social investors and social finance intermediaries
 - Consumers
 - Business partners
 - Constituents

However, on the positive side, as of 2016, a strong and evident collaborative effort has emerged in Romania to shift the use of funds towards real impact. These efforts involve a variety of bodies including the Ministry of European Funds, the Ministry of Labor, Family,

Social Protection and Elderly, social enterprises and intermediaries who are aligning themselves to address issues of poverty and exclusion in the country.

This shift has occurred alongside the growth of social entrepreneurship in Romania. NESsT has seen this through its own experience with an increasing number of applicants interested in joining its portfolio. From one year to the next, the entrepreneurs have a clearer understanding of their businesses and are developing stronger business models.

There are also more organizations (i.e. foundations, corporations and financial institutions with corporate social responsibility programs, intermediaries, incubators, etc.) providing these enterprises with support. In Romania, major private entities are financing the social economy and social enterprises, such as OMV Petrom with its Fabricat in Tara lui Andrei program, the Romanian-American Foundation, Citi Foundation/ Citibank, Romanian Commercial Bank, Unicredit Țiriac Bank, Open Society Foundation (SOROS Foundation), Potsieu.ro (a new crowdfunding platform), Velux Foundation, Erste Foundation, The Swiss-Romanian Cooperation Program and the European Economic Area Mechanism (both managed by The Civil Society Development Foundation), Horizon 2020, Erasmus+, and other European Commission grants. Although this increasing commitment of the private sector on social change is a positive trend, there still needs to be a greater focus on longer term impact. See Box 3 (page 13) for more details.

BOX 3: CORPORATE SOCIAL RESPONSIBILITY VS SOCIAL INVESTMENT

The concept of corporate social responsibility (CSR) has been evolving over the past decade and more advanced companies are beginning to regard philanthropy and CSR activities as somewhat outdated and focused more on marketing than actually sustainable social impact. Increasingly companies are embracing the concept of “social investment” as they begin to assess how they might incorporate social and environmental impact as part of their core business and investment activities.

Despite this global trend, corporations in Romania (and CEE overall) continue to house their CSR and philanthropic efforts within their marketing, public relations or community affairs departments, which means that they are regarded as a cost of business for the company. It also means that the amount of funding and their “expected return” is dictated by marketing and public affairs considerations. At the same time, because the concept of social investment has become trendy, many companies have started to use the term interchangeably with CSR support. This is misleading, as it disguises the true characteristics of social investment and hides real unmet needs. CSR is very often short term, based on ad hoc funding, which can be coupled with volunteer engagement on the part of the corporation’s employees. It is rarely set up in a way that would ensure either long-term engagement or sustainability, but rather around annual campaigns or programs with significant visibility and marketing. Social investment, on the other hand, implies investing in social enterprises and other types of organizations for a measurable social return, while also allowing for modest financial return if the business model allows it. These investments are committed for the long term, look to create a sustainable operation and share the risk with the investee. Social investment does not expect a reputational or marketing benefit. CSR and social investment both play a significant role in supporting and financing worthwhile efforts to solve social problems, but we should be aware that they are quite different models and approaches to supporting social issues, and therefore shouldn’t be used interchangeably.

Source: NESsT, 2016.

Financing Social Enterprise for Maximum Impact

SOCIAL ENTERPRISES NEED CAPITAL TO GROW. THE TYPE AND LEVEL OF CAPITAL IS CLOSELY TIED TO THE STAGE OF DEVELOPMENT OF THESE COMPANIES.

Based on the now well-accepted “From Blueprint to Scale” model of social enterprise development (see Figure 1 on page 15), enterprises move from the blueprint (idea, launch or pre-revenue) stage, to the validate (post revenue but not yet breaking even) stage, to the prepare to scale (breaking even and sustainable but not yet growing) stage to, finally, the scaling stage. To go through these stages can take anywhere from five to 10 years, and each stage requires focusing on a different set of objectives that are fundamental to achieve before moving onto the next stage. Successful social enterprises that reach scale are those that are led by entrepreneurial teams that have the core competencies needed at each stage or that realize that they must bring on talent with these competencies. They are the ones that are able to get their high-quality products and services to market at the right price for the right cost/revenue structure. They are also the ones that can leverage the networks and financing needed at each stage of growth.

In the blueprint stage, social enterprises need grants that allow entrepreneurs to plan and get their enterprises off the ground. These funds come mainly from public sources, private grants or friends and family donations. In the validate and prepare to scale stages, patient capital⁶ continues to be very important. In many cases, enterprises have not reached break-even and are not in a condition to take on debt, nor do they have clear

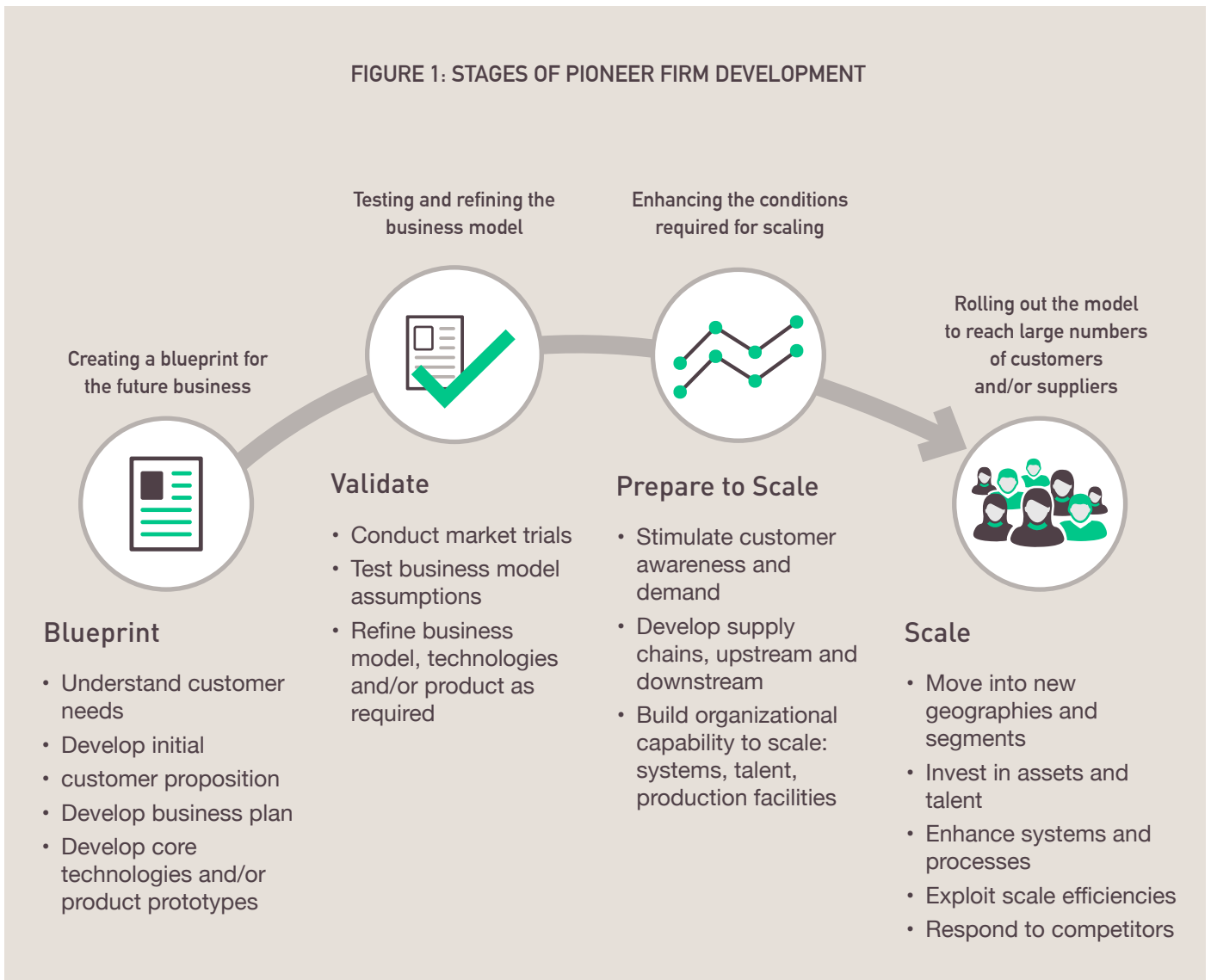
exit strategies allowing them to offer equity. In these cases, donations and/or long-term, low-interest loans whose repayment is tied to performance milestones, are very effective and valuable instruments for the development of these enterprises. In the most advanced stages, enterprises are usually in a position to take more commercial types of financing. In addition, the instrument used at each stage of enterprise development also has to do with levels of financing needed. At the blueprint and validate stages, levels tends to be US\$25,000 to US\$300,000, whereas at the prepare to scale and scale stages, the levels move from US\$300,000 to more than \$US1 million. Figure 2 (see page 16) shows the appropriate mixed instruments for the growth stage and level of financing needed.

Mixed Financial Instruments for Social Enterprises and Hybrid Models

To respond to the diverse financing needed by social enterprises and other types of hybrid models, a wide array of financing instruments have emerged in the past 25 years, and particularly in the past decade. These innovative instruments are often backed by socially focused donors (both private and public) and investors, piloted and validated, before they are introduced in the marketplace on a wider scale. The more advanced markets are actively using many of these instruments while emerging and frontier markets, such as those in CEE, are slower to adopt them. To follow is a comprehensive list of these instruments, their purpose and how they are funded.

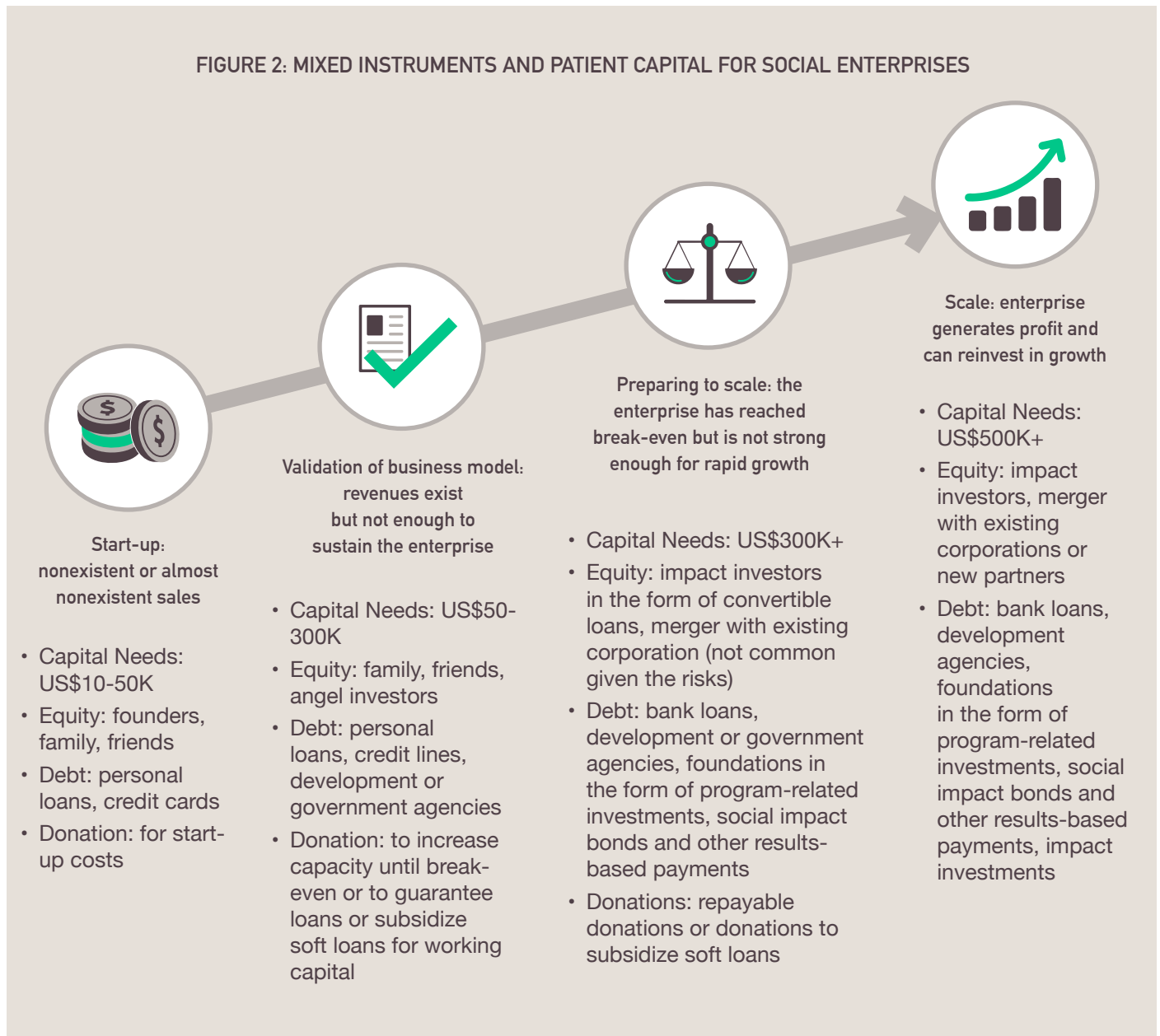
⁶ Patient capital refers mostly to debt capital that has softer lending terms, including lower interest rates and longer repayment periods. This type of capital gives the enterprise more time to achieve sustained growth until it is ready to take commercial financing. It is capital that financially backs enterprises during their consolidation process and it often comes from philanthropic sources.

FIGURE 1: STAGES OF PIONEER FIRM DEVELOPMENT



Source: Koh, Karamchandani and Katz, *From Blueprint to Scale: The Case for Philanthropy in Impact Investing*.

FIGURE 2: MIXED INSTRUMENTS AND PATIENT CAPITAL FOR SOCIAL ENTERPRISES



Source: Adapted from *Enterprise Development Toolkit* and *Social Enterprise in Emerging Market Countries: No Free Ride*.

Non-recoverable Grants

Non-recoverable grants can be used for a whole range of purposes, including capacity building, organizational infrastructure, business planning, hard assets investments—mainly real estate—innovation and research. They are disbursed under a wide range of conditions, including as unrestricted grants, matching grants, challenge grants or seed grants. Non-recoverable grants are available from national and local governments, international and regional organizations, foundations, trusts and corporations. The donors expect social impact returns only. They are usually used at start-up stage, before a social enterprise becomes investment ready,⁷ as they do not bear any interest rates or return expectations, and tend to be awarded based on a convincing proposal that has to:

- Demonstrate a need for the project.
- Show that the project is well planned and accurately budgeted.
- Provide evidence of good management.
- Illustrate how the project will make a difference.

Recoverable Grants

Recoverable grants include an agreement to treat the investment as a grant if the project, program or enterprise is unsuccessful. If successful, the grant must be repaid, based on mutually accepted milestones. This enables the recycling of investment capital from successful enterprises, with focus on social value creation. Recoverable grants are used to finance higher risk activities where revenue generation and repayment are not as certain, mainly at the beginning of the growth stage when early results are already visible.

They are also used in regions with high currency or other macroeconomic or political risks and are useful to test business feasibility, potentially attract additional capital, and develop market discipline within the social enterprise.

Program-related Investments (PRIs)

Program-related investments is a concept initiated by the Ford Foundation in 1968. PRIs are investments made by foundations to support activities that involve the potential return of capital within an established period. PRIs include financing methods commonly associated with banks or other private investors, such as loans, loan guarantees, linked deposits and even equity investments. PRIs are made with the explicit understanding that those investments will earn below-market returns, adjusted for risk and mission. PRIs have been around for a while, but grant makers have been slow to implement them. They provide a bridge to mission-related investing. To NESsT's knowledge, the Romanian American Foundations is the only organization that is using this instrument in Romania.

Loans

Repayable form of finance of varying structures, depending on the purpose (i.e. investment vs. working capital) and the provider(s) of the loan. Loans carry interest, which has to be paid to the lender on a regular basis, within the agreed time, often along with regular installments of the principal (the initially borrowed amount). Patient loans are made available by foundations, patient/impact investors, financial intermediaries, and have longer repayment periods and/or lower interest rates.

⁷ For NESsT, these are the main characteristics for a social enterprise to be considered investment ready: (1) strong business performance, (2) tools and practice to measure social impact, (3) strategic planning, (4) good governance, and (5) realistic and ambitious growth plans.

Lines of Credit

Lines of credit provide flexibility to a business, because a line of credit allows accessing money when needed rather than having to take it in a lump sum. The flexibility makes lines of credit a useful tool for managing the cash flow of a business—tapping into the line of credit when needed and paying it off with future revenues. Social enterprises registered as nonprofits are not eligible for lines of credit in Romania. This instrument has been used by the for-profit social enterprises in some cases, but it does not represent a wide practice in the sector.

Guarantees

Guarantees are written commitments to assume responsibility for all or part of a third party's debt or obligation or for the successful performance by that third party of its obligations if an event occurs which triggers such guarantee, such as a loan default.⁸ They are a promise to pay from the guarantor, in order to facilitate loans from third-party lenders and are especially useful when the borrower has no collateral.

Convertible Debt/Loan/Notes

Convertible debt involves borrowing money from an investor with an intention to convert the debt to equity later. The final document needs to set out when the loan will convert and how it will convert. Convertible debt is very well suited for short-term investments. It is especially useful in situations where there is a desire to participate in long-term growth, but a reluctance to

be exposed to high levels of risk. It is also suitable for uncertain markets e.g. where the expected growth is initially low, but where growth may rapidly accelerate due to certain foreseeable factors. The most popular conversions are equity and grant. The convertible notes can also be paid back to the investor with below-market interest.

Angel Finance

Angel finance is an investment in a business with high growth potential that can be made at the start-up, early results or beginning of growth stages—in exchange for equity ownership interest. Often, angel investors get involved in the boards of their investees, providing strategic guidance.

Equity

Equity is provision of capital to a firm, invested directly or indirectly in return for total or partial ownership of that firm and where the equity investor may assume some management control of the firm and may share the firm's profits.⁹ In some cases, the investor is interested in obtaining a social impact first and secondarily a financial return. In other cases, it's the other way around. To be able to obtain equity finance, social enterprises have to be registered as for-profit companies and must be able to provide the investor with an exit, meaning that the company is sold and the investor obtains the profits from the sale. This instrument therefore requires valuation of the business.

⁸ European Commission, *Guidance for Member States on Financial Instruments – Glossary*.

⁹ European Commission, *Guidance for Member States on Financial Instruments – Glossary*.

Quasi-equity (Mezzanine Finance)

Quasi-equity is a type of financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity. Quasi-equity investments can be structured as debt, typically unsecured and subordinated and in some cases convertible into equity, or as preferred equity.¹⁰ A quasi-equity debt security is particularly useful for enterprises that are legally structured as nonprofits and therefore cannot obtain equity capital. Such a security is technically a form of debt, but it has an important characteristic of an equity investment: its returns are indexed to the organization's financial performance. The security holder does not have a direct claim on the governance and ownership of the enterprise. It's generally used for business start-ups and to meet various short- and long-term needs of existing businesses, such as equipment purchase, working capital, leasehold improvements, inventory or real estate purchase. It usually requires an asset as collateral. It should be noted that some current definitions of quasi-equity also embrace use of subordinated, unsecured debt as well as social impact bonds that are provided as upfront capital tied to expected results of a specific social initiative.

Hybrid

Mixed financial instruments, usually public funds taking part of the risk or providing a guarantee, in order to leverage private capital.

Social Impact Bonds

Social impact bonds are financial mechanisms in which investors pay for a set of programs or services to improve a social outcome that is of social and/or financial interest to a government agency. If the social outcome is realized, the government agency repays the investors for the initial investment plus a return for taking the initial financial risks.¹¹

P2P Business Lending

A major innovation in the supply of debt to business, peer-to-peer (P2P) business lending is based on the use of internet-based platforms to match lenders with borrowers. P2P business lending is a direct alternative to a bank loan. It can often be more quickly arranged and it allows partners, customers, friends and family who invest through the platform to share in the returns of the business. Investors can lend small parts of individual loans, for very small amounts, which encourage a wide range of lenders to participate across multiple loans. Kiva is NESsT's strategic partner in leveraging such debt for its Latin American portfolio. To date, NESsT has made four loans to its portfolio with capital raised through the Kiva platform.

¹⁰ European Commission, *Guidance for Member States on Financial Instruments – Glossary*.

¹¹ Social Finance Limited, *Introduction to Social Impact Bonds*.



CASE STUDY 1

Successful Lending to a NESsT Social Enterprise

Kék Madár Foundation
Hungary

ACCESS TO FINANCING HAS ALWAYS BEEN A BARRIER FOR MANY EARLY-STAGE SOCIAL ENTERPRISES IN THE NESST PORTFOLIO.

From the beginning, NESST provided grants for its portfolio in amounts of \$US10,000 to US\$20,000, often offering several rounds of funding. However, as these companies matured, had consistent cash flow and needed greater levels of financing for investment and growth, new forms and levels of capital were needed.

In 2009 NESST made its first mixed financial investment in Kék Madár Foundation, which had been a member of its portfolio for two years. This was also the first time the enterprise took this type of financing.

Kék Madár is a foundation established in 1997 in Szekszard, Hungary, with the mission to create economic and educational opportunities for people with intellectual and physical disabilities. It provides job training and temporary employment, to help its beneficiaries with the transition to full-time employment and independent lives. In 2006 Kék Madár approached NESST and started the business planning process for a restaurant. This restaurant would train and employ people with intellectual disabilities, and would offer a nutritious dining alternative to customers. With NESST's capacity building and financial support (in the form of a grant) the restaurant (Ízlelő) was launched in May 2007 and entered the NESST incubation portfolio. Offering daily specials to a group of loyal customers, plus catering for events, the restaurant became one of the favorites in Szekszard.

In order to finance the launch of the restaurant, Kék Madar applied to the EU-funded Human Resource Development Operative Programme (HEFOP) of the Hungarian government, and they succeeded in getting a grant to cover the initial investment for the renovation of the building and the purchase of equipment, as well as some of the early salaries and operating costs of the restaurant. The EU covered 68% percent of the start-up costs, and the remaining 32% was covered by the organization. The business reached its break-even point when they were able to have a stable, loyal customer circle of about 70-80 people and were employing seven people with disabilities.

Kék Madár needed significant liquidity to cover running costs, so they agreed to an overdraft facility with their bank (a local savings cooperative named Dunafoldvar Savings Cooperatives Ltd)—with an interest rate of 12%. The organization used the overdraft two times, in 2005 for €38,610 and in 2006 for €77,220. Both were bridge loans for EU projects that required fronting expenditures that would be reimbursed by the EU grant. The loans were guaranteed by the EU contract. To be eligible for the guarantee, they had to apply, submitting a detailed application form, cash flow plans, financial statements and documentation of current contracts. The whole process—from submission of the application to receiving a decision and receiving the funds—took about two months.

The biggest challenge throughout the process was preparing the documentation, as the lender did not provide much assistance. The organization had to pay

a fee to the bank (close to €2,000) and four members of the board had to give personal guarantees or collateral.

Between 2007 and 2009, they validated their business model offering a high-quality, family-friendly proven menu and services to a loyal and growing customer base. In 2009 Kék Madár approached NESsT again, this time with an ambitious plan to quadruple the restaurant from 25 to 100 seats, with 60 seats serving 150 daily customers and 40 seats in a separate space for catering services. However, the enterprise needed significant funding to purchase a neighboring building to transfer the Kék Madár offices, freeing up the needed space in the existing building for the expansion and refurbishment of the restaurant which would be funded by the EU. The estimated overall costs for this was US\$181,700, or 23% of the organization's total projected revenues in 2009. The business plan demonstrated that there was a clear market demand to expand the restaurant's capacity and to launch a catering service. However, Kék Madár had not been eligible to obtain commercial loan financing without using the executive director's home as collateral.

Kék Madár had a solid track record and a history of winning and strategically implementing significant grants. The foundation's executive director is an exceptional, committed leader who won the "Most Inspiring Woman of the Year" (business category) award by a Hungarian women's magazine. These factors carried a lot of weight when NESsT decided to offer a grant and loan combination totaling US\$85,000

(US\$30,000 grant and US\$55,000 loan) for the purchase and refurbishment of a new building. This financial investment has been accompanied by about US\$60,000 worth of capacity support—mainly in the areas of sales and product development, client feedback and satisfaction rate collection system, inventory management and higher-level financial management—an essential part of the NESsT portfolio package.

The investment enabled the organization to move its offices and childcare facility under a new roof. According to initial calculations and sales projections, the expanded restaurant and catering services would yield a 13-17% increase in revenues over five years, which would result in net revenues of up to US\$21,000 per year. Repayment would be made through six annual installments with NESsT receiving a 3% interest rate contingent on business revenues. NESsT decided to request this modest transaction fee and made it payable in installments, depending on the business performance of the restaurant, in order to provide flexibility for the management. The loan was backed by a mortgage on the newly purchased building, standard practice for real estate loans in the social finance sector. The conditions were jointly determined by NESsT and the foundation to ensure the best loan solution for Kék Madár's needs.

The term was long enough to take into account the refurbishment period and the relaunch of the restaurant. This was also an advantage when the processing of the government grant was delayed by two years. Supplementing the loan with a grant helped to

determine the optimal level of debt that the organization could comfortably take on. Overall, the package proved to be the right combination of mixed instruments to use in the Kék Madár case. The enterprise was always on track with repayments and earlier this year the loan was fully reimbursed, allowing NESsT to recycle the money by investing it in other portfolio enterprises.

From 2011 until 2015, the social enterprise was preparing to scale. They expanded the restaurant, launched a food production unit, prepared the documentation in order to franchise the business model and replicate it in other cities in Hungary.

Kék Madár is now ready to scale the business with two new restaurants to be opened in 2017 and two more in the next five years. NESsT provided additional grant funding of US\$54,000 and supported the foundation in developing the franchise model by leveraging pro-bono legal advice. Kék Madár needs an additional US\$650,000 from co-investors: US\$230,000 from an EU grant, US\$140,000 from the local government of Paks, and the remaining US\$280,000 from private sources. NESsT is working closely with the enterprise to prepare the investment documentation and introduce the leadership team to its network of investors.

To date, the social enterprise has trained 45 disabled people in catering, provided dignified jobs to 27, and ensured the sustainability of the social services provided to more than 500 disabled persons.



Thanks for financing from NESsT, the Kék Madár Foundation was able to expand its restaurant and catering services, offering greater opportunities for training and jobs for people with intellectual and physical disabilities in Szekszard, Hungary.

The main reasons NESsT felt comfortable with taking the risk and making its first social enterprise development loan in Kék Madár are:

- Strong relationship: NESsT had been working with Kék Madar for a number of years. It had a strong alignment with the organization and influence over the way the business was shaped.
- High performance: The organization had made great progress in meeting its financial and social goals at the time of the loan decision, and made a convincing case that it would continue to do so. This was and continues to be well documented

and monitored in annual performance plans and agreements, which are fully integrated into their processes.

- Strong human resources: The organization has a very committed and professional staff led by an extremely capable, resilient, strategic and visionary leader.
- Transparent governance: Kék Madár provides timely information about key board decisions to NESsT. Its financial management and statements are accurate, transparent and up-to-date. This and the above factors lead to a trust-based relationship, which is the essence of a formal partnership with commitments and regular monitoring.
- Right phase of enterprise growth for new financing: Kék Madár reached an expansion phase in the development of the social enterprise backed by a convincing value proposition and documented with a new business plan.
- Need for debt finance: The organization was open to the idea of borrowing from NESsT. The initial quick analysis indicated that a loan, perhaps mixed with grant, would be an adequate form to address the financing needed and that the enterprise would have the potential to repay the loan from the expected increased cash flow.
- The existence of complementary financing options: NESsT was a co-financer which ultimately allowed the enterprise to leverage the EU grant.

Both partners made the story a success. Kék Madár offered its long-term view, strong leadership, openness to keep on learning and overcome challenges, commitment to the social cause, high-quality branding and positioning. NESsT provided a long-term approach, strong business acumen and networks, and flexible and patient funding.

Like Kék Madár, social enterprises in Central and Eastern Europe (CEE) need patient capital in the form of recoverable grants, low-interest loans, loan guarantees, convertible debt and other forms of quasi-equity. These types of instruments practically do not exist in the region, though, leaving most enterprises dependent on short-term, project-based funding which stifles their growth. Some manage to package their enterprises into employment or social service projects in order to access EU grants. However, this is also non-sustainable or tied to business performance. Private donors tend to have a low appetite for risk, providing small amounts, for short-term and restrictive budgets.

Since its first investment in 2009, NESsT has made and guaranteed further loans in CEE, both in Hungary and Romania. Globally NESsT had more than US\$277,000 in outstanding loans (receivables) with a repayment rate of 100% at the beginning of 2016.

NESsT's Investment Process

Today NESsT has built investments into its overall portfolio strategy. The enterprises in the NESsT portfolio are early-stage enterprises. They have a sales track record, have a proven management team and strong social impact, but are still not ready for pure market investment. Therefore, they rely on both soft investment and philanthropic capital (i.e. grants, recoverable grants, soft loans, guarantees) and ongoing and tailored capacity support to get to the next phase of growth. NESsT invests such financial instruments, in order to allow the enterprises to consolidate and scale.

NESsT's lending process is formal, concluded with a debt agreement, and ensures that NESsT remains objective about the payment potential of the applicants and determines realistic and feasible repayment conditions. The structuring of the loan process is based on clear steps, with an external investment committee making the decision:

1. Due diligence is conducted by NESsT, including interviews and site visits, concluded with an investment memo written by the NESsT portfolio team, based on the information provided by the social enterprise management team. It includes historical results and three to five years of business and financial projections. Official financial statements and other funding agreements are required and analyzed.
2. Decisions are made by the investment committee, based on the investment memo, with clear information on amount, terms, conditions, sanctions of non-payment and collateral (if any).
3. A Memorandum of Understanding is developed, including the debt agreement with the repayment schedule and monitoring process with the Performance Management Tool (PMT), with goals for the next year and key social, business performance, financial and sector-building metrics.



Suritex, a social enterprise that increases the earnings of alpaca producers in Peru, received a loan from NESsT in 2016 after successfully completing the organization's new investment process.

In comparing and selecting one or more alternative sources of financing, the financial statements that document the investment are the foundation of the decision-making process. When making a financial package proposal, the portfolio managers first assess the portion of the financial support that can be provided as an investment, either as a patient loan (i.e. working capital needs, CAPEX/infrastructure developments), recoverable grant (i.e. first experience with repayment, growth preparation) or loan guarantee (i.e. when the guarantee unlock capital from a third-party investor). NESsT supplements this investment with grant support if needed (i.e. piloting/prototyping, subsidizing operational losses until breaking even).

NESsT structures three to five year financial packages for its portfolio of social enterprises, aligned with the organization's overall long-term commitment towards its investees. When deciding on the type of capital to be invested, the key variables to consider are the following:

- The stage of development of the business
- The amount of “due diligence” (effort) required for each type of funding and to monitor the investment performance
- Return expectations—financial, social and environmental
- Timeline and exit strategies
- Level of control/involvement desirable in each case (i.e. board seats)
- Use of the money (i.e. to sustain sales growth resulting in increased working capital needs, fixed-asset expenditure, infrastructure investments, investment into research and development, increased social costs, coverage of short-term losses)
- Sources of repayment (i.e. sales revenue, cash flow, accounts receivable, future donations, secured funding contracts)
- Repayment risk (i.e. presence/absence of cash flow, presence/absence of collateral)
- Growth and scalability prospects (i.e. probability for the enterprise to succeed)
- Need to work with other co-investors

Expanding the Market

The growth of social enterprise coupled with the increased interest among stakeholders to ensure that financing is better directed toward impact, provides an opportunity to create a capital market of diverse financing for the sector in Romania. The many tools that already exist worldwide, including those that NESsT and a few other investors are already using, provide a baseline from which to start. To build on this, there is a clear need to prepare more social enterprises to take investment on the demand side and a need to convince investors and donors to experiment and offer new instruments on the supply side.

Findings of the Demand Research

In CEE and Romania, social enterprise don't usually think about loans. This is not surprising given, as already discussed, their dependence on grants, particularly EU funding, and their lack of experience with other financial instruments. In some cases, founders have provided their own start-up funding for enterprises or have taken personal loans, though this has also meant relying on personal collateral which is never ideal.

As per a research study performed in Romania by the Institute of Social Economy and Eurom¹² in April 2016, 10% of the 34 social enterprises surveyed already had a bank loan and 2% tapped into microcredit opportunities. While more than 50% of them would be interested in taking a loan in the future, most of them expressed needing technical assistance and consulting services before doing so. Unfortunately, there are no other reliable national statistics on the number of social enterprises taking loans or using non-grant type of instruments in the country.



Timural Group is a social enterprise in Mureș, Romania, that manufactures and sells educational toys and small wooden furniture.

To find out more about the perceptions and experience of Romanian enterprises in relation to debt financing, NESsT built on its nine-year experience in the country to survey nine social enterprises, most of them in the NESsT portfolio. The enterprises were selected in such a way, so they would include a wide range of: legal entities (i.e. nonprofits and for profits), business models (i.e. service based and production based), stages of developments (i.e. blueprint, validate and scaling), settings (i.e. urban and rural), and types of marginalized groups supported (i.e. disabled persons, rural low income women, at-risk youth, long-term unemployed). Three social enterprises out of the nine are generating profits—one of the key conditions needed to be considered for investment—and most of them have financial expertise in their teams. The nine social enterprises interviewed were Alaturi de Voi, Concordia,

¹² Doiciu, Ganci, Vameșu and Opincaru, *Romanian Social Enterprises' Funding Needs and Access to Financial Services and Technical Assistance*.



Alaturi de Voi, a Romanian foundation in Iași, Romania, runs a social enterprise to train and employ youth with HIV/AIDS.

EcoHerbal, Iluminis, Made in Rosia Montana, Mai Bine-CUIB, Motivation, Timural and Viitor Plus. For more information on these enterprises, please www.nesst.org.

NESST did not research cases of recoverable grants, convertible debt or other instruments as they are not yet currently used in the region. The social enterprises all work with different banks (i.e. BCR-Erste, BRD, ING, Raiffeisen, Transilvania, Unicredit), and they receive basic banking services. Only one has an overdraft facility agreement with its bank, for up to €27,000 at a 4.5% interest rate; it generally taps into 50-100% of the credit line for pre-financing production until receiving customer payments. The facility's annual cost is less than €700. Only three currently have loans (i.e. start-up, growth and bridge) from specialized loan funds or commercial banks. Three others might consider taking debt finance in the future to invest in long-term assets,

working capital and inventory, operating expenses, bridging needs, scaling strategy implementation and technology development. The remaining three were not interested in loans, at least for the moment.

Debt financing is seen by some of the social enterprises as a way to diversify their funding mix and reduce their dependency on anchor donors. However, most indicated they would only use loans when grant funding is absent. They also reported that the an acceptable interest rate is the key factor in deciding whether they would be willing to take a loan for their businesses. The ones not interested in loans cited as main reasons the following:

- Prefer grant finance, as the management team and board and/or operating staff are not willing to take the risk of loans
- Too costly, as interest rates are too high on available loans
- Banks generally don't understand the social enterprise
- Not comfortable with having liabilities
- Too much pressure on sales and the quality of products (i.e. the feeling that having to repay a loan can jeopardize the slow and high-quality production process, endangering, in the end, the social impact of the enterprise)

Furthermore, the social enterprise leaders who may consider soft loan financing, were reluctant to consider commercial banks loans, for the following reasons:

ALATURI DE VOI

The most common loan currently used by social enterprises is the bridge loan, secured to cover the negative cash flow generated by the reimbursement mechanism of the EU grants.

Alaturi de Voi (ADV) is a Romanian foundation set up in 2002 in Iași, whose mission is to ensure that people living with HIV/AIDS in Romania have access to the key services and support they need to improve their quality of life. ADV launched a social enterprise to train and employ youth with HIV/AIDS and joined the NESsT portfolio in 2007. Util Deco is a sheltered workshop that provides business support services, such as photocopying and binding, and creates and sells quality handmade products, such as textiles, paintings, glassworks, postcards, agendas and calendars. Currently, it also provides archiving services.

In 2010 ADV needed bridge financing of €100,000 for an ongoing EU-funded project on social enterprise development. ADV had to work with a project management authority that had unclear procedures for VAT reimbursement and delays in reimbursement of more than one year. Therefore, the organization—despite being one of the strongest in the country—faced difficulties in ensuring the necessary cash flow to run project-related activities. NGOs in Romania rarely have access to bank loans, so bridging the cash-poor periods by applying for a commercial loan was not possible.

ADV managed to take a €100,000 bridge loan from a third-party lender with a guarantee provided by NESsT in order to cover VAT costs in the project. NESsT collaborated with TISE,¹³ a social enterprise lender from Poland to provide the financing to ADV with tailored conditions: (1) an acceptable interest rate and (2) a repayment schedule that matched the project cycle. No collateral was required, but NESsT guaranteed 20% of the disbursed amount, based on its knowledge of ADV as a portfolio member and on a thorough analysis of its EU project and organizational cash flows. NESsT led the negotiations with TISE, and this guarantee unlocked debt financing for ADV.

The key risks identified by NESsT were the unpredictable reimbursement schedule by the Romanian government, which could negatively affect cash flow and cause repayment delays, and the potential for lower than projected revenues from the social enterprise, which would have reduced the other source of repayment. In order to mitigate these risks, NESsT decided to continue working closely with ADV and monitor their organizational financials regularly. ADV paid the interest and principal on schedule during the three years of the loan. TISE did not need to call on the NESsT guarantee, and it did not even need to communicate with ADV, as all repayments were made on time.

¹³ For more information on TISE, please see the profile on the organization on page 44.

TIMURAL GROUP

The Timural Group manufactures and sells educational wood toys and small furniture under the Woodjoy brand, employing persons with disabilities in the manufacturing process. They used the de-minimis state aid¹⁴ through the Ministry of Finance twice: (1) for €168,000 in 2010 and (2) for €200,000 in 2014. The financing was used for the development of the three production facilities and acquisition of wood processing machines. In order to get the funding, the team needed to submit a business plan, a project proposal and cash flow projections. In order to pre-finance the state aid, the team secured two short-term bridge loans—one for €90,000 in 2010 and another for €67,000 in 2014—from a commercial bank with which the organization had a long-term banking relationship. Both were guaranteed with the building owned by Timural. The social enterprise assessed the bank's approach as very long and bureaucratic, and found the loan expensive and risky, as the bank asked for a 200% guarantee. Therefore, Timural would think twice before taking another one. They were lucky to own enough assets. Otherwise it would have been impossible to have secured the financing needed to launch the social enterprise.

RECOVERY CLINIC MOTIVATION

The Motivation Clinic is a medical recovery social enterprise, whose proceeds fund the social services provided by Motivation Foundation for the benefit of children with disabilities. The clinic was founded in 2011, as a separate for-profit legal entity, owned by Motivation Foundation (95%) and Motivation Ltd (5%). The latter is the first social enterprise launched by the nonprofit organization, selling and adapting wheelchairs and other assistive devices for all kinds of disabilities.

The aim of the clinic is to support the social work of the foundation and to provide adequate medical and recovery services, including services for disabled persons. The clinic reached breakeven in 2014 and increased its profits 10 times in 2015. Its current goal is to consolidate its position on the market. The management team is not considering any expansion activities for the moment.

To finance part of the start-up costs in 2012, the clinic secured a €30,000 loan from a commercial bank with very favorable conditions: five year loan with 0% interest rate, a one-year grace period on repayment and no collateral requirement. In order to qualify for the loan, the social enterprise submitted a business plan, an investment plan and cash flow projections. The organization had a good long-term relationship with the bank, which eased the lending process once the bank announced its intention to support social enterprises with friendlier loans. There was little reticence among the internal team in considering accessing debt finance. They discussed the exposure and vulnerabilities associated with having a liability, and the director made the final decision. The board approved it.

The enterprise started repaying the loan from sales revenue in 2013 and managed to repay the loan in advance. The social enterprise could count on the financial expertise of its parent foundation, which also supported the business financially during cash flow negative periods. Based on this initial experience, the Motivation Clinic will take other loans, if needed, as they see them as a great mechanism to grow.

14 This type of financial support is provided by the state for amounts less than €200,000, based on a competitive, selective, transparent process, aimed at producing a comparative advantage to the selected enterprise (i.e. helping start-ups with their initial investments).

- Many of them are not eligible due to their legal status
- They have no required collateral
- Fear of repayment risks associated with mainstream instruments (i.e. not tailored to their needs or ability to repay interest, not taking into account and valuing the social impact generated)
- They do not feel comfortable having liabilities
- They do not trust traditional investors (i.e. as one social enterprise manager clearly said, “I feel that they help me with one hand, but they take interest back with three hands.”).

One of the main findings of this research is that the lack of experience with debt financing is also based on a lack of education with regard to other instruments. The absence of information is one of the first reasons why social enterprises do not see investment as a viable funding alternative, not even in more advanced stages.

The boxes on page 29-30 describe the experiences of the three social enterprises from the research that have accessed different types of loan financing: (1) Alaturi de Voi with bridge financing, (2) Timural with growth financing, and (3) Recovery Clinic Motivation for startup financing backed by an existing parent organization.

These examples demonstrate that there are social enterprises in Romania that have been willing to take loans and who have for the most part had good loan experiences. The types of loans they have secured have been for bridge financing, working capital, start-up investment and growth investment. The terms have varied, in some cases they have been quite

favorable with 0% interest rates, but in others they have required unrealistic guarantees. Having a longer term relationship with banking institutions has made these loans possible in most cases. All of this points to the need to set loan conditions that take into account sector-specific elements, such as difficulty in providing collateral and the need for longer repayment periods. As demand continues to grow, and more patient and flexible loan products are offered, these can begin to be standardized making the industry more effective and efficient. Also, good practices should be heavily promoted, in order to diminish the emotional and psychological barriers that many social enterprise leaders cited when considering debt financing. Finally, it’s important to reiterate that some of these loan products and other instruments at early stage will need to be backed up by philanthropic sources such as non-recoverable and recoverable grants.

Findings of the Supply Research

From the perspective of the banks or suppliers, the immaturity of the social enterprise sector is the main showstopper: the limited—or perceived as such—business potential of these enterprises prevent suppliers from proactively developing appropriate lending products or to even consider adapting some of the ones already in place. Institutions revealed that the main reason they do not provide loans to social enterprises is their lack of credit history and creditworthiness. They feel that many social enterprises lack convincing business plans, clear and reliable cash projections and skilled staff. They also are perceived to have limited abilities to offer financial returns.

Apart from signed grant contracts, social enterprises do not have collateral or securities. The fact that these organizations rely on grants that are tied to projects—which most often cannot be invested in assets or show surplus revenues—prevents them from having the types of collateral and financial statements that banks desire. In the absence of well-established financial institutions serving NGOs and social enterprises, such as Charity Bank in the United Kingdom (see case study on page 34) or Banca Prossima in Italy, CEE social enterprises do not have opportunities to remedy this situation.

The fact that social enterprises focus first and foremost on social impact, including in many cases the employment of marginalized people, often gives the impression to potential investors that social enterprises are riskier and less profitable than other businesses. They tend to be small with limited human resources and tight financial budgets, which make them appear to be less performance-driven than they actually are.

Lenders also face external and internal barriers to entering the CEE market and to providing loans to social enterprises including:

- There are significant legal entry barriers for new players and a lack of stimulating policies for social investments in CEE. Providing financial services requires the authorization of the national financial supervisory authority, a license granted in very strict conditions (i.e. significant upfront investment, capital stock, high qualified and experienced investment teams and developed methodology, reporting burdens). Assuming the license is granted, it gives rights to invest only in the country that issued it. For a regional approach, an investor would have to comply with every country's requirement—not at all incentivizing. International organizations could eventually lend, but only on ad-hoc basis and not as a main activity. This limits the interest of non-CEE based organizations to start investing in the region.
- Banks don't have the right risk assessment tools to assess social enterprises. They don't know how to assess companies that lack collateral and other forms of securities.
- Lending to social enterprises requires, besides financial and banking expertise, understanding of what are often complicated cost-revenue structures of nonprofits.
- The financing amounts they usually need are relatively small, which means that financial intermediaries incur higher costs since they use the same standardized due diligence and internal procedures.
- Institutions need to provide support to potential investees during the due diligence processes, as many social enterprises lack investment understanding and have overstretched management capabilities. Even when tailored made to social enterprise needs, financial products need to be explained in detail.
- Difficulties in evaluating social impact, as many providers do not have in-house capabilities to do this. Also, there is no industry-wide accepted mechanism for evaluating social impact which lenders could use to make these assessments.

BOX 4: LESSONS FROM WESTERN EUROPE

The region would do well to assess the range of financial and non-financial organizations investing in social enterprises that exist at the European level. Many existing practices could potentially be adopted and adapted for Romania and CEE. These include:

- Venture philanthropy funds: These funds use the venture capital approach to fund social enterprises, always combining financial investments with non-financial support services and are focused on social and business performance measurement. They can provide multi-annual grants, equity or loans, and some request moderate financial returns besides the social ones. For more information on venture philanthropy funds, please refer to the NESsT publication *All in The Same Boat: An Introduction to Engaged Philanthropy*¹⁵ and the European Venture Philanthropy Association, the umbrella organization which NESsT joined as the first CEE member in 2006.
- Charity, civic or social ethical banks: These banks provide loans specifically to social enterprises and nonprofit organizations.
- Commercial banks: Banks may offer financing through special social enterprise specific products (i.e. lower interest rates, grace periods, possibility to renegotiate repayments in case of difficulties, mainly for pre- and co-financing EU projects) or by simply by not excluding social enterprises from their risk assessment practices.
- Impact investment funds and special loan funds for social enterprises: Some of these funds rely on the European Investment Fund and the EuSEF label (introduced in 2013) for mainstream investment funds. Very few funds have obtained the label to date. There is general consensus that the costs of the EuSEF structure outweigh the benefits, and that the EuSEF regulations should be revised.¹⁶
- Crowdfunding platforms: Individual investors donate, lend or invest equity in the projects and businesses listed on the platform, as per their individual interests or preferences.
- Foundations: Foundations can provide funding through their program-related investments, using the dividends from their for-profit investments.

Source: NESsT, 2016.

¹⁵ Davis, Etchart and Costello, *All in the Same Boat: An Introduction to Engaged Philanthropy*.

¹⁶ Catana, Daniele, Hehenberger and Nogales, *General Report 2016, Improving Access to Funding*.



CASE STUDY 2

Ethical Banking that Works for Social Enterprises

Charity Bank
United Kingdom

SOCIAL ENTERPRISES IN BRITAIN ALSO STRUGGLE WITH ACCESS TO FINANCE BUT HAVE MORE OPTIONS THAN THEIR CENTRAL EUROPEAN PEERS.

In the United Kingdom (UK) there is a developed financing, technical assistance and support infrastructure that is aimed at or includes social enterprises. Community development finance organizations, as well as social banks and social enterprise loan and investment funds, provide loans, quasi-equity and equity type financing in addition to or mixed with grants to social enterprises at different stages of development. This offer is supplemented by the products of mainstream banks, which see a segment of the social enterprise sector as good business and therefore increasingly try to target them.

Social enterprises in the UK may obtain loans with varying conditions and for different purposes. An important strategy for asset building and sustainability is for them to buy property with loan finance, then exploit the property for business purposes (i.e. rent), and repay the loan from the proceeds of the business activity. This requires loan products and risk assessment procedures to be adequately tailored (i.e. loans for investment are available, interest rates tend to be below market, the loans can be large amounts with long maturities and accompany a fairly simple business model based on cash flow from rent or government contract).

Some of the social enterprise loan funds are willing to provide a mixture of financing (loan and grant) depending on the applicant's capacity and needs. This is true only for funds whose performance is not measured principally on financial return, but where the social return is strong. In these funds, there is a drive to make social enterprises investment ready through technical assistance or capacity-building and thus prepare borrowers either for taking out loans from the fund or from banks.

At Charity Bank, other social banks and most loan funds, the financing support is strictly separated from the capacity-building support. For the sake of objective assessment and to avoid the consequences of "bad advice," the financier does not provide both funds and consulting. If banks and funds have a capacity-building program for their investees, it generally consists of providing them with a grant to pay for external expert advice, rather than providing it themselves.

Social enterprises are scared of debt and try to avoid it there as well. In the UK there is an ongoing education effort done by social enterprise loan funds and social banks to make social enterprises understand the allocation principles of scarce grant money and loans. The education process is equally necessary in Romania and CEE, where the additional element of grant dependency needs to be taken into account.

When assessing the risks of lending to social enterprises, two main factors stand out: (1) cash flow and (2) governance. If a borrowing social enterprise can show convincing cash flow for the future years (duration of the loan) and it has a transparent governance structure with a board fully understanding the organization's activities and the implications of borrowing, repayment is most likely.

Market conditions dictate the terms to loan funds and banks that depend on the financial markets for their capital, so for example lending rates will always reflect the cost of funds. At the same time, because of the social mission of the lenders, the conditions they offer to borrowers tend to always be more favorable, flexible and tailor-made, than the standardized offer of mainstream banks. Lower interest rates, longer terms and less collateral all add to the social cost of lending to social enterprises. This affects the sustainability of

the loan funds to a great deal, so they are in constant search of social investors or targeted government funds that can “subsidize” the lower costs of lending and higher costs of operations.

Measuring the social impact of the lending activity is a real challenge to social enterprise loan funds and social banks, yet it is ever so important in order to convince their investors that their money is working well and efficiently. There is no standardized, across-the-board approach among loan funds and banks. Some employ paid external evaluators to measure social impact. Others accept the social impact claims of their borrowers (i.e. if they are a good charity, they must be making impact), while others try to estimate the financial and social costs of what would happen with beneficiaries if the NGO ceased (i.e. government subsidies, institutionalization).

Overview of CEE Findings

A scan of social enterprise lending in CEE revealed that they are only a handful of providers that lend to social enterprises in the region. NESsT identified through secondary research 20 global and regional investors that are open to investing in CEE (see Table 2 on pages 38-39).

In the case of Romania, there is only one bank that has developed products for social enterprises in the form of soft loans and one foundation that currently lends to these entities. Several other commercial banks do not exclude social enterprises from their lending policy, but also do not provide them with friendlier conditions. There are credit cooperatives—more than 80—and mutual cooperatives as well, who usually lend short-term financing to their individual members. In exceptional rare cases, there are also some social cooperatives or small enterprises that do the same. However, these were not the subject of this research, as they do not target social enterprises nor community-wide social needs. Also, some microfinance institutions—there are less than 20 in Romania—might include social enterprises among their borrowers, usually for smaller amounts and assessing them in the same way as any other micro or small enterprise.

In order to widen the research, and learn from practices in the rest of the region, NESsT interviewed in detail, one Polish bank, two Polish loan funds and one Hungarian social investor, in addition to the institutions surveyed in Romania. To follow is a description of the loans they provide.

Romanian Institutions

Romanian American Foundation

In Romania, the Romanian American Foundation (RAF) helps to build an ecosystem of successful entrepreneurs, investors, government officials and other support organizations. Although RAF promotes the use of grants, their strategy also allows for experimentation with loans, often referred to as repayable grants. RAF believes that innovation with financial instruments helps partners create capacity and discipline. Timing and cash flow can often present barriers to organizations implementing EU-funded projects. RAF recognizes this and often provides bridge financing for partners with repayable grants. Recently, NESsT and RAF collaborated in order to help the creation of two social enterprises—Reciproc and Ambasada—with bridge loans. NESsT took the currency exchange risk and the two social enterprises were able to launch their operations and repay, in due time, the US\$100,000 loans each secured. NESsT did incur a \$US5,600 foreign exchange loss, since the grant used to reimburse the loan was paid by the EU through the Romanian government in RON and the loan was made and repaid in dollars. Again, philanthropic capital could help to mitigate these types of risks. Risk-sharing strategies might also be useful.

BCR Romania

Four years ago, BCR—the Romanian Commercial Bank—started a special policy to lend to social enterprises, even if they are perceived as riskier than regular small and medium enterprises (SMEs). The due diligence happens under specific circumstances, assessing each request

Table 2: Current and Potential Investors in Central and Eastern Europe

Name of Investor	Geography of Interest	Area(s) of Work	Range of Investments	Types of Financial Instruments	Level of Involvement
Alterra Impact Finance	Europe	<ul style="list-style-type: none"> • Health • Water • Food and agriculture • Responsible consumer goods 	Starting at €500,000	<ul style="list-style-type: none"> • Patient and supportive equity 	High
BMW Foundation	Europe	<ul style="list-style-type: none"> • Social enterprise 	Up to €200,000	<ul style="list-style-type: none"> • Loans with 3% interest rates • Equity 	Medium
European Fund for Southeast Europe	Southeast Europe	<ul style="list-style-type: none"> • Intermediaries that support micro, small and medium enterprises • Commercial banks, microfinance institutions and non-bank financial institutions 	No available information	<ul style="list-style-type: none"> • Loans • Guarantees • Equity/quasi-equity 	Medium
European Investment Fund Social Impact Accelerator Fund	Europe	<ul style="list-style-type: none"> • Funds that invest in social enterprises 	€5 million to €10 million	<ul style="list-style-type: none"> • Equity with 3-5% returns, up to six years 	High
Global Innovation Fund	Global	<ul style="list-style-type: none"> • Solutions improving the lives of people living with less than two dollars per day 	US\$50,000 to US\$15 million	<ul style="list-style-type: none"> • Grants • Loans (including convertible debt) • Equity 	Medium
LGT Venture Philanthropy	Global	<ul style="list-style-type: none"> • Education • Health & sanitation • Agriculture & forestry • Renewable resources • ICT 	Varies, typically 20% for equity	<ul style="list-style-type: none"> • Equity • Loans • Grants 	High

Name of Investor	Geography of Interest	Area(s) of Work	Range of Investments	Types of Financial Instruments	Level of Involvement
Overseas Private Investment Corporation	Global	<ul style="list-style-type: none"> Renewable energy Housing Agriculture Consumer goods 	US\$2 million to US\$50 million	<ul style="list-style-type: none"> Loans and loan guarantees with terms of five to 20 years, with grace period and negotiated interest rates 	High
Partners Group Impact	Global	<ul style="list-style-type: none"> Jobs and income generation 	US\$150,000 to US\$250,000 for investments & US\$50,000 for donations	<ul style="list-style-type: none"> Grants Loans at below-market rates 	High
PYMWYMIC	Europe, Africa, Asia, Latin America	<ul style="list-style-type: none"> Agriculture Education Small producers 	Varies	<ul style="list-style-type: none"> Loans with soft interest rates Equity 	Medium
responsAbility Investments AG	Central & Eastern Europe, South America	<ul style="list-style-type: none"> Finance Agriculture Energy 	Starting at US\$500,000 for loans and US\$2 million for equity	<ul style="list-style-type: none"> Loans with market interest rates Equity 	High
TONIIC	Global	<ul style="list-style-type: none"> Agriculture Health Education Energy Environment Financial service Technology 	US\$50,000 to US\$3 million	<ul style="list-style-type: none"> Varies 	High
Yunus Social Business	Global	<ul style="list-style-type: none"> Social businesses that provide employment, education, health care, clean water and energy 	€50,000 to €350,000	<ul style="list-style-type: none"> Long-term loans with below-market interest rates and grace periods Equity 	High

Source: NESsT, 2016.

on a case-by-case basis. The bank decided not to create a product specifically for social enterprises—as social enterprises represent low business volumes, generally lack collateral and many are not creditworthy yet—but rather to assess applicants using slightly softer terms. BCR also provides overdraft facilities for their current bank accounts holders, implements a microcredit program, guarantees and long-term investment loans.

The bank has lent to 13 social enterprises as of September 2016. All of them are still currently in the loan portfolio of the bank, and the amount of loans outstanding was around €3 million. The amounts range between €50,000 and €500,000 (the average is €230,000), for a maximum of seven years with below-market interest rates and varying according to rating and maturity. Usually, there are no grace periods, though exceptions might be made when the loan funds are used for construction projects. The bank requires securities such as real estate, stock, equipment or personal notes as personal guarantees. The payment is monthly, under a mutually agreed schedule. The enterprises must comply with the general terms and conditions of the bank. The loans can be used for purchasing real estate, refurbishing existing premises, purchasing equipment, working capital, expanding activities and bridge financing—be it for cash flow reasons or ex-post financed EU projects.

Because of the novelty of the program, the bank is just starting to monitor the below market rates of its social enterprise portfolio. However, the bank has been

monitoring the performance of all of its loans on an annual basis, and in case of non-payment or default, it applies its standard collecting procedure after 90 days.

The social enterprises go through the same assessment procedure as other SMEs, but the former must comply with special criteria on shareholders and social purpose. A potential borrower must fill in the bank's application form, submit a business plan to highlight financial projections, competitors and industry analysis, references and the CVs of the director and key staff members.

The bank targets social enterprises through special networking events and helps them with financial projections when needed. It does not discriminate based on area of activity or impact area, but has a clear policy not to lend to organizations involved in political lobbying activities. Based on its experience, the bank perceives the biggest need for loan finance among social enterprises in the areas of bridge finance and expansion activities, while their main difficulties are securing a stable income stream.

BCR is a member of Erste Group who launched a social banking program across the whole CEE region (including Austria) in October 2016. The program includes social enterprises among other unbanked groups and provides business mentoring in addition to access to financial products.

Unicredit Romania

In Romania, UniCredit Bank lends to social enterprises. They are included in the regular loan services for small- and medium-size enterprises. The social enterprises go through the same bank risk assessment procedure as any company, filling in the same application form and having to comply with the same criteria, including collateral provision. The bank offers assistance in the due diligence stage through its sales team, who counsels the applicants with regard to the most appropriate products fitting their needs and helps them with the documentation required. The products offered do not have standard minimum or maximum amounts, as the size of the loan is determined individually for each enterprise. The timeline depends on the type of the product: (1) a maximum 12 months for working capital loans, with the possibility to prolong, if needed, at maturity; (2) 36 months for credit lines; and (3) 15 years for investment loans. Grace periods are available only for investment loans, and only for the principal. The other parameters of the loan (i.e. interest rate, other fees and commissions) are set with the client based on several variables, including the individual analysis of the financials, the type of client and the type of instrument.

Microfinance Institutions in Romania

When it comes to microfinance, NESsT found out through entities surveyed that social enterprises can apply to regular loan services, being assessed under the same criteria and going through the same due diligence process as any potential client. Microfinance institutions offer loans for SMEs and microcredit services, tailored on a case-by-case need.

One microfinance institution recently launched a new service—invoice discounting, providing an 80% advance on invoices to clients. The total outstanding loans from social enterprises to microfinance institutions surveyed was €56,799 as of August 2016.

In evaluating the applications, NESsT found that microfinance institutions assess the capacity of the organization or entrepreneur, including the proven production capacity or a well-researched plan that demonstrates potential production capacity. Collateral is most of the time mandatory and can be real estate, equipment (which can be acquired by loan and pledged as a guarantee), personal guarantee, third-party guarantee, and current and future revenues.

Players in the field also put a strong emphasis on the character of the entrepreneur and usually eliminate enterprises in litigation or insolvency and those which have unpaid loans or an unjustified default on contracts. Start-up capital available and favorable/not-favorable market conditions also contribute to the final decision.

On average, there are a maximum of 10 applications per year from social enterprises submitted to microfinance institutions. As with any other client, they fill in the same form, consisting of a robust analysis of the business, including market analysis, financial modeling and checks with the credit bureaus (with the client's consent). The credit team helps the client to complete the application and performs site visits. The main elements of the decision-making are:

- Financial criteria (i.e. liquidity ratio >1, debt service cover ratio >1 and holistic analysis of balance sheet to determine reasonability between assets and liabilities)
- Qualitative impressions of the site visit (i.e. positioning, facility, amenities, cleanliness, relationships, etc.)
- History and success rate of similar businesses in its own portfolio or overall in the market (i.e. analyzing market demand for the product or service and the strength of the competition)

The loans disbursed vary between a minimum of €500 over three months and €50,000 over a maximum period of five years, with the average size of a loan of €7,000. The interest rates vary between 8-20%, depending on the profile of the client (i.e. non-eligible for banking relationships, potentially eligible for banking relationships, eligible for banking relationships). There are other loan costs which are applicable to social enterprises as well and should be taken into consideration, including analysis commission, administration commission, assurance costs, early reimbursement costs, etc. Repayment holidays or grace periods of up to six months might be granted (assuming that the total timeline of the loan—including the grace period—does not exceed five years), depending on the specifics of the business. Usually these types of terms are applied to agricultural and other seasonal businesses.

The frequency of repayments and the amount of installments are calculated based on the cash flow analysis. The social enterprises are not perceived as riskier than other businesses and 90% of applicants receive the funds. The loans are mainly used to refurbish existing premises, to purchase equipment or to cover working capital needs.

As per the reporting requirement to the National Bank of Romania, the institution monitors the portfolio that is at-risk (i.e. outstanding loans on which a payment is more than 30 days overdue). If installments are not paid in five days from the due date, the credit team starts a conversation about the situation. If determined that non-payment is due to financial difficulty of the enterprise that is out of the area of control of the entrepreneurs (i.e. seasonal business, damage, aging accounts receivable, etc.), the credit officer together with the entrepreneur analyze cash flows to identify if a rescheduling of account balance would allow for optimum operations. If solutions found do not result in on-time payments, the bank will start realizing guarantees for account balances aged over 90 days.

CEE Institutions

BGK

Bank Gospodarstwa Krajowego—the State Development Bank of Poland—developed a special product for social economy entities (SEE) launched in 2012.¹⁷ The product had preferential conditions: (1) timeline of maximum 60 months with (2) a six-month grace period of capital repayments. The interest rate was between 0.44% and 0.88%. It had no fees and commissions, and required a blank promissory note for security, as well as additional ones if the creditworthiness was questionable. The maximum amount to be lent was €24,000 and one social enterprise could only take one loan per a specific purpose. The bank would pay TISE, the selected financial intermediary, to provide the beneficiary of the loan with up to 30 hours of consulting services, based on the individual borrower needs, in areas like accounting, reporting and tax issues. The whole initiative was backed up by the Ministry

¹⁷ Prior to the launch, the bank signed the agreement on the product in July of 2012, announced a public procurement process to choose financial intermediaries (FI), selected the final FI in January of 2013 and extended the first loan in March 2013.

of Economic Development as a managing authority for the EU funds and by the Ministry of Family, Labor and Social Policies, as an intermediate body. The bank is currently setting up a new program, still guaranteed by the EU. The program will provide loans and loan guarantees that will be given by the bank to other financial institutions providing loan guarantees to SEEs, such as TISE, and other types of social investments. The amounts to be invested are up to €24,000, for a maximum five years for social enterprises in early stages and up to €120,000 for those in growth stage. Each social enterprise can apply for a maximum of two loans. If the social enterprise creates jobs, it can benefit with interest rate subsidies.

PAFPIO

Since 1999, PAFPIO—the Polish American Community Assistance Fund—has operated a loan fund aimed at helping the nonprofit sector (i.e. associations, foundations, chambers)—with or without social enterprise activity—with access to finance. The size of the fund is €4 million, and the fund currently has 128 active borrowers, out of which 12 are social enterprises (9 of them are social cooperatives), with €3.7 million in outstanding loans. Since its founding, it has lent approximately 2,200 loans to 670 NGOs and social enterprises with 75% of the portfolio as repeat clients.

PAFPIO communicates with its potential clients mainly through its webpage and by sending targeted loan offers to the beneficiaries of different grant competitions, as they are published on the websites of granting authorities. It receives around 200 applications per year on a rolling basis, and 90% of them are funded. Only a small

percentage of these clients are social enterprises since they tend to prefer the friendlier terms of the loans offered by TISE, who manages an EU fund exclusively set up for them and is better prepared to meet their needs.

The required documents in due diligence are the registered constitutive documents (from the court) and the official financial records as submitted to the tax office from the last two years. PAFPIO might ask for extra details if needed, as well as financial projections—for the next 18 months to two years depending on the lengths of the requested loan.

The due diligence is not limited to submitted documents. Loan officers assess the public materials available (i.e. website, reports) and visit the potential borrower, to meet the management team, key stakeholders (i.e. local authorities, clients) and evaluate the social impact directly. The team visits the existing clients regularly and the repeat borrowers, to observe changes and to assess in real time the on-the-ground status of the operations of the client.

The timeframe from initial screening to decision-making is a maximum two weeks. In some cases, it might be longer, especially when higher amounts are requested. The fund's supervisory board must approve loans higher than €150,000. The loans conditions are as follows:

- Loans given range from €2,500—250,000, with an exceptional maximum amount of €400,000. The average size of the loans given is €30,000.
- Loans carry a 10% interest rate, which is paid by NGOs (usually from 1% tax mechanism,¹⁸ private donations, savings, leader's own money) and a 3-5%

¹⁸ In many CEE countries, NGOs are eligible to receive 1 or 2% of personal income taxes paid by individuals in the form of untied donations. The individual designates this tax to a specific NGO.

administrative fee.

- The timeline of the loans are 18 months on average, with the longest one given for four years. The projections have to match the timeline of the loan.
- Two-thirds of the loans given are bridge loans, while one-third of the loans are for working capital or investments.
- The fund can give grace periods of six months for the repayment of the principal (negotiated and aligned with the revenue flow of the NGO). However, the interest must be paid monthly.

In term of documentation, the fund signs a simple three page loan agreement and a securities agreement; if there is no collateral, the bank accepts 3rd party securities or personal guarantees. The loans can be used for refurbishment of existing premises, purchase of equipment, working capital, expansion of activities, and bridge finance both for cash flow or ex-post financed EU projects. The fund does not provide grants in combination with loans, but can also provide guarantees in front of a grant maker. This is sometimes required in Poland if the grant comes from a public authority.

In case of delays in repayments, the loan officer calls the NGO and performs a site visit, to assess the problem and discuss with the guarantor. 1.7% is the overall default rate. At the time of the interview (August 2016) two-thirds of the loans were at risk; all of them bridge loans, with payments overdue more than 30 days because of delays in EU reimbursements.

TISE

Towarzystwo Inwestycji Społeczno-Ekonomicznych S.A (TISE) is a loan fund based in Poland with whom NESsT has a co-investor relationship. NESsT provided guarantees on behalf of three of its portfolio social enterprises — one from Romania, two from Hungary — for loans extended by TISE.

TISE is based in Warsaw and has provided loans, financial services, consulting and investment in order to facilitate the development of local initiatives for sustainable development, particularly in the social economy since 2006. Loans can be used as bridge loans or for working capital and business development. Loan amounts start as small as US\$2,900. TISE has a very simple, client-friendly and tailor-made approach to lending. Documentation is simple, turnaround is fast, and the terms of the loan take into account individual borrower circumstances to the greatest extent possible.

To date, TISE has made several thousand loans to NGOs and social enterprises exclusively with TISE's own funds with an average remuneration of around 8% per annum and 1% upfront fee. In Poland, they also make loans for small and medium enterprises. This comprises 50% of TISE's loan activity. It is also currently implementing a state-subsidized program for microloans for social enterprises with an average loan amount of US\$20,000 with a 0.5% interest rate. Around 500 such loans have been made so far by this program.

TISE is a 100% owned by Credit Cooperatif, a cooperative bank active in France for 120 years and one of the oldest and largest social investment institutions in Europe. It is a for-profit investor. The organization has a supervisory board, appointed by the owner, comprised of five people—three from Credit Cooperatif and two independent—who makes all strategic decisions, while a management board comprised of two people has the executive role. There are 30 employees based in Warsaw, including eight loan officers for SMEs and four for NGOs and social enterprises. TISE has 2,000 loans under management.

TISE's main activity is in Poland, but the organization can invest in other CEE countries as well. TISE signed an agreement with the European Investment Fund (EIF) at the end of May 2016, for a loan portfolio guarantee whereby 50% of loans made to social enterprises would be guaranteed by EIF. The agreement was made within the framework of the EaSI Facility which provides access to funding for micro and social enterprises.¹⁹ In this case, EIF is providing EaSI funding for the 50% guarantee, thereby decreasing the amount to be guaranteed by the social enterprises themselves. The targeted geography is Poland and CEE (15 countries altogether), with a specific focus on three CEE countries: Romania, Slovenia and Slovakia. The total value of this funding scheme is €8 million, and 30% of the total amount has to be invested outside of Poland. There is a cap on profit distribution within the investees—not more than one-third of the three years of profits can be distributed among owners or stakeholders. The loans are given in Polish zlotys or Euro, for a maximum of five years with no restrictions on the use of funds.

The fund needs to build the portfolio in the next five years. TISE has already made four loans in Poland at 7-8% interest rate. Outside of Poland, TISE would ideally invest in the range of €100,000-300,000. The institution does not want to reject smaller organizations, but are actively looking for bigger ones. As it is difficult to analyze social enterprises from far away, TISE is interested in developing partnerships with intermediaries and referral partners. The expected offering for Romania is loans between €25,000 and €300,000 at a 6.5% interest rate.

In term of documentation required, TISE requires (1) financial statements, (2) financial projections and (3) cash flow projections. TISE will also create a simple application form, with a section on social impact. The social enterprise will need to report on social metrics every other year. The analysis of each request will be done in Poland and will take into account the recommendations from the referral partners. TISE might ask for additional references from clients and other key stakeholders. The applicants will receive support during due diligence and post-investment monitoring from the referral partners. The decision-making process lasts two to four weeks, depending on the quality of the submitted documents.

The loans exclusively target social enterprises. There is no preferred impact area or specific targets, but the key criterion is for the social enterprise to have a real, tangible social impact and to commit to report on impact progress. On the financial side the cash flow forecast is the driver of the decision, as the loan has to be repaid in five years. The source of repayment does not have to be exclusively

¹⁹ The European Commission's Programme for Employment and Social Innovation (EaSI) supports EU Member States efforts in the design and implementation of employment and social reforms at European, national as well as regional and local levels by means of policy coordination, as well as the identification, analysis and sharing of best practices. In terms of financing, it increase the availability and accessibility of microfinance for vulnerable groups and micro-enterprises, as well as access to finance for social enterprises.

sales revenue. The loan can be repaid partly from grants or other income streams. As this funding scheme is a pilot for both the EIF and the EU Commission, and as the market is not so developed in CEE, the idea was to be as friendly as possible and keep restrictions at a minimum.

The EIF guaranteed loans, mirror TISE's regular lending practice. The loans are flexible, friendly towards the clients and adapted to the business. The interest on the loans is repaid minimally on a quarterly basis—in Poland most often monthly—and matched with the principal repayment. In the case of issues, staffers try to identify the reasons why the loan is in difficulty and can reschedule repayments, or take small coercive steps until more severe measures are taken. Thirty percent of its current portfolio is comprised of bridge loans, and often grants that are expected to cover these loans are not paid in time, so loan terms have to be changed. In Poland, 50% of the bridge loans need to be rescheduled, because of repayment issues with the EU or the national government. Rescheduling happens with non-bridge loans as well. What is important for TISE is to keep on communicating with the client. They get worried when the client stops answering requests and does not provide any explanation for the delays.

Monitoring happens through simple quarterly reports. If challenges occur, TISE would like to receive reports more frequently. TISE does not take the business risk. It is a lender, and it does not have a venture capital/private equity type of approach. Overall, TISE assesses NGOs as less risky than SMEs, in general, but social enterprises are perceived as risky as SMEs, as they face the same

business challenges. Social enterprise leaders have evolved to understand that they actually do business, and in business, growth does not happen with grants. By the same token, investors must be willing to take some risks as social enterprises face the same management errors and market risks as any business.

TISE's plans are to grow into a very active financial institution investing in social enterprises across the region. They are a leader on the Polish market and the EaSI guarantee from EIF was a growth opportunity for them. They are interested in other instruments as well; they are considering an impact investment fund, with subordinated loans to social enterprises, to increase their borrowing capacity. They are also interested in hybrid financing and would like to pilot the first social impact bonds in Poland. The team believes that there is demand for instruments with low requirements in profitability, and with these in place the social impact funding will grow.

Portus Buda Group

Exciting news is coming from Hungary with the country's first impact fund recently created—Portus Buda Group (PBG). Its mission is to catalyze societal impact by financing and supporting social enterprises—structured as for profit or not-for-profit—that address social or environmental challenges with innovative solutions.

PBG manages a JEREMIE portfolio and is already regulated by the Hungarian National Bank as financial supervisor. The company can implement social investment activities and plans to get the EuSEF accreditation. The impact fund is to be launched in the first quarter of 2017

and aims at a final closing of €20 million. It will start investing with a €3,75 million first closing. The current investors in the fund are high net worth individuals from Hungary. They are motivated by intelligent philanthropy and social impact and the idea of recycling the money. They commit 1% of their net worth on average, and expect a low return rate (1.5%).

Initial investments will happen in Hungary, but cross border co-investments are planned. Ideally, PGB would jointly co-invest with other social impact funds from the region, especially in more mature social enterprises, with higher investment needs.

The selection criteria for the fund are: (1) strong and measurable societal impact, (2) entrepreneurial and effective team, (3) validated, sustainable and scalable business model with information on the industry and competition analysis, and (4) clear exit strategy. These are to be reflected in a one-page concept note and detailed in its own application form. The fund does not focus on one impact area only, because of the limited pipeline in the region. It may choose to specialize in the future.

In the first round, the team expects around 50-100 applications and plans to make three to four investments annually. It will have a rolling application process. Equity will be a minority investment, based on the valuation of the company. The fund focuses on loans, targeted at a minimum of €100,000 for four to eight years with a 5% annual interest rate. The fund does not require securities. PBG plans to publicize the fund on the website, in industry

relevant communication outlets and via partners like NESsT who would refer investees, hopefully ensuring 50% of the deal flow. The decision-making process will last between one to six months depending on the flow of information and the investment readiness of the social enterprise.

The fund will tailor its financing solutions to each investment, and the investment team will structure the financial package including an individualized schedule of capital and interest repayments. The money can be used for the purchase of equipment, working capital, expansion of activity and bridge financing to cover temporary cash flow difficulties.

In terms of decision-making, the investment manager will propose a deal to the investment committee—comprised of board members, private investors and other investment managers—who meets five to six times per year. The investment manager keeps the relationship with the social enterprise in the post investment work as well. The involvement is expected to be significant and could include problem solving, access to networks, facilitating relationships with donors and investors, consulting on impact measurement, coaching, marketing & sales, financial controls, etc.

From an ecosystem perspective, PBG feels that the demand outstrips the supply of loans, and sees that social enterprises face difficulties in dealing with loans because of their history of relying only on grants and the lack of entrepreneurial attitude and approach.

Conclusion

“SOCIAL ENTERPRISES NEED ACCESS TO INTELLIGENT FUNDING—GRANTS, DEBT, EQUITY, GUARANTEE FUNDS—ACCORDING TO THE STAGE OF DEVELOPMENT THE SOCIAL ENTERPRISE IS IN. DIFFERENT DEVELOPMENT POINTS MEAN DIFFERENT RISK LEVELS.”

— Malcom Hayday, Founder of Charity Bank

The good news from the research indicates that the industry is slowly beginning to grow in Central and Eastern Europe, as a few new special investment funds targeting social enterprises have emerged and a few commercial banks offering special social enterprise products have set the stage for new ones to follow. The Polish banks and funds definitely lead the way with products that they created over a decade ago that are now mainstreamed and part of their ongoing lending. These provide easier application processes, extend softer lending terms, offer longer repayment periods, experiment with new versions of collateral, and are overall less restrictive in terms of the way they approach social enterprises. A key variable with these entities is that they have been or are being backed by public sources, mainly EU guarantees that allow for more patient terms.

The Romanian banks are behind, as they have not adjusted their terms and basically apply the same terms to social enterprises as they apply to SMEs, with one exception. However, the fact that they are lending to social enterprises and are experimenting with lower interest rates and new ways of securing the loans, also makes them innovators alongside others in the region.

What is interesting in all of these cases, is there seems to be deal flow. The track record of social enterprises has been quite good. Many are repeat borrowers. And, banks are willing to work closely with NGOs and social enterprises who are having difficulties to ensure that they are able to eventually pay back their loans. Although the use of bridge and cash flow financing still predominates, there is a good 30%+ of lending for investment and growth.

The launch of Portus Buda Group, the first local impact investor in the region is a good sign. The group's lower investment amounts, lower interest rates, longer repayment periods and social impact first focus is extremely unique not only for CEE but for impact investing overall. There are few funds at the global level that are set up to give amounts that are less than €500,000 with annual interest rates of 5%. PBG will provide these packages alongside both strategic and capacity support either directly or through co-investors such as NESsT.

However the bad news is that given the large and growing number of social enterprises in the region and their strong dependency on grant funding, these few actors are simply not enough. There needs to be many more organizations—traditional and non-traditional—that are willing to provide patient financing to social enterprises. Although there is no doubt that these instruments must be provided when social enterprises are investment ready, a joint effort must be made to work with enterprises to prepare them for investment

and to foster instruments that are useful for each stage of social enterprise development: blueprint, validate, prepare to scale and scale.

Following are the main recommendations that Romania and the countries of the region should consider to improve the success of financing for social enterprises:

- Overall, more support needs to be provided to social enterprises at the earlier stages, so they can validate their business models and become investment ready.
- Social enterprises must practice sound financial management that aligns as closely as possible with those of for-profit businesses and where social costs are clearly accounted for and made transparent.
- EU programs and regulations supporting social enterprises need to be reformed so that they encourage more entrepreneurial models and where subsidy is used only when appropriate.
- Social enterprise investment models that are working in the region need to be assessed more carefully to see what is working and how they overcame challenges along the way.
- Social investment and social finance models from other countries that are actively financing social enterprises should be carefully studied from all angles—legal, financial, social—to assess how they might be adapted to the region.
- Intermediary organizations and investors play a key role in building a market, as they match the supply with the demand and produce investment-ready



The Motivation Clinic is a medical recovery social enterprise whose proceeds fund the social services provided by the Motivation Foundation for the benefit of children with disabilities. It received a commercial bank loan to cover start-up costs in 2012.

- social enterprises. They need to be supported.
- New instruments (i.e. recoverable grants, patient loans, convertible debt, revenue-sharing schemes, program-related investments, etc.) should be piloted—in some cases with philanthropic capital—and then rolled out to the rest of the sector.
- Lenders also need to create new risk assessment tools that allow them to take into account some of the peculiarities of social enterprises, including their lack of collateral and their focus on social ends.
- Lenders and other investors should consider investing in the investment readiness stage themselves—directly in social enterprises or through an intermediary.

- Legal and regulatory requirements are overly cumbersome, making the investment process difficult for both investors and investees. Streamlined processes should be adopted.
- Fiscal incentives for investors should be implemented that recognize the tax savings these social enterprises provide. The UK's Social Investment Tax Relief can be used as a starting point.
- Public-private funds should be created to make sure that more capital is channeled to these enterprises and so that risks that are taken by investors are mitigated by public funding.
- More pay-by-results mechanisms should be explored by the public sector, donors and investors (i.e. social impact bonds).
- Widely accepted performance indicators need to be adopted so that social enterprise impact can be measured and assessed at the industry level.

At national level, collaborative efforts, around a jointly assumed vision, should be fostered between government bodies (i.e. ministries of finance, EU funds, social affairs, regional development and economy), private and impact investors (i.e. banks, funds), donors (i.e. foundations, corporations, EU, multilaterals etc.), social enterprises, capacity builders, universities and other intermediaries.

This is the goal of the CEE Social Impact Investment Task Force that NESsT is launching with the European Venture Philanthropy Association. It aims to catalyze early stage impact investing in the region by creating a movement to foster more investment in organizations that create social impact and offer financial returns. Initial ideas include publishing a state of the sector report to showcase that these types of investments are already happening, as well as encouraging more investment-readiness programs and co-investment opportunities. NESsT will specifically lead national efforts in Romania, Hungary and Poland.

The potential of social enterprises to contribute to solving systemic poverty and exclusion has never been more recognized at the global level. As many of these enterprises work toward reaching the United Nation's Sustainable Development Goals to eliminate global poverty and build a world of peace and prosperity, there is an urgent need to help them succeed. To do this, they will need capital. Not just charity, but patient investment capital that positions them to grow and scale their impact. There have never been as many innovative players and instruments at our disposal to make this happen. Let's assemble this orchestra and work together to do so.

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