



THE BOSTON CONSULTING GROUP

A Tale of Two Funds

The management and performance of Futurebuilders England

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Foreword by Sir Stephen Bubb

I remember when Futurebuilders was set up. A mix of excitement at the scale of the money being committed and the usual round of sector whingeing about the wickedness of loans ('tools of the devil,' as one CEO told me).

I was keen. I had been on Ronnie Cohen's review and saw the importance of social finance and how this could help grow the sector. I had talked to Paul Boateng, the Treasury minister responsible for the birth of the scheme and we both felt this was one practical way we could support the reform of public services by more third sector delivery.

The importance of the Futurebuilders programme and experience cannot be underestimated. Not just to those charities and social enterprises who received loan funds and support in extremely challenging conditions, as pressure on the public purse combined horribly with the financial crisis to constrict the limited pools of money available.

But also, we must take stock of how Futurebuilders tested long held perceptions and behaviours on how frontline organisations accessed capital, which is still a live debate ten years on.

I have witnessed the Futurebuilders experience both from my role as Chair of The Social Investment Business and as CEO of ACEVO. Through Futurebuilders and our other funds, I have seen how the social investment market has evolved and observed its impact on frontline organisations over the past decade, which has culminated – not started – with the launch of Big Society Capital.

As with any pioneering initiative, Futurebuilders was not without its challenges. It was never going to disrupt the boundaries of traditional attitudes towards loan capital without creating tensions and operating in often unknown territories.

We simply must tell the full Futurebuilders story – from its inception to present day, on its 10th anniversary. It's a success story. Our sector is better as a result of it.

I would like to thank Adrian Brown and his team from The Boston Consulting Group for their analysis and all those who gave up their time to contribute to this piece.

A handwritten signature in black ink that reads "Stephen Bubb". The signature is written in a cursive, slightly stylized font. There is a horizontal line drawn underneath the name.

SIR STEPHEN BUBB

Chair, Social Investment Business

Foreword by Jonathan Jenkins

Everyone in the UK social investment market has an opinion on Futurebuilders.

That's not surprising: it was the biggest fund – by far – of its time, launched in the early days of a social investment ecosystem that is now globally recognised as one of the most advanced.

I certainly had a strong perception of the fund, which I took into my interview for the job of chief executive of the Social Investment Business (SIB) in the summer of 2011. I was asked whether I had any questions for the panel. One was top of my list. Was the financial performance of the Futurebuilders fund really as strong as SIB's limited published headline data – write-off rates in the low single digits – made out?

As I kept probing, the panel became a little irritated with my persistence. "Why do you keep asking about this?" one panel member asked. "Because I don't believe it, *and neither does the wider market.*"

Having been in the job for more than three years now, I know that we have a fascinating and important story to tell about Futurebuilders. Still the largest such intervention anywhere in the world, the programme changed attitudes to debt in the sector and has been a foundation for much of the growth of social investment since. And while the majority of the loan book is still outstanding, the performance of the fund has been stronger than I (and the wider market) would have expected given its aims.

However, I also know that historically we haven't done enough to tell that story. I wanted that to change. In fact, the story of Futurebuilders isn't just about the performance of one investment fund. It spans and defines the early phase of the UK social investment market – a study of government intervention in an emerging market.

I believe passionately that this market can grow, and key to that growth is the sharing of the experiences of the pioneering organisations such as SIB. There are many pertinent lessons and benchmarks to consider, as we enter the second decade of large-scale social investment in the UK.

2014 was the 10th anniversary of the first investment from Futurebuilders, so what better time than to capture the data and ask the Boston Consulting Group to undertake this analysis and develop recommendations for social investors based on the lessons from those first ten years.

I hope you find the outcome as interesting and useful as I do.



JONATHAN JENKINS

Chief Executive, Social Investment Business

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Executive summary

As the title of this report suggests, views about Futurebuilders are wide-ranging. However, until now the story of the fund has been told through incomplete data and disparate voices. With access to a decade's worth of data, and interviews with many of the individuals involved, we can now paint a more complete picture.

It is easy to forget now that Futurebuilders set out to attempt something that many people thought impossible – to persuade the voluntary and community sector to make greater use of repayable finance. Prior to Futurebuilders' existence, lending to the sector, while not unheard of, was commonly restricted to loans securitised against assets such as buildings or vehicles, so this fund represented a bold new direction.

In that context, we consider both the management and performance of Futurebuilders across two disbursement phases (2004-2008 and 2008-2010) and the period since then during which the loan book has been managed.

It is clear that a lack of clarity about the fund's objectives hampered the initial management team, as did the fact that the oversight of the fund changed three times in the first four years. However, in the first phase of Futurebuilders a total of 227 organisations received funding worth a total of £60 million, which included just £3 million of full grants. For a sector unused to repayable finance this was a significant achievement.

The second phase was characterised by increasing deal flow and deal size, which for some meant that Futurebuilders became too dominant in the market. While we find no evidence that Futurebuilders was abusing its position, it is clear that more could have been done to increase market engagement and transparency during the second phase.

At fund close, our analysis shows that Futurebuilders had invested £145 million in 369 organisations, including £117 million of loans. The typical Futurebuilders investee profile was a midsize charity with a turnover of ~£3 million. The average loan size across the whole book was ~£500,000. Of the loans written, approximately 20% of the capital is now closed (either paid down or written off) representing 40% of deals.

The fund's performance may surprise many. Our analysis focuses on the 20% of the book that is now closed, which yielded a moderately negative Internal Rate of Return (IRR) of -3% per annum. Given the pioneering nature of the fund, the fact that it was targeting organisations that were unused to accepting loan finance and that the period included a major financial shock, this performance is unarguably more positive than might otherwise be expected. A summary of the fund is shown in Figure 1 below.

In conclusion, we offer six recommendations for designers and managers of funds.

1. **Be clear on objectives from the outset:** Futurebuilders has been dogged by a lack of clarity over its objectives. Crucially, return expectations have never been made explicit.
2. **Take care when blending grants and loans:** blending grants and loans allowed the perception to develop that grants were subsidising lending activity.
3. **Keep products simple:** the simplicity of Futurebuilders' main product (6% fixed rate loans) made the product easy to communicate and (relatively) simple to administer.
4. **Develop clear investment criteria – and stick to them:** too much effort was spent chasing opportunities that would never be investible.
5. **Be transparent and engage other lenders:** rightly or wrongly, Futurebuilders was viewed with suspicion by other lenders, which greater transparency would have helped to counter.
6. **Measure social impact alongside financial impact:** measuring the social impact of Futurebuilders was not given much attention until after the fund had closed.

Figure 1: Summary of Futurebuilders' financial performance¹

	Total Portfolio	Phase 1	Phase 2
Capital invested	£145m	£59m	£84m
Loan capital invested	£117m	£45m	£71m
<i>Of which loan capital written off</i>	£8m	£5m	£3m
Grant capital disbursed	£28m	£14m	£13m
Repaid to date, incl. interest	£66m	£27m	£37m
Number of recipients	369	227	158
Grant recipients only	151	121	21
Loan recipients only	183	104	104
Mixed grant/ loan recipients	35	2	33
Number of loans	254	99	150
Number of grants	501	323	153
Average recipient size (turnover at time of investment)	£3.2m	£1.5m	£5.2m
Average loan size	£461k	£460k	£478k
Average loan term	8.5	8.9	8.2
Average grant size	£55k	£44k	£76k

¹ ~£1.5m worth of deals are not split by phase but are included in the total

1. Introduction

It was the best of funds, it was the worst of funds.

Futurebuilders,² which provided loan financing to voluntary and community sector organisations in England to help them bid for, win and deliver public service contracts, certainly won its share of supporters and detractors.

For some, it was one of the founding pillars of the UK social investment market. Others viewed it as a distortive influence that undercut other nascent players to ‘get funds out of the door’. Allies said it helped introduce the concept of repayable finance to a sector that had grown far too reliant on grant finance. Its critics believed it created unrealistic expectations about the cost of lending to the social sector, which remain to this day.

In short, no other intervention in the UK social investment market has attracted such conflicting, and strongly held, points of view.

One fact speaks for itself. With £117 million of loan financing, Futurebuilders was the largest social investment fund in the UK and its total disbursements remain larger than Big Society Capital's payouts to date. Given its size, and the fact that it now has up to 10 years' worth of performance data to draw on, it offers one of the richest sources of insight for those interested in how such funds can be designed and managed in the future.

Facts about Futurebuilders have long been scarce. The inside story of the fund's creation and management has remained hidden in internal government memos, tender documents and the personal experience of Futurebuilders' management teams. In particular, detailed data on the financial performance of the loan book has never been made public. Until now.

Through access to this data, and interviews with many of the protagonists over the years, we have built up a detailed picture of Futurebuilders, from inception to the present day.

In chapters 2 and 3 we draw on extensive stakeholder interviews to examine the fund's two disbursement phases:

- Futurebuilders 1 includes the set-up and start of lending up to the re-tendering process in March 2008, and is discussed in chapter 2.
- Futurebuilders 2 continued under a new Fund Manager from April 2008 to January 2010, when the loan applications closed, and is discussed in chapter 3.

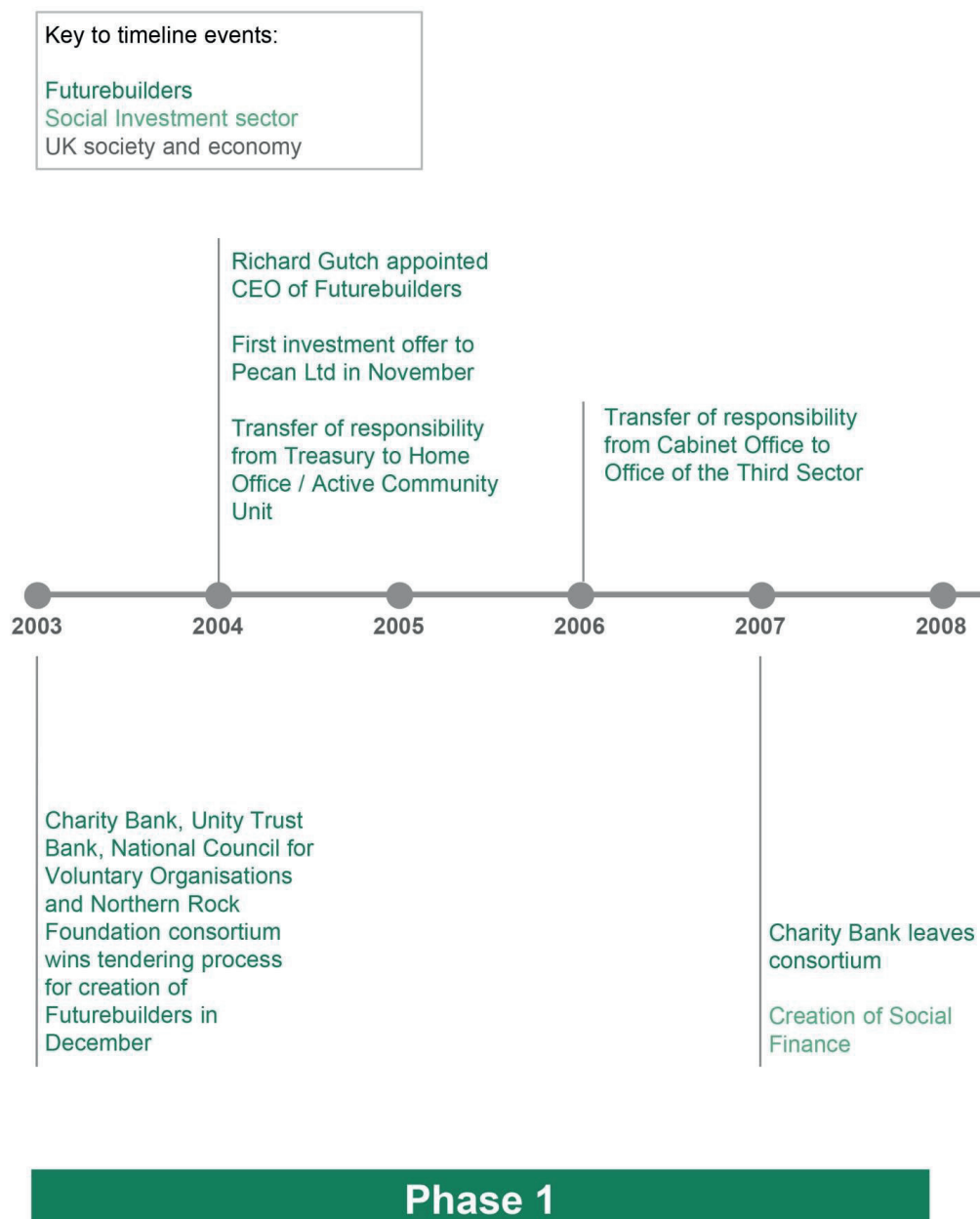
Chapter 4 includes a detailed analysis of the financial performance of the book to date.

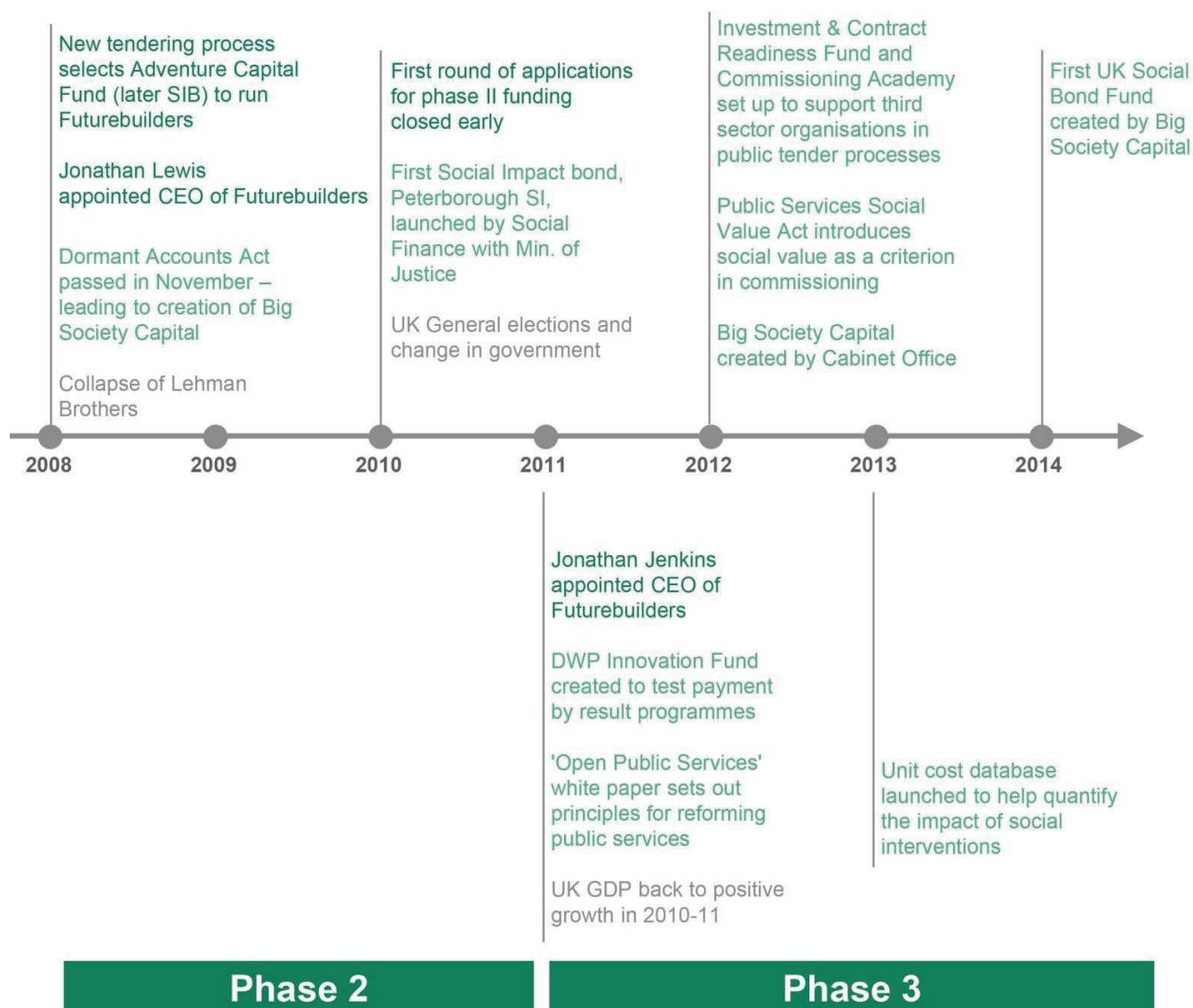
Chapter 5 draws conclusions and highlights lessons learnt.

While our report considers both sides of the debate, it is hard to conclude that Futurebuilders was anything less than a largely positive contribution to the UK social investment market.

² While officially known as the Futurebuilders England Fund we refer to it simply as Futurebuilders throughout this report for the sake of brevity.

Figure 2: Futurebuilders – timeline of key events





2. Futurebuilders I (2004-2008)

It is easy to forget now that Futurebuilders set out to attempt something that many people thought impossible – to persuade the voluntary and community sector to make greater use of repayable finance. Prior to Futurebuilders' existence, lending to the sector, while not unheard of, was commonly restricted to loans securitised against assets such as buildings or vehicles, so this fund represented a bold new direction.

But the purpose of Futurebuilders was not restricted to growing what we might today call the social investment market. Indeed, the main rationale for Futurebuilders was to enable social organisations to participate in government contracts.

The initial mission for Futurebuilders was therefore both bold and broad. Too bold and too broad in retrospect, as the Fund Manager struggled with ambiguity of purpose and an ever-changing cast of government handlers with different expectations.

The result was a sense of unrealised potential during Futurebuilders I that eventually led to the re-tendering process that awarded the second phase of Futurebuilders to a new Fund Manager.

2.1 Futurebuilders' origins

In 2002, HM Treasury conducted a review of the role of the voluntary and community sector in public service delivery and identified a series of barriers that were preventing such organisations from participating in the market. Perhaps the greatest was access to suitable finance, and the then Labour government proposed deploying up to £215 million to help enhance the capability of voluntary and community sector organisations working in four priority policy areas.³

The Treasury review also outlined three objectives for the proposed Futurebuilders fund:

1. Overcome obstacles to efficient voluntary and community sector service delivery;
2. Modernise service delivery organisations for the long term; and
3. Increase the scale and scope of voluntary and community sector service delivery.

Futurebuilders was established to invest directly in the capacity of so-called 'third sector' organisations that lacked access to commercial sources of finance. This finance could be used for capital investments, such as for new premises or equipment required to deliver public services, or investments in capability and skill building such as the additional capacity required to bid for and manage public sector contracts.

A consortium made up of Charity Bank, Unity Trust Bank, Northern Rock Foundation and the National Council of Voluntary Organisations won the tender to manage the fund. Richard Gutch became chief executive in February 2004, with the first application for

³ Health and social care; Crime and social cohesion; Education and learning; Children and young people

funding opened in July and the first full investment offer in November of that year. Figure 2 above shows a timeline of key events.

2.2 Purpose of the fund

Although the Treasury had set out the fund's aims in the tendering document, there remained some confusion amongst key stakeholders about the precise purpose of the fund during the early years.

Uncertainty existed about whether Futurebuilders was set up to grow the market for loan finance, use government funding more efficiently or support the social sector in their financial capability building – or a combination of all of the above. "There were several different – and competing – aims at the beginning," recalls one member of the original management team.

Another stakeholder recalls that "the key challenge at the beginning was to figure out what the fund intended to be." Those concerns were also echoed by a member of the board, who explained that the team "had to do to some 'mind-reading' of the government" to understand what Futurebuilders was for.

This 'mind-reading' process was made more difficult as responsibility for Futurebuilders was passed between three different government departments. "Over the first four years we had three different government departments and four different contract officers, so we had to keep explaining Futurebuilders to them, which was odd given that they were ultimately responsible for it," admits Richard Gutch.

2.3 Pass the parcel

The initial tendering process was led by the Treasury. But although its staff set out the guidance and were closely involved in the set-up of the fund, it emerged that the department could not legally be responsible for the budget on its balance sheet as it needed to be managed by a spending department. This meant responsibility for the fund was transferred to the Active Community Unit in the Home Office in early 2004.

"The transfer of responsibility from the Treasury to the Home Office was disastrous"

"There was a period of trying to clarify the objectives with the Treasury (who aren't used to running things)," says one interviewee. "They then passed [Futurebuilders] to the Home Office, who themselves weren't very clear about the nature of a loan fund, whereas at least in the Treasury they understood this. The Home Office had a grant-making mindset."

Under this new management, the fund's objectives began to shift, with a stronger focus on the speed of investments and less on market building. "The transfer of responsibility from the Treasury to the Home Office was disastrous," says one observer. "It never acquired the sort of support in the Home Office as it had in the Treasury. They didn't quite understand the original aims and unilaterally decided to make some fairly fundamental changes to the

rules." As another interviewee noted, "the Treasury staff initially involved had bought into the project, yet much of this enthusiasm was lost during the transfer."

Futurebuilders was destined not to remain with the Home Office for long. In May 2006 responsibility moved once again, this time to the Office of the Third Sector in the Cabinet Office. "In the Cabinet Office, Futurebuilders became a bigger fish in a small pond and people started paying more attention to it and worrying about whether it was on the government books," says Richard Gutch.

2.4 Changing attitudes

There is little doubt that Futurebuilders played a significant role in changing the mindset of the sector. Introducing repayable loans as a sustainable source of funding represented a significant departure from the traditional grant-based model.

"People like free money," one stakeholder explained. "The sector was very used to receiving grants. The larger organisations were used to raising loans against property in the standard way, but the idea that you might raise money in order to take on bigger contracts was viewed with uncertainty and a lack of belief that you could actually do it."

Such caution was understandable, says David Carrington, now a non-executive director at Big Society Capital, as "charities were suddenly invited to take on a new form of risk – if things did not go to plan, they would probably have no previous experience of how to deal with the consequences to draw on." He goes on to say, though, that the fund provided useful education to the sector. "A series of regional roadshows were organised around the country to explain Futurebuilders and to introduce an unprecedented use of government funding, which was completely different to what the sector was used to."

*"The government
clearly thought
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everything"*

However, the need to guide the sector in this way was seen by some as distracting from the fund's core activity of loan disbursement. "The problem was getting wrapped up in the education of the sector, as opposed to focusing very quickly on giving out loans," says one of the original team.

In this sense, it was not just the sector that needed a shift in mindset but the government too. As one board member explains, "the government clearly thought that Futurebuilders was the answer to everything. They weren't interested in the 'tolerance' of the sector for loans or in the size of the market. I'd say there was a failure on both sides to clearly communicate with each other."

2.5 The ‘Goldilocks strategy’

One aspect of Futurebuilders that was left surprisingly vague was the return expectations of the fund. "The nature of the loan fund was that it was given to us to manage without much sense from the government about what the return should be," says one of the original executives, "or whether there should even be a return."

The lack of clarity around return expectations was in part a result of the fact that it was unclear whether the fund sat on the government's balance sheet or not. It was only when the National Audit Office (NAO) became involved that concerns were raised. "When the NAO questioned it people began to get a bit anxious about the balance sheet issue," says Richard Gutch. "The original vision was that the fund would be self-sustaining, although we were clear that it couldn't ever be fully self-sustaining."

Given the significant uncertainties of lending to a largely unknown market, the management team decided not to charge variable interest rates but rather offer a standard rate of 6% on all loans. Whether or not this reflected the true risk of the loans was impossible to determine but it was hoped that the simplicity and clarity of the model would benefit applicants and fund administrator alike.

The 6% rule meant that the performance of the fund would be determined by the quality of the loans written and the management of the book over time. Determining which applicants would be eligible for loans and which would not was therefore of particular importance, as was the use of grant funding in conjunction with the lending.

Although not being run on a commercial basis, it only made sense to offer loans where there was a reasonable chance of repayment – otherwise the principle of repayable finance would be undermined. "Unbankable could mean completely unbankable or something that banks didn't understand," explains Fiona Ellis. "Futurebuilders were interested in the latter group."

However, it was also recognised that as a government-subsidised fund Futurebuilders must avoid distorting the market by undercutting other lenders – effectively setting an upper boundary. "One of the principles was that if a commercial, semi-commercial or a social bank was willing to make the loan, then this was not something that Futurebuilders should do – and at least in earlier phases, this was a rule adhered to," recalls David Carrington.

"We went to great lengths to ensure that, whenever possible, bank finance could be used – and it was indeed used, sometimes with the backing of Futurebuilders," explained Richard Gutch. "The board thought leveraging Futurebuilders in this way was terrific, but it took time."

Futurebuilders therefore effectively adopted a ‘Goldilocks strategy’ during this period. Loans should neither be too risky nor too secure. Instead, the aim was to serve the ‘just right’ part of the market that would be unable to secure finance elsewhere but nonetheless offered a serious chance of repayment. As our analysis in Chapter 4 reveals, whether by accident or design it appears that this objective was achieved.

2.6 Commissioning landscape

As described above, Futurebuilders aimed to provide access to loans to help organisations bid successfully for government contracts and subsequently use contract payments to repay the loan. This meant that it depended on organisations to win these contracts to get its money back. Unfortunately, this was often easier said than done.

"We had to try and change the government procurement system so that government would buy the services of these entities," explains one member of the original team. "But government couldn't force the hand of local authorities who were focused on the cheapest services – so if social enterprise couldn't offer 'best value' then they were unlikely to win contracts."

Richard Gutch pinpoints commissioning as the biggest challenge of those early days. "Commissioners didn't understand the sector very well," he admits. "The Home Office, and subsequently the Office of the Third Sector, had a large commissioner training programme, so the hope was that this would improve the commissioner environment. From about 2007 we started working with the commissioners and local authorities ourselves."

It is clear that the system at the time was not particularly favourable for social organisations to win government contracts, making the work of Futurebuilders more difficult. "Futurebuilders was not created as a fund in isolation, but as a result of discussions between the voluntary sector and the Labour government," says one stakeholder. "Not only the financial environment but also the procurement system needed change, but that wasn't clearly articulated. I don't think the Treasury ever made it explicit that there was a procurement revolution needed. We always knew that it was needed for Futurebuilders to succeed – and given that there was no revolution, some may say that the fund failed."

2.7 Futurebuilders I activity

CASE STUDY: BeyondAutism

BeyondAutism educates severely autistic children and young people, aged from 4 to 19 years and from 13 London local authorities, and provides support and training to their parents, carers and other professionals. It meets the needs of an extremely vulnerable group, and around 40% of its students are entitled to free school meals. Without the school the only option for these children would be a residential school placement.

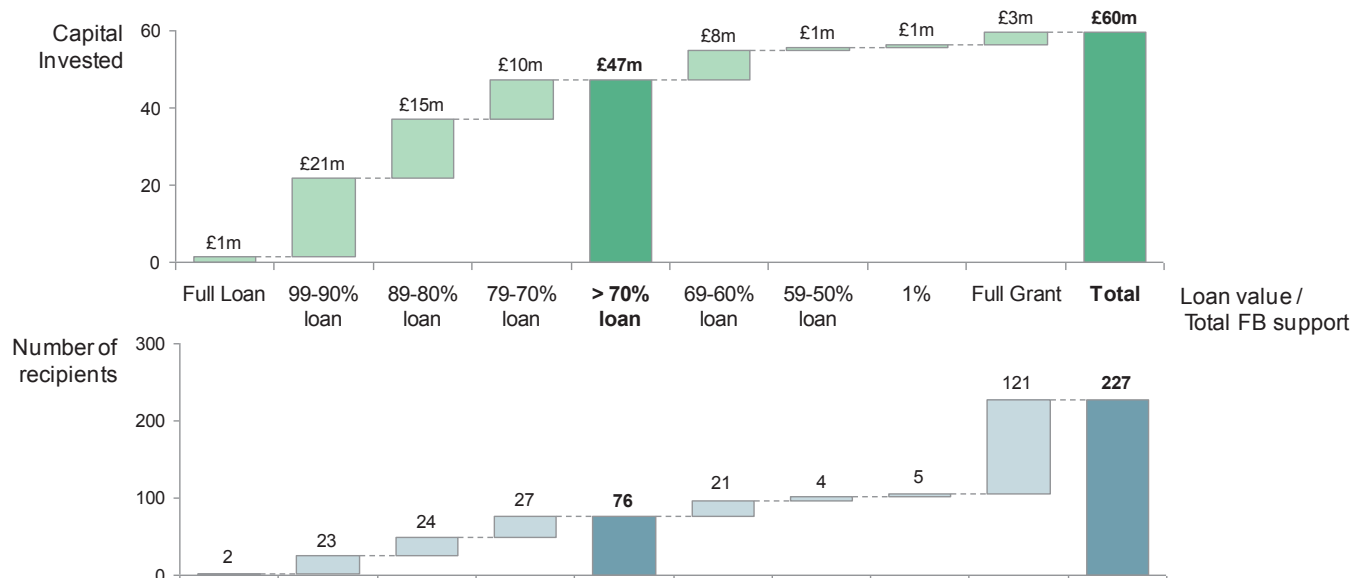
In 2010 BeyondAutism received a loan of £2,018,500 from Futurebuilders to purchase and redevelop a secondary school at Wandsworth Common, south west London.

Karen Sorab, CEO and Principal at the school, said: "The investment was vital as it enabled us to grow our school from its original size of 18 pupils max to 64 and it allowed us to increase the age range of our pupil intake. Prior to the investment we could only take pupils up to the age of 11 years; now we can take them from up to 19 years."

Since receiving the loan the charity has created 45 new jobs, growing from 30 to 75 employees, and its annual turnover has risen from £816k to £2,738,500.

During this first phase a total of 227 recipients received a total of £60 million (loans and/or grants). Just over half of these deals (121) were pure grants, although these represented just £3 million (4.4%) of the total value as the grants tended to be small compared to the average loan size [Figure 3].

Figure 3: Capital invested and recipients by loan proportion during Futurebuilders I

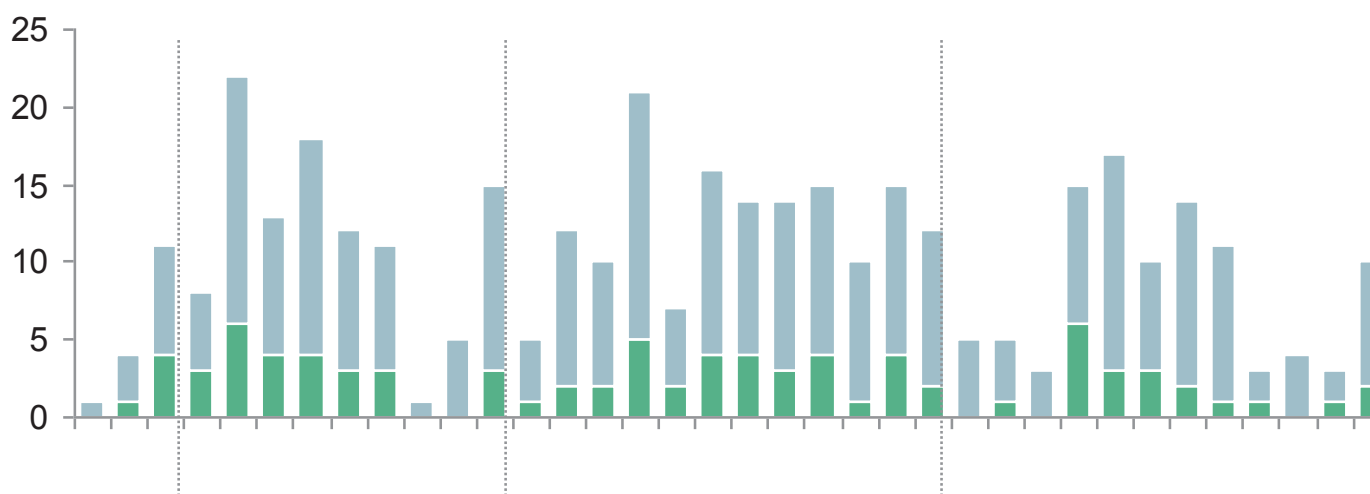


With about 1.5 deals per week and £20 million capital invested per year, questions were raised about whether Futurebuilders was dispersing funds quickly enough. As will be discussed below, this became an important factor in the re-tendering process and the subsequent performance of Futurebuilders II.

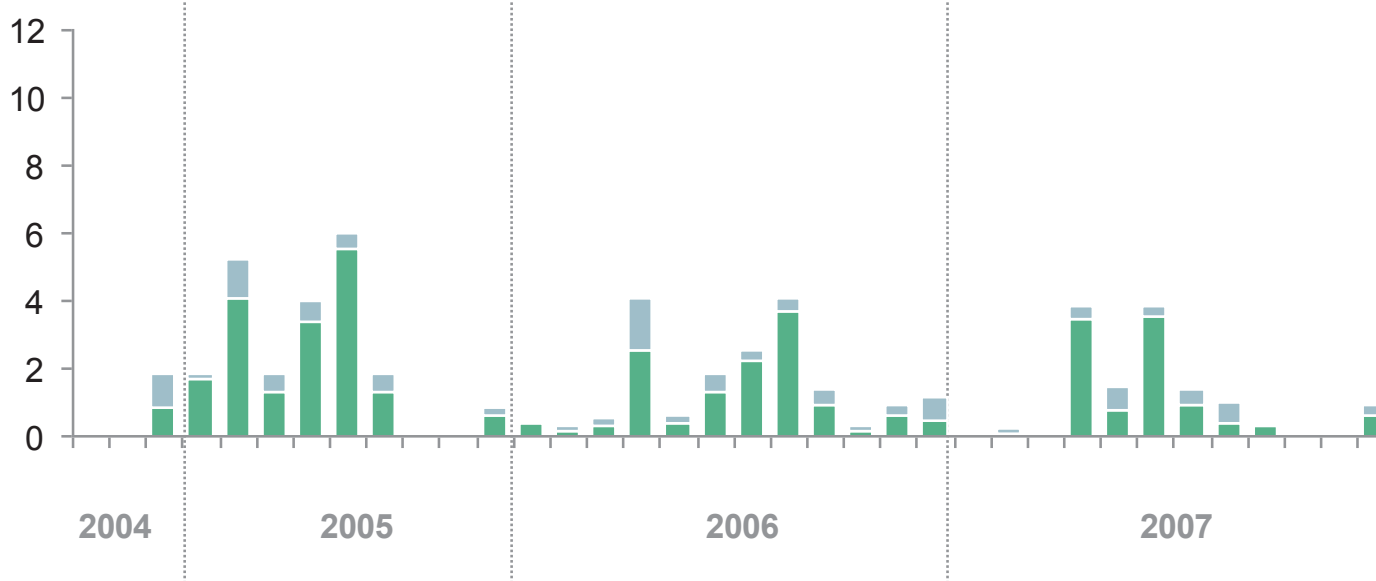
We will not comment here on the validity of this critique, or whether the appropriate balance was struck between the value of loans and grants, as it is impossible to determine from the data. What is clear, though, is that momentum seemed to be faltering in late 2006 and 2007 as both the volume and value of deals drifted downwards [Figure 4].

Figure 4: Futurebuilders transactions and capital invested over time

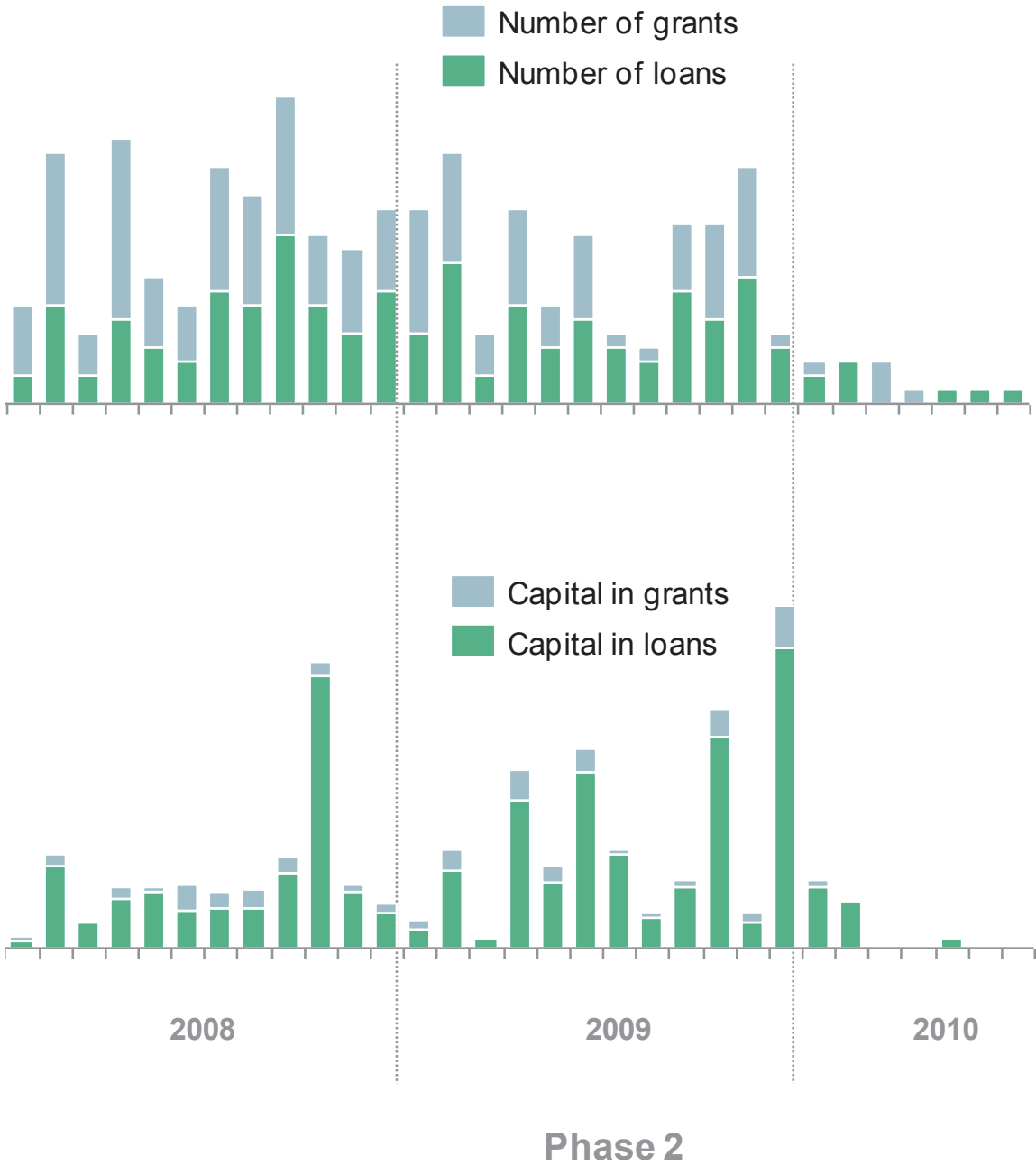
Number of transactions initiated



Capital invested, £m



Phase 1



3. Futurebuilders II (2008-2010)

There is no doubt that the second phase of Futurebuilders saw a step change in volumes of activity and lending [Figure 4]. With a new Fund Manager in place, it is clear that the emphasis shifted to increasing levels of lending and away from some of the market-building aims of the early years.

Many of the challenges during the first phase were arguably the result of a difficult relationship between the Futurebuilders management team and the government, in contrast to a more sanguine response from the wider market. The second phase saw this situation reversed, with a happier government relationship contrasting with increasing concerns being voiced from other players in the social investment market about the role of Futurebuilders.

The large external shock caused by the financial crisis created an opportunity for Futurebuilders to demonstrate its worth, although its use of grant funding in conjunction with loans increasingly raised suspicions that the fund was undercutting other players. In reality, the use of grants was markedly lower during Futurebuilders II than in the earlier phase.

3.1 Speed kills

Towards the end of Futurebuilders I the perception arose, within government at least, that funds were not being dispersed quickly enough.

"The government was very focused on the speed of getting the money out of the door," says one of the original team. Nat Sloane of the Big Lottery Fund agrees that speed became an issue. "Futurebuilders was viewed as not investing quickly enough," he says. "I don't think that was actually corresponding to the aims, which were to achieve certain goals, not necessarily about the time needed to do so."

Richard Gutch believes that the government's conviction that the pace of disbursement was too slow had a number of important ramifications. "Speed was important as it made politicians sound efficient," he points out. "So that became a crunch issue – despite the original aim being to invest in non-bankable organisations. If we wanted to get the money out quickly we could easily have lent to 'bankable' projects."

Another interviewee points out that speed is a matter of perception. "From the government's point of view, Futurebuilders went too slowly; from the market's point of view probably too quickly; and for the third sector it probably provided a reasonable supply but was maybe too loan-oriented."

Retrospectively, many of the interviewees agreed that Futurebuilders might have been too slow in dispersing its budget. As one of the first organisations attempting to provide loans in this emerging market, there was much to learn in the initial period – but there was still scope to move faster.

CASE STUDY: Disabled Living

Based in the North West, Disabled Living provides information and advice about equipment and products to support independent living. Their services include an online shop for equipment providing competitive prices and impartial advice on different assistive technologies, as well as training programmes for professionals and carers.

Futurebuilders invested a total of £350k in loan and grant funding to help the charity relocate and refurbish a facility purposely designed for older people and people with disabilities. It was the first time the charity took on debt finance and the £250k loan was fully repaid in December 2013. Grant funding was used to refurbish the premises, which they would not have been able to afford otherwise.

Positioning itself as 'A Centre of Excellence for Assistive Technology in the North West', the new Centre has attracted significant interest from statutory, commercial and third sector organisations, resulting in increased partnerships and an improved service for the clients they are serving. Having a brand-new facility portrays business growth and success for Disabled Living, which has been instrumental in their being awarded contracts.

"At the beginning they were mainly involved in secured deals and should have done more risky deals," says one observer. "They were quite cautious, not quite as the government expected." And a member of the original management team admits that the pace of disbursement could indeed have been raised up a notch, or two. "With hindsight I think we were pretty slow about getting loans out the door. We were deliberately aiming our efforts at the bits of the sector that weren't used to taking loans so it took an age."

"Our staff didn't come from the banking sector, which meant they could be empathetic to the investees but, on the other hand, we were much slower at doing the deals and we were not at good at spotting when to shut off a conversation with an organisation when there wasn't an investible deal there. After the first couple of years we were much sharper on that and once we started to make loans things started to move more quickly."

3.2 The tender trap

Driven largely by concerns over the slow pace of disbursement, in 2007 the Office of the Third Sector initiated a competitive re-tendering process. Although the initial consortium applied, it was not selected to continue managing the fund.

From a broader provider view, the decision to re-tender highlights a risk for organisations involved in similar arrangements with the government. While this can allow the government to incentivise the provider to achieve its aims if those are clearly and transparently communicated, various voices in the sector suggest that, at the time, it was unclear to the management what exactly triggered this change in policy and the decision to re-tender had its sceptics.

As one observer notes, the move was "guaranteed to undo the work that had been done in the early years", and another says the re-tendering meant that the original aims of the fund were cast aside. "I think the key aims of Futurebuilders got derailed by government. This made it difficult for the management to know what aims to go after and it remains unclear whether

it was transparent to them which aims they missed which subsequently resulted in losing the contract."

From an investor perspective, changing the provider had implications for the potential value of the loan book, adding a key risk for potential buyers if ever offered in a wholesale market. "It was set up as a loan fund that could have been brought to the market," recalls one interviewee. "Yet there was an argument that the value of the loans was devalued when transferring the fund."

Adventure Capital Fund won the tender process for the second phase of the fund in 2008 under the leadership of Jonathan Lewis. An evaluation of Futurebuilders published by the Centre for Regional Economic and Social Research in 2010 concluded that the management changes led to a more streamlined process and additional tailored support packages. It also suggests that this second phase saw the introduction of a series of investment products, in addition to the development grants and full investments offered during the first four years of the fund. As one observer notes, the fund underwent a change of focus with "much tighter KPIs".

3.3 Futurebuilders' finest hour?

The start of the second phase of Futurebuilders coincided with the financial crisis of 2007-08. With the economy going sharply into reverse, many banks implemented a tighter credit policy – a move that accelerated demand for funding from the third sector. Futurebuilders' ability to provide access to finance helped bridge this gap.

"Futurebuilders had its finest hours during the financial crisis as other sources of capital fell away," says Harriett Baldwin, who chaired the Futurebuilders Investment Committee between 2008 and 2012. "Commercial banks might have been prepared to do a part of the investment but not all of it, particularly not during the significant financial crisis; thus Futurebuilders significantly improved access to credit."

*"Futurebuilders
had its finest
hours during the
financial crisis"*

However, as demand for funds increased during the crisis, and the volume of lending ramped up [Figure 4] other social lenders began to question whether Futurebuilders' impact on the social lending market was entirely positive.

"After the contract changed, the behaviour of Futurebuilders changed as well," says one. "It just seemed more competitive, driven by the government's push to get money out of the door, which was a completely different type of mentality. I don't think they were thinking about building a market, there was a certain arrogance around."

Another confirms that under the new regime, speed was now of the essence. "The CEO commented to me that we need more marketing managers to get the funds out – that seemed to have been the key aim at the time, at any cost."

This shift of emphasis coincided with a growing social investment market. The Dormant Accounts Act, passed in November 2008, enabled the government to collect the proceeds of unclaimed bank and building society accounts to create a social investment bank – leading to the creation of Big Society Capital in April 2012. Meanwhile, the world's first Social Impact Bond, focused on reducing reoffending in Peterborough, was launched in 2010 by Social Finance together with the Ministry of Justice and a range of social investors.

In light of this changing market landscape, the sector increasingly came to perceive Futurebuilders as a threat. Several interviewees suggested that the focus on dispersing loans may have incentivised a looser definition of 'unbankable' and this undercut other social investors. "On the whole, there were a couple of deals where our team did all the work, but at the last minute Futurebuilders came in and undercut the deal," recalls one such investor. "They threw money at anything that felt even moderately secure." Another market commentator agrees that the competitiveness of the market took a hit. "Other players felt excluded as investees did not bother to even approach them as there was this big organisation that quickly gave out cash."

3.4 Money for nothing

This perception was further fuelled by Futurebuilders' ability to combine loans with grants. While the data suggests that there was a limited use of grants in the second phase, interviews suggest a misconception had taken root.

"They should have more deliberately avoided undercutting other players in the market," comments one social investor. "Grant funding is very tricky. If trying to build a market, you shouldn't undermine the emerging market by giving out free money as we felt Futurebuilders did."

Another investor felt that undercutting became synonymous with the fund during this time. "There certainly was a period [during Futurebuilders II] when they were pretty aggressive in the market, where they built up a reputation of undercutting anyone in the market, if necessary by using their grant funding."

This perception may have been shaped by limited communication and transparency surrounding the fund's performance. Futurebuilders was seen to provide only limited information about its investment criteria and portfolio performance – a point alluded to by Kate Markey, former managing director of CAN Invest, a social investment finance intermediary. "Futurebuilders' objectives and performance should have been better communicated to the wider market, including its financial performance and its role in the public service market, but also the social impact it had on the communities it was working in," she says.

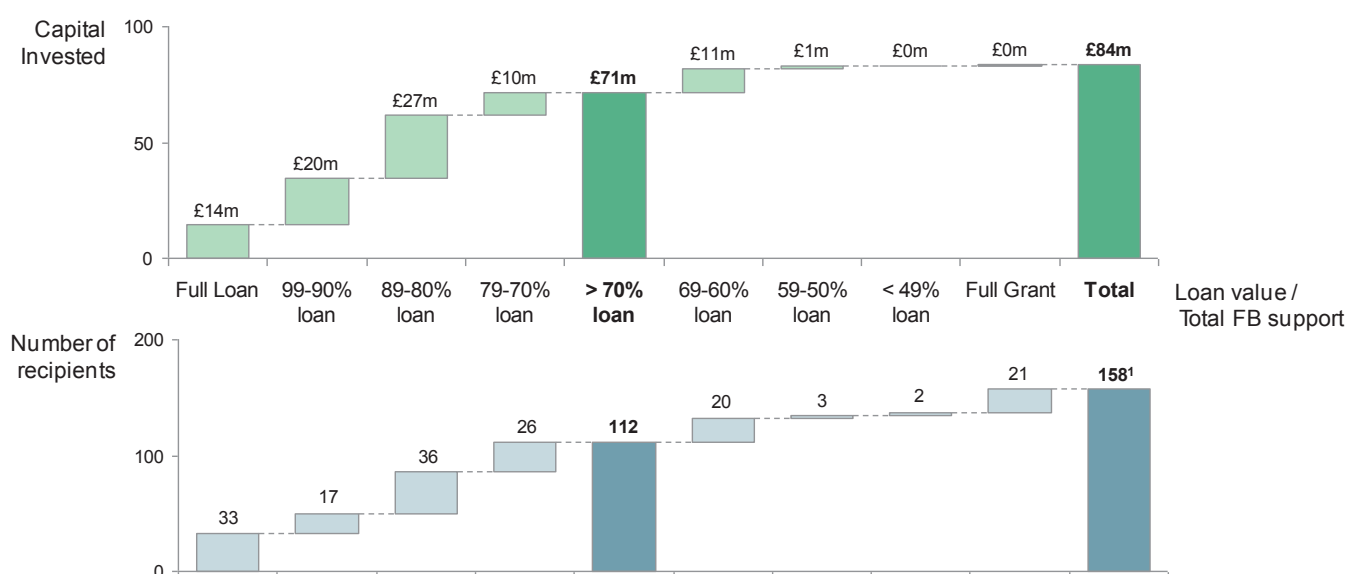
While Futurebuilders did operate a Funders Forum, designed to ‘investigate joint funding options’, which included representatives from all the major social lenders,⁴ it appears that at least for some members this mechanism was insufficient.

SIB continued to manage Futurebuilders throughout the second phase, with Jonathan Jenkins succeeding Jonathan Lewis as chief executive in late 2011. Overall, Futurebuilders is seen to have improved its transparency and clarity of operations during this later period. "In the final years, Futurebuilders really changed the perception it gave to the market, due to its increased transparency," says Antony Ross.

3.5 Futurebuilders II activity

During the second phase a total of 158 recipients received a total of £84 million (in loans and/or grants). Compared to the first phase, when over half of the deals were pure grants, just 14% were pure grants during the second phase, representing a negligible proportion of the capital deployed. At the other end of the spectrum, during the second phase Futurebuilders offered far more pure loans than during Phase One, representing 21% of the total volume worth £14 million [Figure 5].

Figure 5: Capital invested and recipients by loan proportion during Futurebuilders II



This data both supports and refutes some of the perceptions about Futurebuilders during this period. The perception that grant funding was being abused to undercut the market is hard to support from the data as the level of grants was actually far lower in this period. However, the possibility that the fund had switched to more ‘bankable’ organisations that could absorb larger loans to help get funds out of the door would be consistent with the increased use of pure loans.

⁴ Funders Forum included representatives from Unity Trust Bank; Kingdom Bank; Bridges; Charity Bank; The Co-operative Bank; Venturesome; RBS/NatWest; Triodos Bank; Co-operative & Community Finance Fund; Barclays Bank; Big Invest; and UnLtd

4. Fund performance

What is the best way to judge the performance of Futurebuilders? For the purposes of this report we take a predominantly financial lens, and focus particularly on the 20% of book that is now closed (representing 40% of the deals).

This approach has clear limitations. Firstly, we are unable to systematically consider the social impact of the fund, primarily because no social impact data was routinely collected over the last 10 years, so our only insight is through selected case studies.

Secondly, the majority of loans (both by volume and capital) remain outstanding and most of these have many years left to reach maturity. Only when the full book is closed will the full performance of Futurebuilders become clear.

Nevertheless, we believe our analysis provides an instructive set of insights. Not least because this is the first time such data has been made public.

4.1 Futurebuilders performance overview

January 2010 saw Futurebuilders close its application window earlier than expected. At fund close, it had invested £145 million of which £117 million (81%) were loans. Of the loans written, approximately 40% are now closed (either paid down or written off), representing 20% (£20m) of capital. The fund has so far returned £47 million to the Cabinet Office.

Over its lifetime, Futurebuilders supported 369 organisations. The typical Futurebuilders investee profile was a midsize charity with turnover of ~£3 million. The average loan size across the whole book was ~£500,000 and the average grant size ~£55,000 [Figure 6].

Futurebuilders did not focus on any particular policy area; instead it mainly invested in multipurpose organisations, in most cases working across education, employment and health [Figure 7].

Figure 6: Futurebuilders key facts

	Total Portfolio
Capital invested	£145 million
Number of recipients	369
Average recipient size (turnover at time of investment)	£3.2 million
Average loan size	£461,000
Average grant size	£55,000

4.2 Performance of closed loan portfolio

As noted above, 20% of Futurebuilders loans are now closed. This closed portfolio has yielded a moderately negative Internal Rate of Return (IRR) of -3% per annum. Given the pioneering nature of the fund, the fact that it was targeting organisations that were unused to accepting loan finance and that the period included a major financial shock, this performance is arguably more positive than might otherwise have been expected. Also worth repeating is the fact that the fund had no IRR target and so never aimed for a particular return performance.

Note that this IRR calculation focuses purely on the financial performance of the closed loan book and excludes the share of administration costs incurred by the Fund Manager managing these loans. If these are included the IRR turns strongly negative, highlighting the significant challenge of lending to this sector in a wholly sustainable manner.

In simple terms, the IRR is driven by loan performance (in terms of defaults) on the downside and the interest rate charged on the upside. The extent to which the latter is able to cover the former determines the overall IRR.

Two design features of Futurebuilders arguably depress the potential IRR. Firstly, there are no repayment penalties and indeed SIB has a KPI that encourages the refinancing of loans. This means that as organisations became more bankable, and loans are refinanced, future interest payments are lost.

Secondly, there has never been any recirculation of repaid loans, and the returned cash has just been sitting in immediate access accounts at the request of the Cabinet Office.

An analysis of the defaults in the closed portfolio reveals that the vast majority were either total or very significant write-offs. For approximately 50% of defaulting loans no capital was repaid at all and, in 80% of the cases, less than 30% was repaid [Figure 8].

CASE STUDY: North Liverpool Citizens Advice Bureaux

North Liverpool Citizens Advice Bureaux provide free, confidential, independent rights-based advice and training, particularly in respect of debt, money management and welfare benefit issues.

They received £951,500 part loan, part grant to purchase a site and build a Citizens Advice office in the Walton area of Liverpool. The money went towards the employment of administrative support for two years to assist in project planning and other related matters.

As a result of the Futurebuilders investment, they won a variety of public service contracts and have been able to offer a range of new services.

However, Siw Jones, CEO, stated that “while the investment has undoubtedly helped us attract a diverse range of funding, we have also lost major sources of funding (for example, Legal Services Commission funding and large reductions in local authority funding). The loss of core funding means that it is now a continual struggle to make the repayments – something which we didn’t anticipate pre-2008.”

The organisation highlighted that the interest-free period and reduced interest payments from SIB were both helpful.

This suggests that most defaults were caused by a lack of financial stability and the bankruptcies of recipient organisations rather than a longer-term performance issue. Indeed, this evidence would challenge the notion that Futurebuilders was exclusively pursuing more 'bankable' deals, as most defaults are associated with loans that could never have been described as performing.

Figure 7: Recipients of Futurebuilders investment by sector

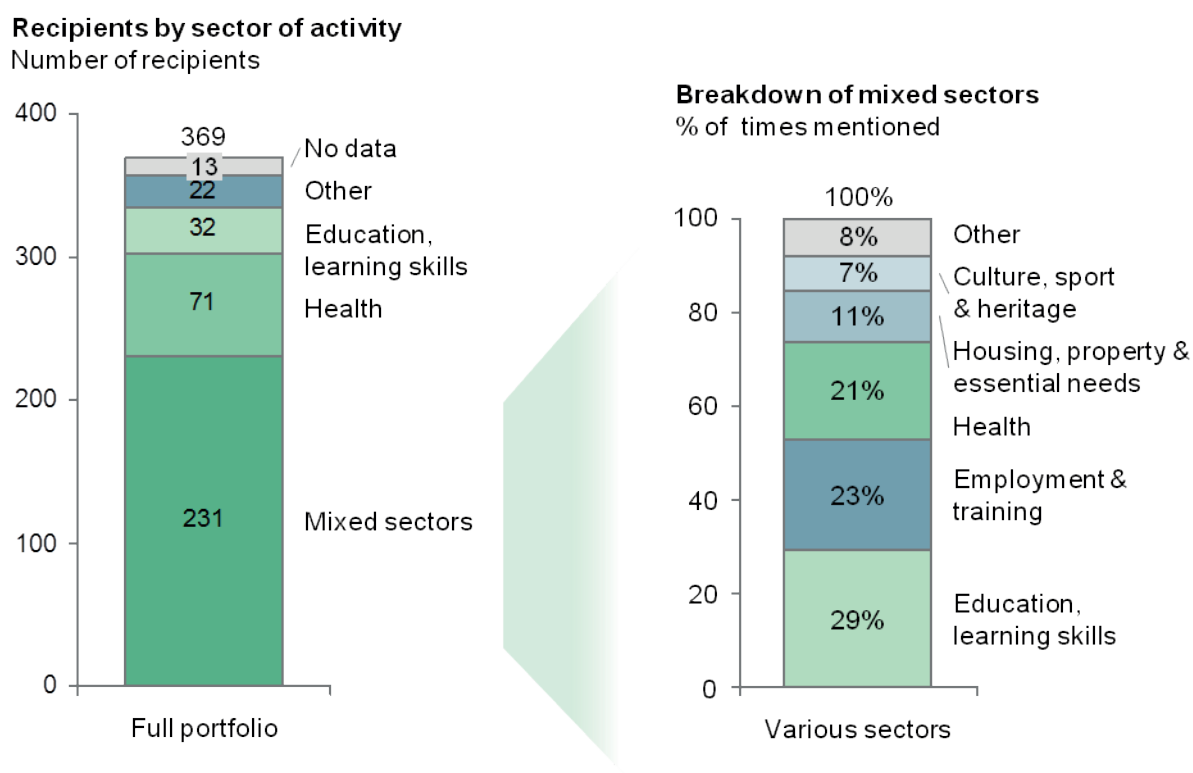
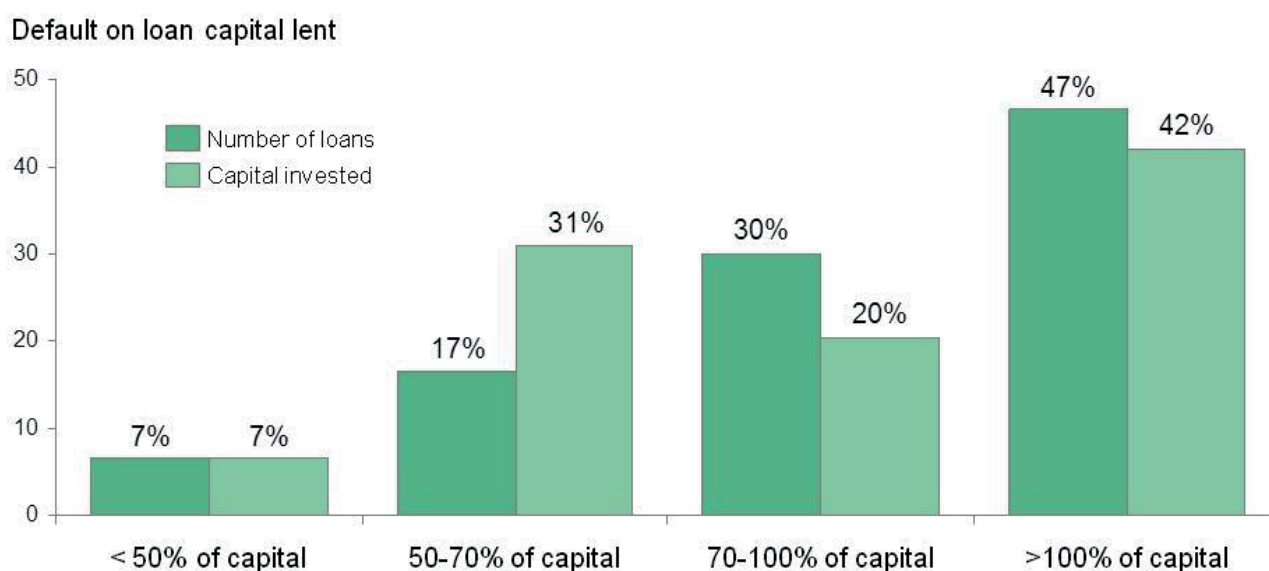


Figure 8: Percentage of default on total capital by all defaulting loans in closed book



Analysis of defaulted loans shows that:

- Amongst the 30 loans written off, the top three account for 45% of total write-offs with two of these due to bankruptcy or total closure of the recipient organisation;
- Organisations that defaulted were likely to be smaller organisations: their turnover at time of investment was on average half the size of the rest of the closed portfolio;
- Organisations that defaulted were also likely to be at earlier stages of development: 67% of them were start-up/growth investments, compared to 30% in the rest of the portfolio, which was mainly composed of expansion investments;
- The potential financial vulnerability of these younger and smaller organisations is confirmed by a lower loan/grant ratio: organisations that defaulted received an average of 74% of total Futurebuilders support via a repayable loan, compared to 81% for the remainder; and
- Smaller size and higher vulnerability did not correlate to smaller loans: the median loan size for written-off investments was £100,000, compared to £90,000 for the rest of the portfolio.




This analysis suggests that defaulted loans were mostly riskier investments in smaller and less established organisations that did not necessarily have the resources to support the loan they were granted. The ratio of loan size on recipient annual revenues was much higher amongst write-offs (54%) than in the rest of the closed portfolio (19%).

The 'standard' interest rate offered by Futurebuilders was 6% (as described above), but due to a mix of interest holidays, early repayments and defaults, the actual interest charged on the closed portfolio was closer to 2%.

This reflects the flexible approach that Futurebuilders took in setting the interest rate, especially given the lack of precedent on lending to the third sector. "We were actually flying pretty blind to know what the appropriate level was, it felt like a 'stab in the dark' as there was no secondary market for the unbankable," recalls Harriett Baldwin. Nat Sloane agrees it was difficult to choose an appropriate level: "6% seems to be the accepted baseline, but for some 6% was still not doable," he suggests.

It is noteworthy that if Futurebuilders had managed to maintain an interest rate even moderately closer to the 6% target, the overall performance of the book would have rapidly turned positive.

Figure 9: Comparison between closed and open loan portfolios

KPIs		Closed portfolio	Open portfolio	Risk assessment	Comments
Recipient revenues - median		£475k	£617k		• Larger organisations more likely to have diversified sources of funding
Stage of development	Expansion	70%	74%		<ul style="list-style-type: none"> • Focus on larger, more mature organisations minimises risk but increasing investment in start-up investment may increase risk of portfolio • Capital reflects distribution of recipients, with a slight skew towards expansion loans: 81% expansion, 14% start up for open portfolio
	Growth	16%	8%		
	Start-up	14%	17%		
Average loan/ total support ratio		79%	83%	=	• Broadly in line with closed portfolio
Loan size	Average	£217k	£715k		• Increase in loan size likely to concentrate risks on fewer investments
	Median	£89k	£310k		

4.3 Closed versus open portfolios

It is not the purpose of this report to project the future value of the Futurebuilders loan book. However, it is instructive to reflect on the likely relative performance of the open portfolio compared to what we already know happened to the closed portfolio.

A comparison between the closed and open portfolios is shown in Figure 9 above. Given the larger average loan size and slight shift towards start-up lending, it is reasonable to conclude that the open portfolio was slightly riskier than the closed portfolio at the time of lending. However, given that write-offs tend to occur earlier in a loan's lifetime, the relative maturity of the open book is arguably a significant mitigating factor and on balance it would be hard to argue that the open portfolio represents a significantly different quality to the closed portfolio.

It is also worth noting that early repayments have accelerated over the past couple of years as the investees become more bankable and cheaper rates have become more widely available on the market - a trend which could dampen future IRR performance.

4.4 Role of grants versus lending activity

As discussed above, one of the most fundamental questions surrounding Futurebuilders' legacy is whether it struck the appropriate balance between grants and loans. Harriett Baldwin argues that grants were very much the exception rather than the rule. "Futurebuilders only offered a very limited amount of grant capital; and when it did use grants, they only paid it out very moderately and it was actually needed," she says.

This belief is supported by the data: 87% of Futurebuilders' capital was invested in repayable loans, and this ratio of loans to grants remained relatively homogenous across the investment book. Overall, £120 million from the total £145 million of capital invested by Futurebuilders was in organisations receiving 70% or more of their financial support from Futurebuilders in the form of a repayable loan [Figure 10].

Figure 10: Capital invested and recipients by proportion of loan over total investment



Futurebuilders did provide grant funding without a loan to a large number of organisations, but these represent a small share of its invested capital. Approximately 3% of the total capital invested was distributed to 150 organisations who only received grants. This supports the argument that Futurebuilders adopted an active policy of capacity building, using grants as a way to bring organisations to relative financial autonomy and an investment-ready stage.

Northern Rock's Fiona Ellis says that grants were often needed before a loan could be considered. "Grants were necessary to help entities to set up business plans in order to be ready to receive loans," she suggests. "People often said that there were so many social enterprises around that wanted to borrow, but when you got to know them better you realised that they actually needed grants first before transitioning to loans."

While a vast majority of the capital invested was dedicated to loans, the large number of grant transactions – 65% of all transactions – probably accounts for a skewed perception that Futurebuilders disbursed more grant capital than it actually did. This raises questions about whether or not grants may have required too much of Futurebuilders' organisational capacity.

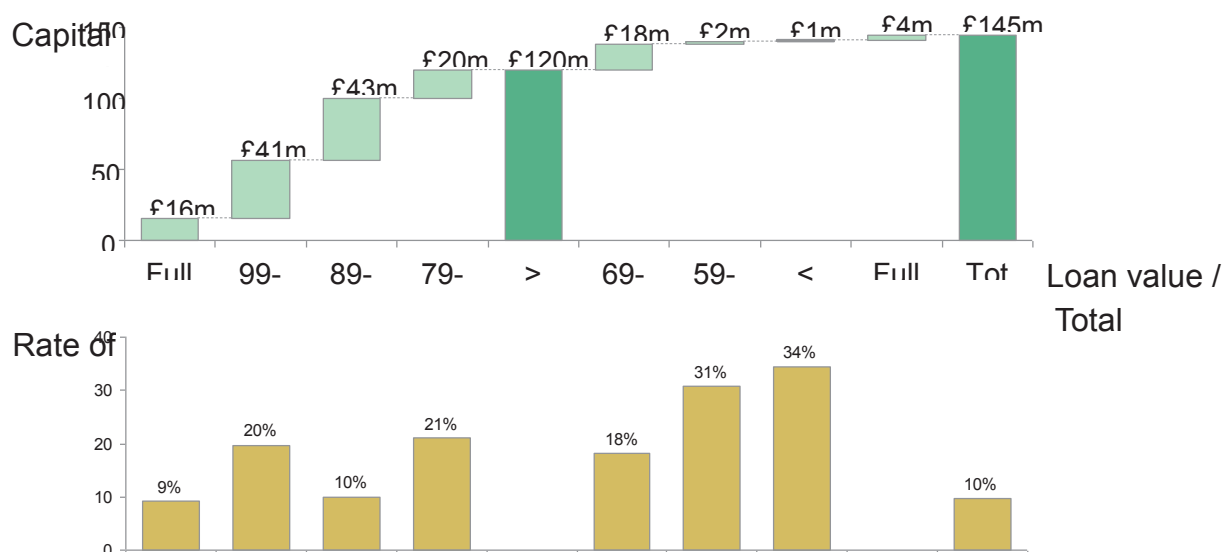
Focusing on a more limited number of larger transactions might have increased the quality of the due diligence and monitoring support, in turn limiting the rate of defaulted payments. Antony Ross of Bridges Ventures believes that there was scope for improvement. "It was like an in-house Investment and Contract Readiness Fund to fund the diligence process," he says. "I think there is a need for grants, but it is much better if independently managed."

*"There is a need
for grants, but it is
much better if they
are independently
managed"*

Whilst data clearly establishes that Futurebuilders implemented a mixed lending system, grants could have been used to cover the risk of loans, instead of strengthening the organisation's capabilities and promoting greater independence from public and charitable funding. If grants effectively subsidised loans, higher rates of default should have been observed amongst organisations who received little or no grant support.

However, the data suggests that, on the contrary, higher rates of default were observed where recipients received more grant support. Recipients who received less than 50% of support in the form of a loan have the highest rate of defaults at 27%, while at the other end of the scale, organisations that received no grant support have the lowest rate of default at less than 1% [Figure 11].

Figure 11: Capital invested and rate of default by proportion of loan over total financial support to recipients

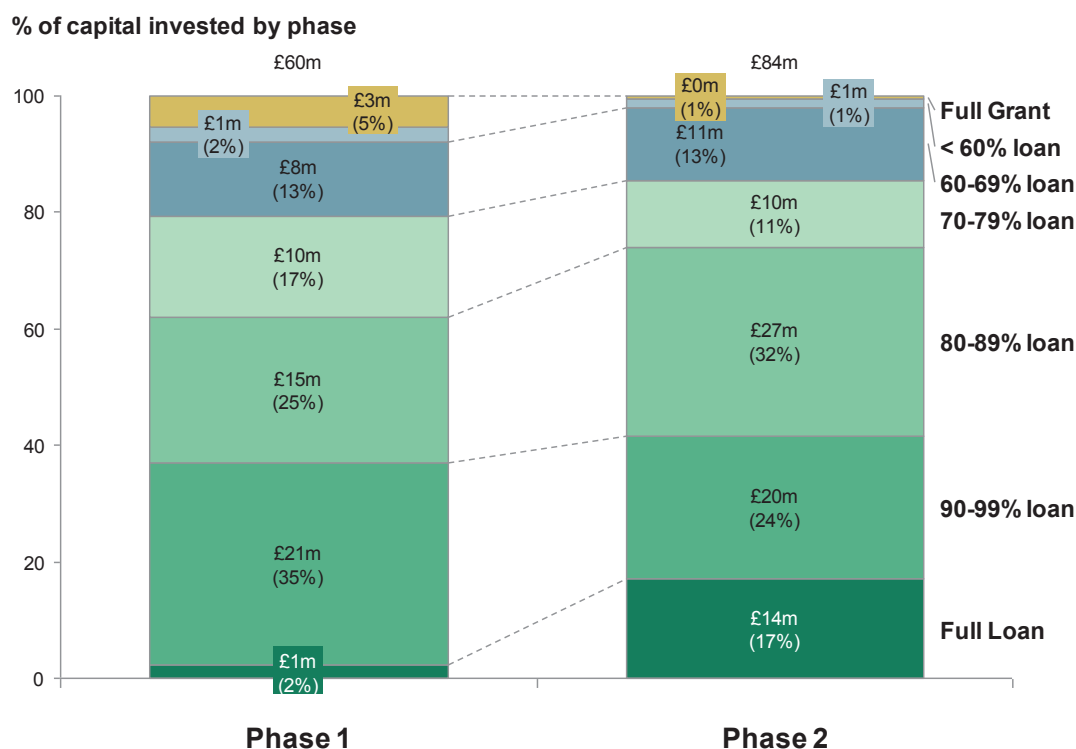


This suggests that defaults were not linked to the lack of subsidy from Futurebuilders, but to inherent characteristics of the organisations the fund lent to (e.g. organisations that are more financially vulnerable and/or in early stages of development) for which grant support did not compensate. This can also be considered a consequence of one of Futurebuilders' core goals – to reach out to those organisations less able to access loans from other sources – as one of the early team confirms. "We rigorously ensured that the organisations we funded were not ones that traditional banking sector would not serve, i.e. 'the unbankable', while having a sustainable investment model and be credible, so that Futurebuilders would help achieve social impact."

Clear differences can be seen in the use of grants versus loans between the two phases of Futurebuilders. While 6% of the capital invested in the first phase was only dedicated to grants, almost no capital was released as grant only in the second phase of management. The more cautious approach taken in the first phase can be explained by resistance from a sector not used to repayable loans and a sense that the organisations targeted by Futurebuilders had to be supported in order to become investment-ready. "There was a strong feeling from the sector that loans weren't going to be appropriate for the sector," recalls Richard Gutch.

Jonathan Lewis' team introduced the practice of writing loans without any additional support, investing £14 million in these loans over three years. An increasing focus was also given to 80-90% loan transactions, resulting in a more commercially-oriented portfolio. For example, 75% of the capital invested in this phase was in organisations that received more than 80% of Futurebuilders' financial support in loans, compared to 60% in the previous phase [Figure 12].

Figure 12: Capital invested by phase and by proportion of loan over total financial support



The more commercial approach deployed during the second phase of the fund was also supported by an increasing focus on larger organisations, which were potentially better equipped to receive loans. The average recipients' turnover at the time of investment increased from £1.5 million in the first phase to £5.2 million in the second phase. Transaction size did not increase proportionally to the size of the investees, as the average loan size remained broadly stable: £460,000 in the first phase compared to £478,000 in the second.

4.5 Social impact of Futurebuilders

Ideally, a social investment should be judged on both its financial and social performance. Unfortunately social impact measurement was predominantly absent throughout the majority of Futurebuilders' lifetime, although in the last three years SIB has tried to build in some impact assessment retrospectively. The lack of impact assessment is at least partly understandable given the prevailing view at the fund's inception that investing in socially motivated organisations was enough 'guarantee' of social impact.

Overall then, other than with reference to specific case studies, it is difficult to draw conclusions about the social impact achieved. For this reason we do not attempt to comment on the social impact of Futurebuilders here.

5 Conclusions and lessons

There is little doubt that Futurebuilders was, and remains, a highly innovative fund that helped to catalyse the growth of social investment in England. Given that the market was largely untested at the outset it is not surprising that the Futurebuilders teams (and their government handlers) needed to learn a great deal along the way.

The six lessons drawn here reflect the journey that Futurebuilders has been on over the last decade. Clearly these are written with the benefit of hindsight, and through the collective wisdom of many of the contributors to this report. In that sense, they should not be read as criticisms of the past but more as suggestions that designers and managers of similar funds might wish to reflect upon in the future.

5.1 Be clear on objectives from the outset

The establishment of Futurebuilders, and its early years, were dogged by a lack of alignment over the precise objectives of the fund. It is clear that different parties had different perspectives as to whether, for example, the fund was aiming to build capacity in the sector or 'get funds out of the door'. Crucially, the return expectations were never made explicit. This situation was exacerbated by the multiplicity of government departments that took responsibility for Futurebuilders. Greater clarity and alignment of objectives from the outset would have made a difficult task slightly easier. Note that this is not necessarily a one-way street. For an innovative fund such as this, it is important to build in sufficient flexibility so that lessons can be learned from experience and objectives adapted in response to management suggestions – not just government aims.

5.2 Take care when blending grants and loans

Blending grants and loans was one of the most controversial aspects of the design of Futurebuilders. This feature allowed the perception to develop that grants were somehow subsidising lending activity, allowing Futurebuilders to distort the market unfairly. Our analysis shows that this criticism is not necessarily supported by the data, and in fact many of the grants were very small and aimed at organisations that did not receive loans. However, even the perception of unfairness or distortion can be highly destructive and so establishing separate grant funds, such as the Investment and Contract Readiness Fund, would now be considered better practice.

5.3 Keep products simple

The simplicity of Futurebuilders' main product (6% fixed rate loans) was of great benefit. It made the product easy to communicate and (relatively) simple to administer. Sophisticated risk-based pricing, in such an immature market, would have been both unrealistic and unhelpful. Straightforward loans also reflected the real demand from the market. These facts are worth considering with respect to the range of, often complex, social investment products available today.

5.4 Develop clear investment criteria – and stick to them

It took some time for Futurebuilders to identify the Goldilocks investments that were not too commercial and not uninvestible. This is understandable given the fact that the market was new and evolving, but in retrospect too much effort was spent chasing opportunities that would never be investible. This sucked up resources and diverted attention from the better deals. Clear investment criteria, that can quickly rule out those deals that will not be successful, help to avoid this pitfall.

5.5 Be transparent and engage other lenders

Rightly or wrongly, Futurebuilders was viewed with suspicion by other lenders. This was partially because of its ability to offer grants alongside loans as discussed above. The broader complaint was one of a lack of transparency. What types of deals was Futurebuilders doing? What were their investment criteria? Mechanisms such as the Funders Forum, whilst welcome, were not enough to dispel the sense that too much was happening behind closed doors. Adopting a policy of maximum transparency, as well as bringing other lenders into the process as much as possible, helps to strengthen the fund and ensure it maintains support in the market.

5.6 Measure social impact alongside financial impact

A fund such as Futurebuilders sends multiple signals to the market. While social impact can be notoriously difficult to measure, it is nevertheless important that major funds play their part in building expectations about the importance of at least tracking social impact where possible. Futurebuilders did not have such a mechanism in place until recently, although this is something the current management is focused on as well as promoting greater transparency of performance more broadly. More recent innovations such as Big Society Capital's social impact tests and outcomes matrix have helped to provide greater alignment across the sector in this regard.

Annex A: Interviewees

The authors would like to thank the following individuals for giving up their time to be interviewed as part of this research. Note that they are listed here with their role that is most relevant to Futurebuilders, which in many cases is an historic position.

Harriett Baldwin MP ⁵	<i>Vice Chair, Futurebuilders</i>
Sir Stephen Bubb	<i>Chair, Social Investment Business</i>
Kieron Boyle	<i>Head of Social Investment, Cabinet Office</i>
David Carrington	<i>Independent consultant and adviser to Futurebuilders</i>
Peter Deans	<i>Former Operations Director, Futurebuilders</i>
Nick O'Donohoe	<i>Chief Executive, Big Society Capital</i>
Fiona Ellis	<i>Former Chief Executive, Northern Rock Foundation</i>
Seb Elsworth	<i>Chief Executive, Access Foundation</i>
Caroline Forster	<i>Deputy Chief Executive, Adventure Capital Fund</i>
Richard Gutch	<i>Former Chief Executive, Futurebuilders</i>
David Hutchinson	<i>Chief Executive, Social Finance</i>
Jonathan Jenkins	<i>Chief Executive, Social Investment Business</i>
John Kingston	<i>Chair, Access Foundation</i>
Jonathan Lewis	<i>Former Chief Executive, Futurebuilders</i>
Kate Markey	<i>Managing Director of CAN Invest</i>
Vinay Nair	<i>Director of Business Development, Social Investment Business</i>
Antony Ross	<i>Director, Bridges Ventures</i>
Nat Sloane	<i>Co-founder and Vice Chair of Impetus Trust</i>
Fred Worth	<i>Trustee, Social Investment Business</i>

⁵ Note Harriett Baldwin's quotes all relate to the period of time before she became an MP

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