FELLOWS PROGRAM | MILKEN INSTITUTE

February, 2014
No. 86

Executive Summary

Creating a Social Investment Fund in Israel: Policy and Financial Considerations

Daniela Kandel
Milken Institute Fellow

MILKEN INSTITUTE

About the Milken Institute Fellows Program

The Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental challenges. Our goal is to accelerate Israel's transition from a Start-up Nation to a Global Nation with solutions that others can replicate.

Directed by the Milken Institute Israel Center, the Milken Institute Fellows Program awards annual fellowships to outstanding Israeli university graduate students. Through the Milken Institute Fellows program, we train some of Israel's best and brightest young professionals in creating pragmatic financing and economic policy solutions, and they deploy them as resources to government ministries, nonprofits and other key organizations. Our applied research and Financial Innovations Labs® are a launching pad for transformative change, using innovative financing mechanisms, programs and policies to bridge social, regional, economic and productivity gaps within Israel and between Israel and the world.

In addition, Fellows craft their own policy studies during their internship aimed at identifying barriers to job creation and capital formation in Israel. The Fellows' research, carried out under the guidance of an experienced academic and professional staff, support policy makers who shape economic reality in Israel. The program offers the ultimate training opportunity, combining real-life work experience with applied research.

Throughout the year, Fellows receive intensive training in economic and financial analysis, public policy processes, and research methods. They acquire tools for communication and presentation, policy analysis, leadership and project management. The fellows participate in a weekly research workshop where they meet senior economic and government professionals, business leaders, and top academic and financial practitioners from Israel and abroad. They also participate in an accredited MBA course. The course, which focuses on financial and economic innovations, is taught at the Hebrew University School of Business Administration by Prof. Glenn Yago (Senior Director/Senior Fellow at the Milken Institute).

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve in key positions in government ministries while others work at private-sector companies or go on to advanced graduates studies at leading universities in Israel, the United States and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, accelerating economic growth, and improving the quality of life for Israel's citizens.

The Milken Institute Fellows Program is a non-partisan, non- political organization. It is funded by the Milken Institute and other leading philanthropic organizations and individuals in the United States and Israel.

More about the program: www.mifellows.org

Contact us: info@mifellows.org

Social services in Israel, which rely primarily on government spending and philanthropic donations, are underfunded. The sector cannot keep up with the growing demand for its goods and services. As a result, Israel is in need of new and efficient sources of social-services funding.

One possible solution to this problem is the development of social enterprises. This new category of organizations integrates business strategies with social services so that the enterprises can generate revenue and become more self-sufficient. The revenue could be used to repay loans that would provide needed capital for start-up and expansions. Social enterprises can be in the form of non-profits, business entities, or hybrid organizations such as profit-for-purpose businesses. In economic terms, under certain circumstances, the social enterprise earns its own income, ultimately becoming independent from philanthropic donations and government support, and able to develop long-term, sustainable revenues to fund its operations and grow on its own. This model is also scalable, enabling the social enterprise to make a broader impact with innovative practices and efficient outcomes.

Currently, the social-enterprise marketplace is not well developed in Israel. There are many barriers, including regulatory restrictions, financing limitations, and legal definitions. Nevertheless, social enterprises are slowly starting, gaining support and adapting creative legal, regulatory, and financing solutions through the expanding network of social investors in Israel and abroad.

In 2012, the Israeli government began to take steps to promote social enterprises, calling for the establishment of the “social initiatives fund,” which is an investment fund for social enterprise. The fund’s objective is to leverage public and philanthropic investments to create a new source of financing for the development of social enterprises. The National Economic Council, in cooperation with the Accountant General’s Office at the Ministry of Finance, requested information from Israeli investors and asked fund operators to begin the design work for a formal tender for the fund. In late 2012, the Ministry of Finance, National Economic Council, and the National

Insurance Institute, Capital Department, began work on this tender which was released in July 2014.

This study discusses three main areas of the social initiatives fund:

1) Definitions of social enterprise. By creating an index that identifies the relationship between the financial yield and the desired social benefits of the social business, this study provides clearer definitions. This index introduces a uniform methodology for measuring social benefit based on the impact on those services by the social enterprise and thereby allowing for comparison between different types of social enterprises. This builds upon discussions from the Prime Minister's Office Roundtable on Social Financing in 2012-13.

2) Social and economic outcomes from the investment. This study addresses how to evaluate the economic costs and benefits of services and savings to the public for each individual served by the social enterprise. This evaluation methodology focuses on gathering empirical data by looking at outcome measures and comparing investment choices by the social investment fund during the pilot.

3) Financial structure of the social initiatives fund. This study models three scenarios using a variety of assumptions and variables, including equity, capital market leverage, interest rates, risk premiums, management costs, loss rates, and recovery rates. Each scenario also considers the period of lending, repayment terms and deferral periods for social enterprises.

A. The first model demonstrates social-enterprise loans by using philanthropic investment and government funding to create a reserve for leveraging loans from the capital markets (leverage ratio is 1.7:1). During the short term of the proposed pilot program, with the burden of repaying the capital-market loans from social-enterprise loan receivables, the model demonstrates a return of all principal and interest to the capital-market investors, but loses almost 20% of the philanthropic and government reserve fund's principal and is therefore unsustainable.

B. The second model demonstrates philanthropic investment and government funds as shareholder equity to leverage capital-market loans to the fund (leverage ratio is 1.1:1). The capital-market funding is invested in social enterprises as equity, although with capped repayment terms because social enterprises do not typically return an equity-like yield on investor exits. This model treats the capital-market investments as a loan with fixed terms for repayment and is protected by the philanthropic and government funding. This model is very sensitive to changes in the investment parameters and repayment terms, returning all of the principal and interest to the capital markets and earning approximately 11% on the philanthropic and government investment.

C. The third model demonstrates the philanthropic investment and government fund used to provide equity investments in social enterprises without any loans or funding from the capital market (leverage ratio is 0:1). Instead of using the philanthropic and government investment as a reserve fund to protect the capital-market loan, the model shows direct investments. With no obligation to repay principal and interest to other investors, this model demonstrates a higher rate of return on invested capital (over 80%), though no leverage of additional investors.

Based on these scenarios, the research recommends that the most appropriate model for the proposed pilot period of the social investment fund should combine the different investment approaches, including loans and equity to social enterprises. This hybrid model is based on providing loans and equity to social businesses with some loans from the capital markets. Such a model allows leveraging of the governmental and philanthropic funding in an efficient manner, reducing risks and providing cross-subsidies between the scenarios.

One of the indirect goals of the fund is to normalize the establishment, operations, and finance for social enterprise in Israel. It is expected that the social investment fund will prove the potential of social enterprise, providing more clarity, transparency, and experience with social business models, reducing set-up and administrative costs, and increasing the capacity and financial leverage from the capital markets.

Recommendations

1. After the initial period of the social investment fund (10 years), the Government should structure the fund for a longer period, extending the terms (and repayment) of the capital-market loans and improving the financial performance and sustainability of all of the fund scenarios.
2. The Government should continue the fund's activities with appropriate adjustments, allowing the government and philanthropic investments and returns to recycle in the fund. This type of fund is called an evergreen fund.
3. Collect data about investment and outcomes from social investments to measure the social benefits and refine the definition of a social enterprise. Based on these measures, efforts should be made to target social investments to increase effectiveness and efficiency.

The combination of the social investment fund's financial activities and an updated definition of a social business based on the pilot period can lead to important changes in the social-enterprise market in Israel, as well as attract new and greater sources of funding to address Israel's social challenges

FELLOWS PROGRAM | MILKEN INSTITUTE
Milken Institute Fellows Program
4 Washington St.
Jerusalem, 9418704, Israel

info@mifellows.org
www.mifellows.org