1. Financing forms and the idea of hybrid finance

If you are a social entrepreneur, you will find yourself working between two worlds: one with a more social focus and one with a more commercial focus. By one way or another you will have developed a strategy of dealing with both worlds and hopefully make use of the advantages this brings. In terms of financing, the position means that you as a social enterprise can work with a variety of options. The aim of this article is to first give you a good overview of the available options by explaining the different forms of financing. Secondly, it will focus on how social entrepreneurs can use hybrid financing as a mean for a solid financial structure. If you would like to understand this topic in a broader context, please feel free to participate in the webinar “The first big step: How to transform from a donation-based project into a sustainable social enterprise”, which is available on this website.

Generally, it can be differentiated between non-repayable and repayable forms of financing. While at first the non-repayable forms seem to be clearly preferred, each of the options has its advantage and right timing. The following paragraph will introduce the most prominent forms of financing and gives a short description for each. The graph below offers a good overview of how the categories can be structured:

![Forms of financing](image)

**Non-repayable forms of financing** are usually provided by means of donations/grants or sponsoring. Please note that non-repayable financing can also come from business operations, meaning for example revenues your company generates. Any profit that you make belong to your company and thus can be a way of financing your business. However, these forms of financing will be excluded as the article only focuses on external sources of financing.

**Donations or grants** display a relevant and big source of financing. Over the last years, the amount of donations has increased worldwide and thereby shown that a growing number of players are supporting social and ecological projects. Donations or grants can be made by private persons, associations, foundations, organizations or companies. In most countries strict laws govern the donation process. Because of many abuses in the past, governments want to make sure that donations are not misused for tax evasion or fail to actually support a project. One clear obligation thus is that a receiver of a donation cannot provide any service in exchange for his support – the donation must be a one-way street. Furthermore, donations often have strict ear markings, which means the money is bound to be spend on certain tasks/areas. This is to guarantee the donor that the money is rather spent on for example the
program development than on paying your office rent. It can be burdensome for a receiver to be limited by this obligation and should ideally be communicated beforehand. Sometimes, there are even certain timeframes in which donated money need to be spend by a social organization. In Germany for example this time frame is two years. Last but not least, the receiver of a donation (i.e. your social enterprise) needs to be a non-profit company in order to receive a donation. Depending on the country law these can be different kinds of entities.

**Sponsoring** is the second source of non-repayable financing and a big lever when starting your business. The idea of sponsoring has many similarities to donations: the sources are often the same, it can be provided in form of cash or donations in kind and there is an increasing activity of sponsoring throughout the world. Nevertheless, there are also some major differences which are worthwhile understanding. First: sponsoring is always drafted in form of a contractual agreement. This means that money is not merely transferred to you but instead a binding agreement comes into effect. Second: a sponsoring agreement always builds on an exchange of services. Whenever you are sponsored by an organization, company or other institution, you will have to provide a service in exchange. This can range from printing their logo in your communication material or on your website to working with them as a partner on local projects. This exchange of services can be very fruitful for both parties and should be considered a viable option. As stated in the paragraph above, it is helpful if the expectations to such an agreement are discussed in advance.

Donations, grants and sponsoring are often used in the **early phase of starting a social business**. Usually, they are summarized under the term “fundraising“. Especially when you are looking for seed money or a way to finance a pilot study, these options will most often be the recommended form of financing. It is advisable to be structured and thorough in your search for funding. Most organizations support a concrete topic or area. The more you can relate your social business idea to their support program, the higher your chances will be to be considered. The relevant institutions can often be found through internet research, news articles or network events. Do not hesitate to contact people, present your idea and take the risk of being rejected. Often, unexpected events result which open new doors for you. The strongest reason why this category of funding is favorable is because you are not burdening your company with repayment obligations. All the money you receive can directly flow into your work and you do not need to care about interest payments. Nevertheless, this way of funding also has its downsides. On the one hand, donations and grants will usually be only a limited amount of money. In rare cases you can be lucky to receive a bigger and also long-term funding, however in most cases the support is limited and only covers initial costs or a pilot study. On the other hand, fundraising is by no means a simple task. It is time-consuming and demanding and most of all an enduring effort. As long as you do not receive a stable long-term funding, you will be spending a lot of time convincing old or new donors to support you. Time, you would probably rather invest in your social enterprise.

**Repayable forms of financing** usually are worth considering when you have professionalized your social business and have received first results and successes. For any kind of repayable funding you need to have a certain proof of concept. (A detailed instruction on how to conduct a proof of concept is presented in the webinar “Testing your idea: Why good preparation is necessary and what you need for a proof of concept“). Generally, this is grounded on the fact that repayable financing will require you to earn money with your social enterprise in the long run, so you are able to pay your investors back.
A loan is a very common type of a repayable financing instrument and belongs to the classification debt. In its simplest form, a loan describes “the act of giving money, property or other material goods to another party in exchange for future repayment of the principal amount along with interest or other finance charges.” (Investopedia, 2016). In essence, a loan gives you the chance to invest in your social enterprise for example by hiring further employees, while committing to paying back the money in a certain time frame. When looking for a loan, a relevant criterion is the lender. This can for example be an institutional bank, an investment club, a microfinance institute or a private person. Depending on who is giving you the loan, the motivation is rather financially driven or rather impact driven. In order to build a stable business with the right supporters, you will naturally prefer the one who is supporting the social aspect of your business. In most cases, these lenders will also accept a lower interest rate than institutional banks or organizations.

Direct investments are preferred by investors who not only want to give money to the enterprise but rather want to “become part” of it. As opposed to the classification debt, direct investments are classified under the term equity. By providing you financing, investors buy shares of your social enterprise and basically own parts of your company (roughly speaking usually between 10-50%). The motivation of this type of investment is, that in case the business will flourish, it will be worth much more than it is today and investors will financially participate in this value increase. While this rationale holds true for most “normal” companies, the logic does not necessarily work for social businesses. The simple reason is that social enterprises do not have financial profitability as their number one goal. In case they are really successful, the entrepreneurs will use the money to reinvest it into the company and increase the social impact instead of distributing it to their shareholders. This means that in reality, the true financial value of the company is rarely realized, which makes it less attractive for investors. Several exceptions exist, where the social impact is closely aligned with a commercial model. In this case it can be interesting for investors to invest for both impact and financial reasons.

Mezzanine capital describes a hybrid form: something between a loan and a direct investment. In praxis, money is borrowed such as for a normal loan but with higher interest rates. However, mezzanine investors are treated more like shareholders than lenders. This means they have more information rights e.g. receive regular updates on the performance of the social business, strategic discussions or the financial development (lenders usually do not get these detailed information). In contrast to these extra rights, mezzanine investors will be active in providing advice and supporting the business to grow. For social entrepreneurs this can be an appropriate form of financing if the terms are fair and you receive a valuable input by the mezzanine capital provider.

Loans, direct investment or mezzanine capital will be interesting to discuss when you are ready to take the next step on a professional level. The relevant questions to consider are the right timing and required preconditions (more on that in the article “investment readiness: am I ready to start?” on this website). As the description will have demonstrated: repayable capital drastically increases your obligations and the pressure to succeed with your social business. Even though you are dealing in the social enterprise world, which is different than the regular business world, there are expectations and responsibilities coming along with repayable financing structures. On the other hand, not every investor is a number cruncher.
and will necessarily urge you to work for his financial benefit. There are enough impact investors out there who actually care for the impact, the social improvement and the change you want to encourage. Thus, if you want to build a long-term and stable business and have enough confidence in your idea, you should not be scared of starting an investor search process.

The beginning of this article mentioned the two worlds you live in as an entrepreneur and how you hopefully make use of the advantages this brings. One way of taking the best out of two worlds is a financing mix for your social enterprise. In most cases, the worlds are divided: social organizations and charities, which have no business model, only focus on fundraising for their activities. Companies in return only focus on investor engagement. As a social enterprise, you have the opportunity to use both channels and thereby increase your chances of finding the right financial support for your business. This idea is summarized in the term **social hybrid finance**. In praxis, such a financing mix requires you to have a non-profit part of your company as well as a for-profit part. Depending on your country’s legislation this can involve running two companies side-by-side. While the one is focusing on the commercial aspects of growing the business, the charitable part can focus on generating the greatest impact. The great benefit is that you can accept donations for the charitable part while working with investors in the for-profit part. By this means each of them will be in their familiar set-up and you are not required to decide between a non-profit and thus donation-based or a financially focused company.

As you will have understood from this article, there are several advantages and disadvantages in the various financing options that are available. It is up to you to analyze your social enterprise and reflect on what works for you best right now and potentially in future. Instead of choosing one extreme, as a social entrepreneur you can build a set-up in which you can benefit from both worlds in order to build a sustainable, financially stable organization.

**Vocabulary for glossary**
- Philanthropist
- Shareholder
- Impact investing
- Social hybrid finance