Social franchising – financing its growth

European Social Franchising Network Research Paper 2

ESFN Research Papers

At the time of writing, there are just over 60 social franchises in Europe employing at least 10,000 people. This is one of a number of case studies produced by ESFN to demonstrate the impact social franchises are having across Europe, share learning and raise the profile of this important approach to growing and developing social cooperatives/enterprises.

ESFN is a network set up by social franchises to support the development of social franchising across Europe. You can find out more at www.socialfranchising.coop. The production of research paper was funded by the European Commission as part of the Better Future for the Social Economy Learning Network of 7 national European Social Fund Managing Authorities.

Background.

Social franchising, as we shall see below, is already having a considerable impact on the growth of the social economy and has the potential to have a substantially greater impact.

Finance has been seen as a major barrier to the realisation of this impact by social franchises. This paper sets out the findings of research conducted into social franchising and finance conducted by the European Social Franchising Network. This exploratory research was carried out with a limited budget. We hope to do more detailed and scientifically rigorous research in the future.

Before we set out the findings, we have set out some information on social franchising, its impact and the context to the work.

Social franchising

Social franchising is a method that allows the replication of proven success whilst retaining local ownership. A social franchise has the following key attributes

1. It shares knowledge and resources
2. It shares a common brand
3. There is a social franchisor who replicated the business model
4. There are independent social franchisee

To be defined as a social franchise, ESFN considers that there must be

1. an independent organisation that replicates a social enterprise business model – the social franchisor.
2. at least one independent social franchisee that has been replicated by the social franchisor.
3. a common brand under which the social franchisees operate.
4. an interchange of knowledge between members.
5. an agreement that regulates rights and obligations and secure the sustainability of the franchise as a system.

And that

6. both the social franchisor and franchisees must be social enterprises (ie businesses that trade and have a social purpose) sharing the same values.

Social franchises are having a significant impact. At the beginning of 2011, ESFN carried gathered information on 19 social franchises and found that

- They employ 6,766 employees
- 65% of their employees are disadvantaged in the labour market (eg have a disability)
- They have a combined turnover of €200 million.
- They have in total 324 social franchisees and the average social franchisor has 21 franchises.

We have subsequently identified 63 social franchises across Europe, ten of whom are aspiring social franchises. This number continues to grow as we find out about more existing social franchises and about new ones that are being established. In total there may be over 100 social franchises in Europe.

Extrapolating from our sample, the total population of social franchises in Europe could employ up to 22,000 people and have a turnover of €600 million. This makes them a significant part of the European social economy.

Background to the research

This research was conducted as the final element of work in the social franchising strand of the Better Future for the Social Economy Programme (BFSE). BFSE is a network of European Social Fund (ESF) Managing Authorities and consists of 5 strands of activities, of which social franchising is one.

The social franchising strand has developed a directory of social franchising, researched the impact of social franchising in Europe, held the first European social franchising conference in London and developed over 10 social franchise case studies. It has set up a website, www.socialfranchising.coop to promote social franchises and developed the European Social Franchising Network as a membership body now with over 30 social franchise members.

This report sets out the findings of the research conducted by ESFN into the financing of social franchising. It sets out examples of methods social franchises have developed to raise finance that could be used by others. It also makes recommendations to ESF Managing Authorities, social franchises, finance institutions and the European Commission on how the financing of social franchising could be improved.

Methodology

This is an exploratory study designed to identify some of the key financial issues for social franchisors and act as a pointer for future more detailed research.

It has involved a number of research activities and discussion groups with social franchisors and finance institutions which have included the following

1. The initial research conducted on the impact of social franchises (see above)
2. A workshop held at the London social franchising conference in October 2011. It was led by Care and Share Associates (a social franchise) and Bridges Ventures Bridges Ventures (a UK social economy finance institution) attended by 35 people.
3. A web based questionnaire specifically on finance was developed by ESFN members and circulated to 60 social franchises in November 2011. Thirteen of them responded.
4. A seminar in Antwerp of finance institutions and social franchisors was held in December 2011. Participating in this discussion were representatives from (social franchises) KOMOSIE, Cap Markt/GDW Sued, Common wheels, Community Renewable Energy, Care and Share Associates, Vägen ut, Le Mat, (finance institutions) - FEBEA, Soficatra, Big Capital and the Polish Ministry for Regional Development.

We hope that the results and issues we raise in this report will provide us with a better understanding of social franchising and its finance needs that will support the development of social franchising across Europe.

The Research Framework - the three stages of social franchise development

As our work developed it has become clear that social franchises have a three stage development process. We have called them Forming (setting up the initial social enterprise, Development (developing the social franchise offer) and Expansion (rapid growth of the social franchise). Understanding this and the work done during each stage provides a useful framework to understand the changing development and finance needs of a social franchise.

We will therefore now look at these three stages in turn and then consider how finance has been raised by existing social franchises for each stage and specific finance issues

Stage One – Pilot

The stage sees the establishment of the social enterprise from which the social franchise model will be developed. This could be any new social enterprise and will generally involve raising the finance to enable a successful start-up, usually through grants. Once the social enterprise has become established and is financially stable, the entrepreneur can consider whether or not becoming a social franchise is an appropriate growth mechanism. This phase might typically take 3 years but can be much longer. This study does not focus in detail on this stage as it is relatively well understood phase all social enterprises have to go through

Stage Two – Development

The establishment of the social franchise based on the founding social enterprise. For most social franchises this will mean codifying the learning from stage 1 and the development of social franchise manual, quality systems, branding for social franchises, development of business plans and so on. Quality systems will also be developed to monitor social franchises and ensure consistency. Other elements will depend on the nature of the social franchise, thus for a care organisation this might include care management systems or uniform designs. This stage is completed when at least one social franchise is established and trading successfully and profitably. An organisation to manage and support the development of the social franchise, the social franchisor, will also be set up and will become distinct from the founder social enterprise. This stage will take a minimum of a year, but is probably more likely to be 3 years.

Stage Three - Expansion

All the basic systems for the social franchise have been developed and tried out. Developing new social franchises is now much quicker and the social franchise moves into an exponential growth phase. The social franchise and franchisees might now begin to develop new product and services and the role of the social franchisee becomes much more about managing a network.

Research findings

We will now look at our findings for each stage and then look more generally at the establishment of franchises.

Stage One The Pilot

Key findings

- The average cost of establishing the first social enterprise is €130,000
- National, regional and European funds are the main sources of finance
- European Social Fund was the second largest contributor.
- 88% used voluntary workers, and other free resources during this start up phase

Capital is needed to start any social enterprise and on average start up costs is €130,000 (there are widely varying start up costs depending on the nature of the enterprise). During 2010, the average profit was €53 800, however, half of the sample had very low profits, something that would provide concerns for their long-term viability.

There is a wide range of legal structures among the respondent, consortia, Community Interest Companies with shares, Company Limited by Guarantee, non profit organisations, Charities, etc. It was clear that legal structures affect the sorts of finance mechanisms open to the organisations.

The net asset on balance sheet, one year after the first social enterprise started, was in average €104 000. 25 % of the social enterprises used some form of leasing to finance their operations

Stage Two Development

Key findings

- The average cost of establishing the franchising model is €150,000
- The main source of funding was the European Social Fund, mostly Equal, a programme that now no longer exists and has not been replaced
- 43 % of the social franchisors offers loan or other forms of finance to their franchisees – a low proportion compared to commercial franchises
- Member's investments (eg Energy4all develop wind farms and get members to invest in constructing the wind farm providing the equity) and regional and national grants are the main source of investments.
- 100% of the franchisees use other ways of lowering their cost such as sweat equity (time put in for no pay or deferred pay when the organisation is established) pure volunteer time or free resources like buildings

The annual average turnover of the founding social enterprise was € 174 000. The net assets shown on franchisors balance sheet at the end of the second year, was, on average, €13700 and 14 % used leasing for equipment etc. One example of investment from franchisor to franchisee involved the franchisor providing the start-up capital and initially owning 100 % of the new franchisee's shares. Over a period of time as the loan is paid back the franchisor released the shares to the franchisee.

Our research was basically with social franchises that had been successful and got through Stage 2. However, we believe that most social franchises would agree that this is the most difficult phase to get through. Anecdotally would be the most likely phase for failure to happen. For example, Recycle-IT (a UK computer recycler) failed at this stage as it lacked the resources to establish social franchises and maintain the founding social enterprise

Stage Three Expansion

Key findings

- For the first time debt (loans) and equity finance are significant. Equity from social finance institutions, eg Bridges Ventures , a social investor, and the European Social Fund were the main sources of finance for the expansion of social franchise. Member investment continues to be important for some organisations to provide equity.
- The equity investors typically expected the social enterprise to buy back their shares as in a conventional business at a premium, thus the exit strategies for equity is repayment and buy back of shares

No one in this phase used leasing of equipment etc. The average net asset on balance sheet, after the year the franchisor expanded was € 21 600.

With regard to equity, 43 % of the franchisors did not use any risk capital or equity 14 % involved equity from an outside investor but had not worked out how the equity investor will be bought out – there was no exit strategy. 43 % had used or were using equity and understood how the equity investor will exit or they have already exited.

Different exit strategies were used. For example

- simple repayment after 6 years, effectively like a loan
- deferred buy back of shares with, for example, re-payments starting 5 years after the investment was made and being completed in 8 years
- straight forward buy back of shares owned by the investors.

The biggest financial challenge for the franchisor is establishing enough social franchises to make the franchisor viable. With grants and EC funding, this phase can become much quicker. Without grants or investment the process is slow and the social franchisor has to rely on their own retained profits and/or sweat equity.

Overall, the social franchisee now finds the raising of finance much easier than a stand alone social enterprise. They are using a proven model and finance institutions, having done due diligence on one financially proven social franchise, can reduce the cost of investment and perceive a reduction in risk..

There are parallels here with commercial franchise and some social franchises have developed a package that not only includes the business in the box (the franchise offer) but also the finance to establish it. Here the franchisor will often negotiate a finance package on behalf of it franchisees and can the offers a package that includes finance. Finance institutions like this approach because it reduces their costs and speeds up the establishment of the business reducing investment risk. In addition, the finance institution can spread risk across a number of franchises allowing them to reduce the cost of finance. Franchisors benefit because it enables more franchisees to set up and gives them greater control whilst the franchisee gets a complete package for the start up of their business.

An example of this in practice is the Italian day care social franchise PAN. Banca Intesa make available through PAN project funding of up to €150,000 with optimum financial conditions and without general obligation bond payments.

Financing individual new franchisees

Our research has highlighted some key factors in the establishment of social franchises across both stage 2 & 3

- The main sources of finance are equity capital, national and regional grants, European Social Fund and members investments
- 86 % need seed funding/risk capital

- 86% thought it was difficult to get loans from banks. Bank loans were needed to finance projects, for research and development, capacity building, working capital, investments in facilities, tools and general expansion
- The main problems in obtaining loans is the bank's lack of understanding of social enterprise ,and their need for personal guarantees

The average net asset value on balance sheet of a new franchisee was €15 700. 14 % of the franchisees use leasing. 86 % used 'free' money or resources such as local development money from the public sector, volunteers, sweat equity and free advice (eg from specialist social enterprise advisors).

Raising finance – how it has been done

Social franchises, as with the social economy in general, have used standard finance methods (eg debt and equity) but also some quite innovative and unique approaches, some of which are particular to social franchising. Here we will give some examples.

Networking Guarantees

Whilst often finance issues for the social economy in general are similar to social franchising, there can be significant differences. One example is the ability of social franchise, operating as a network or federation, to set up Network Guarantees for individual members to raise money. As well as the members of the social franchise, a network of committed partners (private investors, people who want to support the social franchisor) can act as guarantors for the social franchise or franchisees. For an external financial partner this is unusual and innovative and very effective.

Quasi equity/debt

Currently there are a growing number of committed social investors who are seeking to provide equity to social enterprises. However, the usual requirement for ownership and a high return of equity investors, creates problems with some legal structures and ownership of the social franchise. There are also potentially issue of private investors effectively making large profits through a social enterprise. This is a particular problem for legal structures, usually cooperatives, such as Ekonomisk förening in Sweden or Industrial and Provident Societies in the UK which hold to a one member one vote cooperative approach. This means that an investor can not effectively take control of a social enterprise by providing the majority of the equity and without this control many will not invest.

Quasi equity, debentures or other mechanisms allow for investors to get a return based on the performance of the social franchise and make substantial investment without taking a controlling stake. Bridges Ventures in the UK have provided quasi-equity to Care and Share Associates and whilst they have a Board member, they do not take control of the organisation. This means that the money is technically a debt, but the return has been indexed to financial performance at an agreed, but not excessive, level.

Branding & sharing risks

Social Franchising is a development of the social cooperative movement. In Italy they have developed the brand Le Mat as a social franchise. Equal was important in developing specialist tourism know how and the formation of the social franchise.

Le Mat used a franchise system to share risk between franchisor and franchisee. Le Mat needed more capital to expand the social franchise and turned to social cooperative movements to fund this. By setting up a consortium they could double their risk finance by drawing down finance from a social cooperative development fund. The fund was developed using a levy on profits all social cooperatives in Italy have to pay of 0.3% of their profits. This money is then used to support start ups and new developments like Le MAT. Similar arrangement works in France.

Sweat Equity

Commonwheels is a UK car sharing social franchise. It operates in 18 cities, towns and villages and has four social franchises. It has experienced considerable demand for its social franchise offer but has limited funding to respond to demand. Founding members are therefore putting time at risk to develop the franchise to the point that it becomes sustainable. In return for this, these founding members are paid in shares and dividends in return for their time.

Social Financers

KOMOSIE – they have the DeKringwinkel social franchise, the biggest in Europe, which has set up a network of reuse shops and electrical recycling units. To set up a new shop, initial investment is made by local members, investors with a social concern. KOMOSIE also gets investment from ethical finance banks and the franchisor (KOMOSIE) continues to develop their activities using government grants and grant making foundations. Even now new projects get grants for developing new business ideas but they have made the strategic decision not to get grants to cover core KOMOSIE costs. They must be financed out of the income from franchisees.

Division of investments and operations

Capital has traditionally been difficult for social enterprises and cooperatives to raise and has thus meant that the social economy has not had a significant presence in capital intensive businesses.

Social franchises have developed a method commonly used in the private sector whereby the ownership of the capital asset and the running of the business are separated. Such an approach is more viable for social franchises because they have the scale to parcel up assets to make investment attractive to investors. Here we will provide two examples from Sweden

1. *Villa Vägen ut* in Sweden provide half way houses run by and for people with drug and alcohol problems and employment through cooperatives set up by *Vägen ut*. It now has 6 hostels. Equal, which is now no longer available, was used to develop first pilots and the development of the brand and the franchisor. All 6 current franchisees have set up hostels in large houses that

sleep 8 people. Their set up is therefore capital intensive. To overcome this, many of the houses have been bought by private investors and rented to *Villa Vägen ut* at market rate. Franchisees can manage these rents because the hostels are profitable.

2. Le MAT is a tourism brand and Sweden they have set up two hotels with more in the pipeline. They created a company owned by stakeholders and private investors to own the hotel. The investors were state bank and ethical banks like Soficatra with mutual guarantee for banks provided by other social cooperatives. The investment company, Le MAT Estates, bought the building s and the social franchisees use it to run their hotels. Le Mat Estates owns all the hotel properties and which are operated by social franchisees.

Member investment

As we have seen already with KOMOSIE, members can also be a source of finance. In the UK this approach has been developed using the Industrial and Provident Society (IPS) Structure for cooperatives and community benefit organisations who can issue a Community Share Offer. IPS can offer shares to their community without needing regulatory approval making this relatively easy to raise finance of up to €500,000. Social franchises in the renewable field, like H2OPE (water turbines) have developed this approach for their franchisees. However, the most successful has been Energy4All who have raised €millions to develop wind farms using the IPS structure. This then provides the equity which is used to raise bank loans principally from the Cooperative Bank. Members get a healthy return as Shareholders of up to 9% making this an attractive investment. Energy4All have more recently used this approach to raise finance to establish new wind farms (a much higher financial risk) and have raised a £I million Pioneer Fund building on their track record constructing wind farms.

Franchisor as financier

As the social franchise develops the social franchisor becomes a more credible investment vehicle for a finance institution. For example, initially, finance for start up of the CASA franchisees was sourced locally, usually form locally available grants. Now finance goes through CASA, at present from Bridges Venture, as they are more credible with finance organisations. CASA lends money borrowed from investors at the same rates to franchisees.

Conclusions

Stage 2 is the crucial and most risky phase for social franchise development and the key bottleneck. Stage 1 can be financed by grants or public projects (establishing the social enterprise) and Stage 3 through loans and equity and debt finance as the social franchise model has been proven and de-risked. This then leaves Stage 2 as the main bottleneck as it is difficult to raise grants for an existing established enterprise and financiers see it as a high risk investment. It is a high risk high return phase. If social franchising is to reach its potential it is this bottleneck that must be unblocked and it was therefore the area we focussed on and developed the following conclusions.

1) A possible means of financing Stage 2 is to create Social Franchise Development fund generated from a levy on social franchises (as with Italian example mentioned earlier) either on their profits or from a small additional interest paid (say 0.25%) on loans to social franchises in the Expansion phase – a form of mutual leverage. This money is then invested as equity and gets a high return from those social franchises that succeed. Governments and EC could be underwriters. Other social investors could invest in this Fund. This Fund of money effectively shares risk across a basket of social franchises and thus reduces investor's risk.
2) Establishing a social enterprise (Stage 1) and setting up individual social franchises requires general business management skills and sector specific business skills. The social franchisor has to additionally develop new skills so they can also manage franchisees and keep the network together. Thus the managers of the founding social franchise need to learn new skills and change their way of operation as they move from managing the founding social enterprise in Stage 1 to managing a social franchise in stage 2. They also need the capacity and financial resources at some point during Stage 2 to both manage the founding social enterprise and the developing social franchise and probably new social franchises. Thus Stage 2 is bottleneck not simply due to an issue of finance, it is also one of capacity and skills.
3) To provide the expertise and speed up Stage 2, ESFN could use established social franchises to support developing social franchises. Thus social franchisor of developed social franchises become mentors for developing social franchises. CAP Market and KOMOSIE have done this internally. ESFN should develop a methodology of supporting new start up social franchises using grants in combination with such mentors. Mentors could be paid for this by the investor or social franchise. Alternatively, they could take an at risk approach with mentors getting payment on results or out of profits social franchisor generates once it is established.
4) Many funders, including the European Commission, are looking at providing loan and equity finance (eg the Social Business Initiative). ESFN needs to use the window of opportunity to look at providing support with money to develop social franchises and capitalise on the current interest in social investment.
5) Social investors need to invest in early stage development to get pipeline of long term projects – without investment in Stage 2 there will be few Stage 3 investment opportunities. They need to take more risks.
6) ESF needs to support the development of the franchisor (Stage 2) but currently it is difficult to do this using ESF, which is risk averse. A fund like the former Equal programme is needed that is designed to take risks.
7) Social franchises need to move beyond only securing finance and support from ESF and use other, often much larger, sources of EC finance particularly in Stages 2 and 3. Thus they need to be approaching DG energy or DG Regional Policy for issues like renewable energy or enterprise creation. To enable this, DG Employment needs to explain the value of the social economy to other DGs

Key learning

1. A social franchise is a means of development that effectively shares the development risk and responsibility of social franchise amongst more people, the social franchisees. This can help raising finance as well as the general development process.

2. Simply copying finance models from the commercial sector can cause problems. For example, as we have seen, ownership of the social franchise is a major issue when looking at equity investments. Traditionally, equity investors require ownership and a share of the profits in relation to their investment which creates huge problems for social economy organisations. This can conflict with their fundamental values of creating a social rather than financial return and social ownership. We need to adapt and develop new finance models that are more appropriate for the social economy and are still attractive to investors, like debentures and make more use of member or community investment. We also need to make investors realise that a social franchise is lower risk than a normal commercial start up. Commercial franchises and social enterprise both produce lower business failure rates than are found in the commercial sector. Combining both approaches in the form of a social franchise will therefore further reduce failure rates and reduce investor risk and the need for high returns.
3. During the Stage 2 (Development) it is generally easier for new social franchisees to raise finance locally because of the involvement of the social franchisor In Stage 3 this situation is reversed as the franchisor, with a greater proven track record has more credibility than the franchisee and can raise finance centrally for its franchisees and can also do this at a scale that makes investment more attractive.
4. Social franchising provides a more effective vehicle for social investment than stand alone one off social enterprises. This is because franchising, once established, reduces risks.
5. In capital intensive operations like hotels or renewable energy, separating the ownership of the assets (owned by the private sector or social investors and perhaps social franchisor) from the operation of the assets (done by local social franchisees) can be a way of dealing with problems cause by straight equity investment into a social franchise.
6. A Social Franchise Development Fund can be developed to finance Stage 2 from a levy and/or social investor and/or private investor, reducing risk by a basket approach and by using successful social franchisors as mentors.
7. Anther complimentary alternative is for social franchises to raise finance from their members/users through eg share offers (in the UK, social franchises like Energy4All have used Community Share Issues to do this).
8. Managing a social franchise is about managing a network which is different to running an individual social franchise or the founding social enterprise. It therefore requires different skills and a different approach.
9. Social franchising provides a methodology for expanding the social economy at a relatively low cost. Once a successful social franchise is established, like CASA and CAP Market, they will fund their own growth through loan finance and equity without the need for grants from the state. Through this mechanism we can create self financing social enterprise development agencies that can create jobs, particularly for disadvantaged people, and tackle key social issues like climate change or caring for older people

Future Action

ESFN and supporters need to

1. Develop finance case studies. They should demonstrate how to attract and pay back investors within a not for profit distribution structure.
2. Make social franchisors aware that they are not alone and need to raise awareness of social franchising and share knowledge on finance and other issues
3. Develop an investment pot for early stage development of social franchises.
4. Do more in-depth research on how finance works for social franchises and share models. Our research was very constrained by budgets and timescales. With more resources, a lot more valuable lessons could be indentified and shared. A particular area for further research is into the different exit strategies that social franchises and investors have developed that are suitable for the social economy.
5. There is a tremendous opportunity for lobbying given the growing interest in social investment and the proven success of social franchising. We can use each other to carry messages in different fields and use what others have done in other countries in our own localities. We need to find ways of doing this effectively.
6. Organize a syndicate of social investors including ESF Managing Authorities and the Commission and develop and implement best practice in financing social franchisors.