STREAT's acquisition of the Social Roasting Company's café's and roasting business

A case study in social finance: an equity-funded expansion of a social enterprise

SVA Consulting is supported by Macquarie Group Foundation

Contents

Introduction to this case study

- In 2012, STREAT – a Melbourne-based social enterprise – acquired two cafés and a coffee roasting business from another social enterprise, the Social Roasting Company (SRC). This enabled STREAT to rapidly expand its impact.
- The deal is an excellent example of “social finance” – a new and evolving practice of investing in opportunities that offer a combination of social impact and financial return.
- Social financing can take many forms. In this deal, the purchases were funded through equity: investors were sold a share of ownership, and these funds were then used to acquire the three businesses.
- This deal has lessons for social enterprises – who might consider similar approaches for funding expansion. It also has lessons for investors – who may be interested in similar investments that offer both a social and a financial return.

How to use this case study

- This case study outlines both the ‘what’ and the ‘how’ of the acquisition, and is intended to serve as a guide for both social enterprises looking to expand, and investors looking to blend social and financial returns.
- The case study is presented in six parts:
  1. Context: the factors that gave rise to this acquisition
  2. The opportunity to acquire SRC’s assets: the agreement between STREAT and SRC for the sale of two cafés and the coffee roasting business
  3. Defining the structure of the deal: how the equity-financed expansion was structured
  4. Attracting investors: the expected returns articulated to investors (social and financial), how investors were sought, and what mattered to them
  5. Transition and impact: the risks involved in transition, and how they were mitigated
  6. Lessons: what social enterprises and investors can learn from this deal.

Social Finance is an approach to investment that delivers "blended returns" – a financial and a social return

Investors

INVEST

Community organisation

SOCIAL RETURN

Social returns vary by organisation invested in. For example, they may include employment outcomes, environmental benefits, or retained indigenous cultural heritage. How the social return is measured varies, but can utilise methodologies such as Social Return on Investment (SROI).

FINANCIAL RETURN

Financial returns vary from very low, to close to a reasonable commercial return.

Investors

Investors are attracted to the combined social and financial return, even though the financial return itself may be lower than what would otherwise be expected.

Investments

Target investments are organisations that deliver a tangible benefit to the communities in which they are based.

The key players in this deal

Buyer/seller

STREAT Ltd.
Non-profit social enterprise that provides supported pathways to employment for homeless and disadvantaged youth. STREAT purchased SRC.

Social Roasting Company (SRC)
Social enterprise consisting of three cafés and a coffee roasting business. Two café's and the roasting business were acquired by STREAT.

Fair Business
Non-profit that acquires and creates businesses and transitions them into social enterprises. Fair Business owned SRC and sold it's assets and goodwill to STREAT.

Investors

Donkey Wheel Foundation
Philanthropic trust. Invested $150k in the new enterprise.

Small Giants
Mission driven, for-profit investor, that values investments that blend financial and social returns. Invested $50k in the new enterprise.

McKinnon Family Foundation
Private philanthropist. Invested $50k in the new enterprise.

Fair Business
Previous owners that, having already deciding to sell, re-invested $50k in the new enterprise.

Deal advisors

Paul Steele – CEO, Donkey Wheel Foundation
Donkey Wheel provided Paul Steele's time pro bono to act as deal intermediary.

Holding Redlich
Legal firm that provided pro bono legal support – particularly in drafting the shareholder and management agreements.

Social Ventures Australia
STREAT is a venture in the SVA employment portfolio. As part of its support package, SVA provided advice on social financing options and deal structure.

Jo Scott – former Consultant, SVA
Jo provided pro bono support to model the financial implications of the deal and develop the implementation plan.

Executive summary

Context

- STREAT is a social enterprise that provides supported pathways to employment for homeless and disadvantaged youth. Having demonstrated that its model was effective, STREAT had plans to scale the organisation's impact quickly.
- Two influencers – Paul Steele (CEO, Donkey Wheel Foundation) and Social Ventures Australia (SVA) – started to help STREAT think about the role "social finance" could play in its expansion.

The opportunity to acquire SRC assets

- Sydney-based non-profit, Fair Business was looking to sell its Melbourne-based business, the Social Roasting Company (SRC). At the time, SRC owned and operated three cafés and a coffee roasting business. Each of these was profitable except for one of the cafés.
- Fair Business CEO, Alex Shead contacted Bec Scott to see whether STREAT would be interested in purchasing the entire SRC business.
- STREAT saw SRC as a good target to help it expand. SRC saw that STREAT could enhance the social impact of the enterprise.
- Because it had a clear strategy, understood its finances, and had invested time in helping its board understand its expansion options, STREAT was ready to proceed.
- STREAT decided to purchase two of the three SRC cafés as well as the coffee roasting business and a van. A price of $250k was agreed upon, with another $24k also paid by STREAT to purchase additional assets (van, existing stock, and an additional coffee machine). The third café was sold separately by Fair Business.

Defining the structure of the deal

- STREAT decided to finance the deal through equity. To do this, it established a new entity, STREAT Enterprises Pty. Ltd., for which it would sell 50% of the shares to raise the required $300k. $300k covered both the necessary purchases ($274k) and establishment costs – such as legal fees. This entity would then own the three businesses that were being purchased.
- Under the management agreement, STREAT (Ltd – the original enterprise) would be the exclusive manager of the three businesses, for which it would receive a management fee.
- As the deal was arranged, Paul Steele committed one day a week to act as an intermediary. Paul advised on the deal structure, as well as helping to seek investors.

Executive Summary

Attracting investors

- Four investors were found to commit the necessary $300k. These investors shared a desire to see greater recognition for 'blended return' (both commercial and non-profit elements) enterprises in Australia. The investors were the Donkey Wheel Foundation ($150k), the McKinnon Family Foundation ($50k), Small Giants ($50k), and Fair Business ($50k). Donkey Wheel and McKinnon Family Foundation are both Private Ancillary Funds that were investing their corpus.
- Investors were informed that the expected financial return would be between 7 and 12% – and STREAT outlined its strategy for achieving this. In terms of social return, they were given an outline of STREAT's model and shown the results of a Social Return on Investment analysis conducted by SVA in 2009. This forecast predicted that through the STREAT model every $1 invested would generate approximately $3.80 in social return.

Transition and Impact

- There were five key risks that STREAT had to mitigate in the transition: staff leaving, customers leaving, not having the internal capability to expand successfully, losing grant funding and reduced clarity in how it communicated its impact.
- STREAT mitigated those risks, and successfully completed the transition of the cafés and coffee roasting business to their ownership. Revenue forecasts are on track with projections, and in 2013 STREAT will increase its intake to support 50 trainees per annum – double its previous capacity.

Lessons

- Through equity financing, social enterprises can raise capital for expansion at a reduced risk, and benefit from the support network of investors that is developed.
- By investing in social enterprises, Private Ancillary Funds can enhance their social impact by utilising their corpus as well as their disbursements.
- In order to make the most of expansion opportunities that become apparent, social enterprises must be well prepared. Key preparation usually includes having a clear strategy, understanding your financial situation, and bringing the board along for the journey.
- Intermediaries have an important role to play in equity financing – by attracting investors, providing support to the social entrepreneur, conducting due diligence, negotiating between stakeholders and building capacity.

Timeline for the involvement of key players in the deal

	Pre Jun-11	Jun-11	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11	Dec-11	Jan-12	Feb-12	Mar-12	Apr-12	May-12
	Preliminary work					Identify opportunity	Structure the deal				Transition		
STREAT	Develop strategic plan for growth						Put information on deal to investors	Develop deal structure			Complete purchase of SRC assets for $300k	Transition new cafés to STREAT brand	
Donkey Wheel	Conversations with STREAT board and management about equity expansion		Paul Steele working 1 day week (funded through Donkey Wheel) with STREAT to get them investment ready				Decide to purchase 25% equity for $150k						
SVA			Bring STREAT into its portfolio		Helped STREAT refine its strategic modelling	Facilitate meeting about social finance options				Facilitate meeting about deal structure			
Fair Business						Decide to sell SRC for $250k		Decide to purchase 8.3% equity for $50k					
Small Giants								Decide to purchase 8.3% equity for $50k					
John McKinnon								Decide to purchase 8.3% equity for $50k					

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Glossary of terms

Term	Description
CEO	Chief Executive Officer
NFP	Not-for-profit
Private Ancillary Fund (PAF)	A Private Ancillary Fund (PAF) is a fund established by trust instrument to which businesses, families and individuals can make tax deductible donations. Previously known as “Prescribed Private Funds” (PPFs), they were renamed in 2009 as a result of a new regulatory regime.
Social enterprise	A business that trades for a social, environmental and/or cultural purpose.
Social finance	Social finance is an approach to investment that delivers “blended returns” – a financial return and social return
Soft loan	A loan made on terms very favourable to the borrower – often with a flexible repayment schedule.
SRC	Social Roasting Company
SROI	Social Return on Investment – an internationally recognised methodology first developed in the 1990s that seeks to understand, measure and evaluate the impact of a project or program.
STREAT Enterprises (Pty. Ltd.)	The new legal entity created through this deal and used to purchase Social Roasting Company.
STREAT Ltd	The original social enterprise, founded in 2009, which provides supported pathways to homeless youth.
SVA	Social Ventures Australia

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STREAT is a social enterprise providing supported pathways to employment for homeless and disadvantaged youth.

The issue

Every night more than 105,000 people are homeless on Australian streets – 18,000 of these are teenagers between 12 and 18 years old. Of these homeless teenagers, 58% are unemployed and looking for work.

The costs associated with keeping these youth on the streets are enormous. For example, a new study by UNSW has cited one young woman who cost over $5.5 mill (policing, juvenile justice, welfare, housing, health, legal) between the age of 12-21 years.

STREAT's model

STREAT provides homeless youth aged 16-25 years with a supported pathway to long-term employment in the hospitality industry. It combines wrap-around social support with industry training and work opportunities in STREAT's inner Melbourne cafes and coffee carts – ultimately providing these trainees with both work and life skills, in order to help them get their lives back on track.

2

In its first two years, STREAT realised continued growth and demonstrated that it had an effective model for addressing homelessness.

How STREAT began

Between 2004 and 2006, Bec Scott (now CEO) and co-founder Kate Barrelle worked for KOTO, a training program and restaurant providing Vietnamese street youth with life and job skills. During this time they became increasingly convinced of the power of social enterprise to improve the wellbeing of the world's most vulnerable people.

In 2007, Bec embarked upon a study tour, funded by the Vincent Fairfax Ethical Leadership program, visiting similar projects in Thailand, Laos and Indonesia. It was from these key experiences and research that STREAT was born.

Growth to date

After undertaking a full feasibility study on the organisation in mid-2008, the TK Foundation, a Danish philanthropic foundation, funded STREAT's pilot start-up in late 2008. STREAT opened its doors in March 2010 establishing its first food cart at Federation Square. By 2011, it had served over 100,000 customers, launched three coffee cart sites, and was turning over $500,000 per annum.

Evidence for impact

Between 2010 and 2012, 41 trainees took part in the program. The range of issues faced by these trainees included homelessness (98%), drug and alcohol (69%), mental health issues (53%) and family violence (48%).

With these trainees, STREAT was achieving excellent results: 27 out of 41 had moved into either jobs or full apprenticeships in retail or hospitality businesses elsewhere. Their retention rate was 65% – an excellent figure for an intermediate labour market social enterprise.

2

STREAT had plans to scale its impact quickly – and was open to the various ways in which this could be financed.

Context

STREAT had a bold strategy for scaling the organisation.

According to the strategic goals refined in 2011, STREAT was ambitiously aiming to (by FY14/15)

- Have 100 young people complete the program annually
- Scale its business to have turn-over of around $5 million p.a
- Be financially sustainable on its own revenue.

However, it was still too reliant on grant funding.

Approximately 20% of STREAT's operating budget was funded by its own business income, with the remainder funded by grants.

Since 2009, it had raised $2.7 million from philanthropists, foundations and government.

$1.1 million of this had come from the Federal Government's Jobs Fund – funding that ended in June 2011.

As a result, it began to consider how else it could finance its expansion.

STREAT knew that it would be hard to continually secure grants. For example, the Government was not intending to continue with the Jobs Fund program.

Also, growing the business simply on the back of its own profit would result in slower expansion than desired.

Bec began to seek advice from those around her, as to how "social finance" could be used to help her expand the enterprise.

2

Donkey Wheel and Social Ventures Australia started providing advice on how social financing could help STREAT expand.

Context

Organisation	donkeywheel	social ventures australia
Key player	 **Paul Steele** CEO, Donkey Wheel • As CEO, Paul Steele oversees the Donkey Wheel Foundation. He was formerly the Deputy CEO of World Vision, and has had decades of experience advising on business investments and expansions.	 **Kevin Robbie** Executive Director, Employment Social Ventures Australia • Kevin Robbie has over 15 years experience in the community sector in the UK, as Chief Executive of one of Scotland's leading social enterprises. As Executive Director of Employment, he oversees SVA's strategy to reduce employment exclusion in Australia.
Support provided	• Paul Steele suggested to Bec that STREAT had a business model that was appropriate for expansion through social financing options. It had a team with a strong understanding of the commercial realities of running a social business, they had developed a very strong brand, and had a clear strategy. • Paul first met with the STREAT board to share with them the possibilities in November 2010, and continued to meet with them on occasion over the next year. • Through these discussions he was able to resolve some of the key questions around how various financing approaches could work for a non profit. As a result, the board were more open to possibilities they had previously not considered	• As a venture in its employment portfolio, SVA had committed to provide STREAT with both financial and non-financial support. • In September 2011, SVA Consulting commenced a project aiming to develop STREAT's three-year strategic goals. They developed a comprehensive model that considered all the variables for expansion, over the next five years. • Ian Learmonth (SVA Executive Director, former Director Macquarie Bank), committed three days of his time to help STREAT explore options for social finance. This included a "whiteboard session" in October 2011, testing the strategic goals that STREAT had developed with SVA Consulting – and advising on how it could be funded

Both SVA and Donkey Wheel were aware of the role each was playing, and remained in communication throughout the deal.

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Fair Business owned the Social Roasting Company – a set of three cafés and a coffee roasting business in Melbourne.

Alex Shead
CEO,
Fair Business

FAIR BUSINESS owns SOCIAL ROASTING COMPANY

- Fair Business, based in Sydney, is a non-profit organisation that seeks to acquire and create businesses, and transition them in to social enterprises for the benefit of the long-term unemployed and the broader Australian community. Since its inception in 2008, it has created more than 200 jobs; the majority of which have been filled by people who are reliant on welfare and are living in public housing. It joined SVA's venture portfolio in 2009, and is still in it today.
- Alex Shead is the founder and CEO of Fair Business and has more than 25 years of experience in entrepreneurial business management both in the UK and Australia. Alex was formerly the co-founder and CEO of Stuart Alexander which became one of the UK's largest insurance intermediaries and was ultimately sold to AXA UK.
- One of the businesses it owned was the Social Roasting Company established in 2009 when Fair Business acquired three cafés in Melbourne and the coffee roasting wholesale business attached to one. In 2011, each business except for one of the cafés was turning a profit.

Fair Business was looking to sell the Social Roasting Company's assets because it was challenging to run the enterprise from Sydney.

Based in Sydney, Fair Business knew that its location had constrained the growth of the Melbourne-based Social Roasting Company.

- **"Local ownership" is an important part of its philosophy.** Originally, when Alex conceived of Fair Business, he wanted to not only provide jobs to people excluded from the labour market, he wanted them to take a stake of ownership in the business. Although he realised this was not always going to be possible, local "ownership" (high degree of responsibility) remained a core part of the philosophy.

- **It was costly to run Social Roasting Company from a distance.** Alex needed to hire more people in order to properly oversee the business operations. Also, there were additional expenses, particularly the travel required.

- **Without sufficient local networks and knowledge, Alex had struggled to "crack the Melbourne market".** He hadn't been able to raise funds to support the business, despite trying (including applications for grants from councils and philanthropic foundations).

Fair Business contacted STREAT in October 2011 to see if it wanted to purchase its Social Roasting Company assets.

calls

Alex Shead
CEO,
Fair Business

Bec Scott
CEO,
STREAT

- Once Alex became aware of STREAT's desires to expand, Alex decided to call Bec Scott.
- Alex was confident that Bec was both passionate about STREAT's impact, and had the skills to both manage the transition and ensure the growth of the cafés.
- In October 2011, Bec received a phone call from Alex Shead exploring whether STREAT wanted to purchase the Social Roasting Company café's and roasting business.

There was a high degree of alignment between the two ventures.

STREAT saw the SRC enterprise as a good target to help it expand.

- Although STREAT had only previously operated food and coffee carts, they had already begun to assess the possibility of opening cafés. It realised it would be easier to expand through acquisition, than to start new sites.
- Social Roasting Company had grown to be a stable enterprise. The coffee roasting business and two of the three cafés were profitable. They had a loyal customer base, and they had a strong brand.
- There was strong brand alignment. Although the model was different, the Social Roasting Company had become known in the community for its social impact alongside the quality food and coffee.

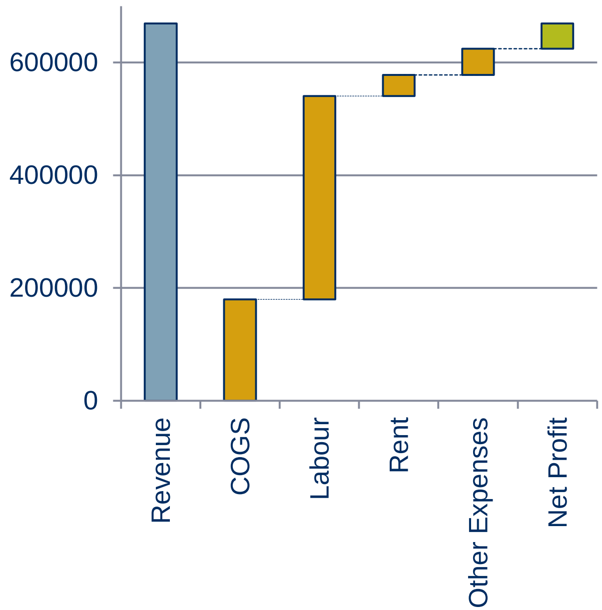
Fair Business saw STREAT as being able to enhance the social impact of the SRC enterprise.

- SRC was profitable. However, Alex wanted to see SRC taken to the 'next level': he wanted a local organisation to take the foundation he had established, and achieve greater social outcomes.
- As a result, he was only prepared to sell to future owners that would be able to successfully expand the business and its social impact. They needed to both care about the social purpose, and also have the capability and resources to expand the operations.
- STREAT was recognised as having a good model for delivering its social impact. Alex also saw Bec as having an excellent understanding of the business model.

Following due diligence, STREAT was only interested in purchasing two cafés and the coffee roasting business.

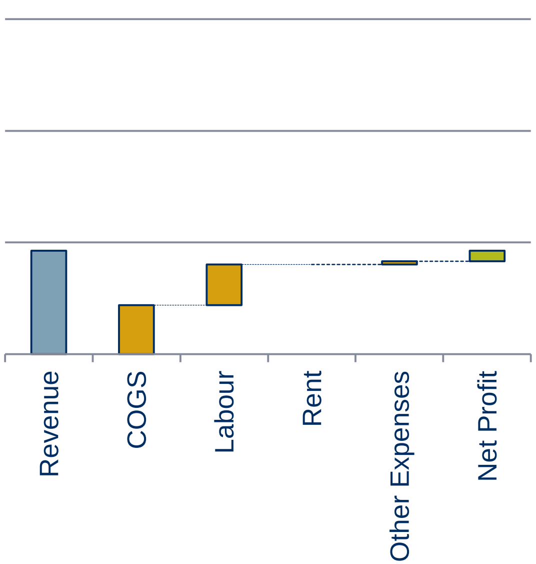
Flemington Cafe

- Location: main road in Flemington, easy train and tram access
- Seats 50, large kitchen, office
- Mon-Sun, 7am-4pm
- 5 staff plus casuals
- $30k assets, no liabilities



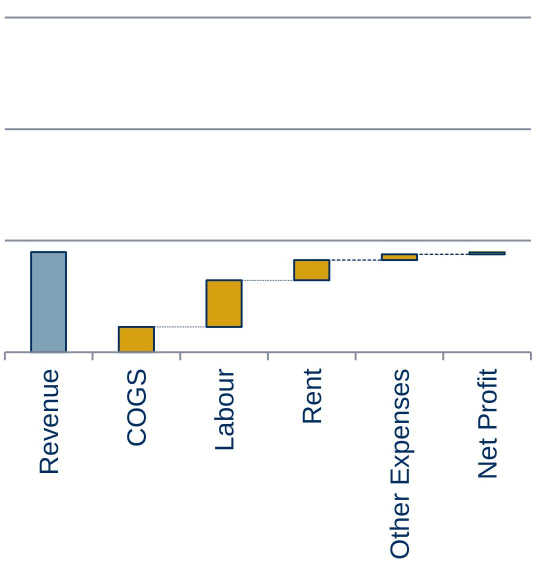
Coffee Roasting Business

- Location: same premises as Flemington café
- Large roasting machine
- 1 staff
- $70k assets, no liabilities



McKillop Lane Cafe

- Location: McKillop laneway in heart of CBD
- Seats 26, small office
- Mon-Fri, 7am-4pm
- 2 staff
- $25k assets, no liabilities



STREAT were prepared to make an immediate decision to proceed

Whilst the opportunity had "fallen into its lap", STREAT was able to make a decision to proceed quickly, for three key reasons:

- **It had strategic clarity.** Since October 2010, STREAT had been developing its plans for expansion, and so was aware of the strategic implications of this decision, and how it fitted into its future.
- **The Board was ready to accept the proposal.** Particularly due to the ongoing advice of Paul Steele, STREAT's Board was open to the various ways that expansion could be financed. It had been made aware of the risks, and was ready to take them.
- **It understood its financial situation.** STREAT's financial accounts were in good order due to three years of diligent account keeping. This enabled them to do the financial modelling to understand the consequences of the decision.

3 STREAT and Fair Business agreed, in principle, on a price of $274k for two cafés, and the coffee roasting business - along with additional assets

- The starting point for discussion was the first sale value proposed by Alex Shead ($300k for just the cafés and coffee roasting business). Paul Steele did a survey of the profitability of other similar businesses in the area, and Bec tested values with a supporter who had extensive experience in the sector. As a result, Bec negotiated the lower price.
- STREAT then also agreed to purchase additional assets from Fair Business: a van, existing coffee stock and an additional coffee machine.
- Price negotiations were quick and easy mainly because of the high degree of trust and understanding between Bec and Alex.
- SVA played an indirect, advisory role, because both organisations were ventures in the SVA portfolio. In particular, SVA acted as a sounding board for each.

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STREAT decided that its preferred way to finance the deal was through equity.

		Strengths	Weaknesses
Community fundraising	*Donations from the community.*	• Funds are not tied to any particular purpose, and do not need to be repaid.	• Very slow to fundraise.
Grants	*Pursue grants from philanthropists, foundations or governments.*	• Funds do not need to be repaid.	• Funds are often tied to a particular purpose, and hence inflexible • Requires significant resources (eg writing grant applications) • Limited supply available.
Debt financing	*A loan from a bank or funder with agreed repayment terms.*	• Always available • Current owners maintain full control of the business • Owners are due all returns.	• Funds must be paid back, and the payment reschedule will reduce future cash flows • Payment schedules are often constant, whereas business revenue may fluctuate, particularly in the early days • There is a risk involved. If the business does not produce sufficient returns, it may not be able to pay off the loan.
Equity financing	*Investors purchase an ownership stake, and receive a share of the profit. Their purchase provides the business with additional capital.*	• The risks of business failure are shared between the operators and the investors.	• The business will often need to forego a degree of control, due to diluted ownership • Investors now also take a proportion of the return • It can be challenging to find investors who are willing to accept a low return, because of the social impact.

STREAT decided for equity. Given this expansion was new, STREAT was attracted by the lower level of risk (compared to debt financing), whilst being able to raise the funds sufficiently fast (compared to grants, or community fundraising).

There are a number of risks involved in an equity-funded purchase, although none of them became an issue in this case.

Risk	What happened during this deal
Buyer is unable to properly assess the financial situation	Support from Paul Steele and Jo Scott ensured that financial projections were modelled carefully and comprehensively.
Buyer and seller are unable to negotiate a fair price for the purchase	Alex Shead and Bec Scott had a strong working relationship and there was a strong alignment in values. As a result, they had no issues negotiating a price.
Insufficient investors attracted	Paul Steele, acting as an intermediary, spent months in the lead up to the deal identifying potential investors. Paul had a large network.
Agreement unable to be reached between investors on the details of the deal	All the investors were keen to see more deals like this in the sector. As a result, they cared more about ensuring that the deal occurred, and were not prepared to let disagreements get in the way. This meant that negotiations were fairly smooth.
The organisation unable to handle the expansion	Bec identified the five key issues for STREAT in transition, and developed a strategy to mitigate them. These were: staff leaving, customers leaving, not having the internal capability to expand successfully, losing grant funding, and reduced clarity in how it communicated its impact.
Agreement documents are not sufficiently clear	STREAT was able to acquire pro bono legal support from Holding Redlich in drafting agreements. Combined with the experience of Paul Steele, this ensured that the documents captured the necessary details.

To enable the expansion through equity, STREAT needed to establish a new for-profit entity that would own the purchased businesses.

STREAT

STREAT Ltd.

- Existing social enterprise
- Non-profit, Public Benevolent Institute
- Deductible Gift Recipient (DGR) status

establish

STREAT

STREAT Enterprises Pty. Ltd.

- New enterprise
- For-profit structure
- Partially owned by STREAT Ltd
- Partially owned by other investors

STREAT Ltd. owns a share

Other investors own a share

owns Flemington Cafe

owns Coffee Roasting Business

owns McKillop St Cafe

STREAT then needed to sell shares in STREAT Enterprises to finance the purchase.

Structuring an equity deal involves balancing three factors: sale price of the equity, amount of equity sold, financial return proposed.

Amount of equity sold	Sale price of this equity	Financial return expected
• STREAT knows that the more equity it sells, the less control it has over the organisation. • If it sells less than 50%, it retains full control.	• STREAT ideally want to sell shares worth a total of $300k, so that these funds can cover the entirety of the expansion. • If it sells less than $300k, it would need to raise additional money elsewhere, or use its own capital.	• By selling only a portion of a business for a price, there is an inferred valuation for the entire business. • If you sell less equity, for a higher price, the overall return the business generates each year will need to be high to provide sufficient returns to investors. • Investors would need to believe these returns are possible.

For example, some possible scenarios:

Equity sold	Sale price of this equity	Financial return expected	Inferred value of business	Actual returns required (pa.)
75%	$300k	7%	$400k	$28k
50%	$300k	7%	$600k	$42k
25%	$300k	7%	$1,200k	$84k
75%	$200k	7%	$266k	$19k
50%	$200k	7%	$400k	$28k
25%	$200k	7%	$800k	$56k

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Balancing the factors, STREAT proposed a structure under which it would sell 50% of the equity for $300k.

Amount of equity sold	Sale price of this equity	Financial return expected
50%	*$300k*	*7-12% on average, over the three years*

This means that STREAT Ltd. would retain control of STREAT Enterprises by retaining a 50% stake.

This means that if STREAT sold the equity it would have raised sufficient funds to cover the entire purchase ($274k), as well $26k to cover establishment fees – such as legal costs.

Because of the inferred value of the business, STREAT Enterprises (consisting of the two cafés and coffee roasting business) would hence need to generate at least $42k per annum in profit, to repay investors.

Inferred value of business:
$600k

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To confirm this was a realistic forecast for the future, STREAT modelled financial projections accompanied by a high-level strategy.

- The businesses had been acquired for $250k, but the inferred sale value of the business was $600k – a significant difference! This valuation may be explained by a combination of factors:
  - **The business could've been bought for less than it was worth.** Fair Business was prepared to sell at a reasonable price because of the alignment in values.
  - **STREAT may be able to add significant value to the existing business.** This value-add could be achieved through business efficiencies (STREAT applying its management approach), increased marketing as a social enterprise (which STREAT do very well), increased sales through the strength of the STREAT brand, and tax benefits through using the STREAT Ltd. non-profit structure.
- Although expected returns were outlined, they were not guaranteed. The return was assessed through both bottom-up and top-down financial modelling:
  - Bottom-up: aggregating the value of cash flows projected into the future
  - Top-down: applying an appropriate multiplier to the current earnings before interest and tax (EBIT).
- Accompanying these figures, STREAT outlined a high-level strategy for each business to potential investors. This included an indication of what the strategic focus areas would be to maximise profitability.

Determining the business value upon which returns were calculated

Value of acquired business
- Based on current profitability

+

Value-add by STREAT
- Business efficiencies
- Increased marketing as a social enterprise
- STREAT brand value
- Tax benefits through STREAT Ltd non-profit structure.

−

Additional cost of delivering STREAT's social impact
- Various costs associated with the STREAT model in excess of current costs.

Operational and ownership details were then clarified.

Operational details

- According to the management agreement, STREAT Ltd. is the exclusive manager of the three businesses owned by STREAT Enterprises. For these services, STREAT Ltd. receives a management fee of 12% of business revenue per annum. This management fee covers the additional costs to STREAT Ltd. of running the cafés – such as additional costs incurred when working with very high needs young people.
- Staff would be employed by STREAT Ltd. This enabled salary packaging to take advantage of STREAT Ltd's non-profit status for the benefit of employees. Procurement contracts are purchased by STREAT Ltd in order to take advantage of its buying power (four cafés, rather than three). All assets and leases are owned by STREAT Enterprises.

Ownership details

- All shares are ordinary shares: there are no preferred shares. This means that each investor is entitled to their share of the dividends paid.
- Shares are transferrable, and hence investors are able to exit. However, there is no existing mechanism to enable the transfer of ownership. If an investor wanted to leave, they would need to identify someone to replace them. In this way, the shares have a low liquidity.

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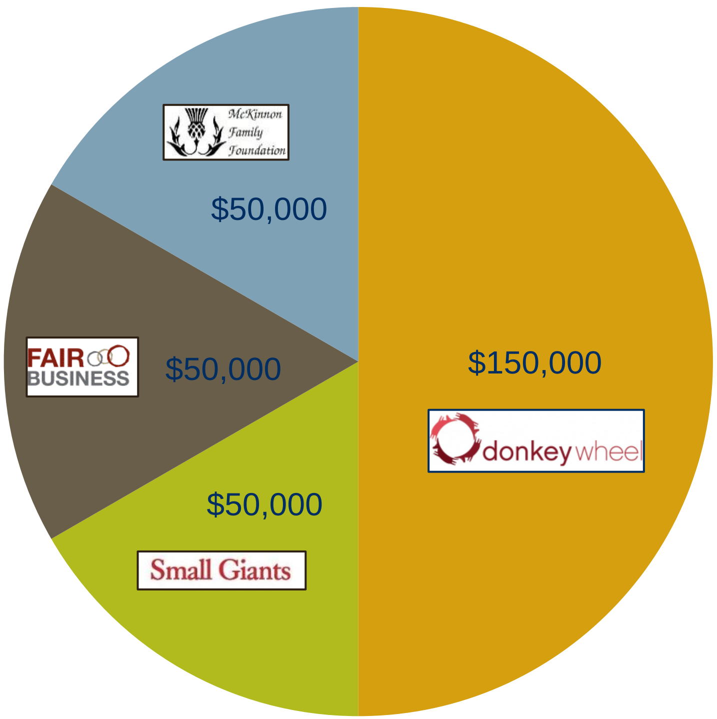
STREAT decided to only look for investors that had an alignment with its values, and were prepared to invest a sufficiently high amount.

STREAT was clear in its criteria for investment:

- **STREAT was only interested in investors that would use the return for purposes that aligned with its values.** The organisation undertook a 'positive screen' in its capital raising, proactively searching for investors who positively contribute to society and the environment.
- **STREAT made a decision to only accept investors who were prepared to commit to at least $50k.** Knowing the work that is required to seek and engage stakeholders, STREAT's management team did not want to overburden themselves. A couple of the investors had originally wanted to invest less than $50k, but STREAT stayed firm on its minimum.

The search for investors was quite quick because Paul Steele had already started to introduce potential investors to the possibility of STREAT's expansion. As a result, when the deal became a viable proposal, it only took a month to confirm the four interested parties who ended up making the investment.

Four investors were found; their motivation varied slightly.



McKinnon Family Foundation

Passionate about the social enterprise model for solving labour market exclusion, John McKinnon has written a PhD on the subject. Through his fund, he provides grants to organisations whose social impact he values.

FAIR BUSINESS

As the previous business owner, Fair Business wanted to ensure that it left a legacy by remaining involved. It also wanted to support Bec & the STREAT team throughout the deal, and increase the confidence of potential investors by staying involved.

donkey wheel

As an impact investor, Donkey Wheel wanted to promote the opportunities for more foundations to leverage their corpus. It saw this deal as a great opportunity to do this, but also one whose success could be widely promoted.

Small Giants

Part of Small Giants purpose is to promote ‘blended value’ organisations: for-profits that have a substantial social impact. It saw STREAT as having a strong, credible brand and hence this deal as an example that could pave the way for future deals.

Two of these were PAFs who were able to enhance their social impact by utilising their corpus, as well as their distributions.

The traditional approach of many PAFs

Corpus: money sitting in the fund

$

Corpus is invested in standard financial assets (eg. stocks, property, government bonds) so that it grows over time.

A minimum of 5% of the corpus is distributed to DGR-status social enterprises to use for impact.

IMPACT

The approach of these PAFs by investing in STREAT

Corpus: money sitting in the fund

$

Corpus is invested (where possible) in social impact organisations (such as STREAT), so that it grows over time and also achieves a social impact.

IMPACT

A minimum of 5% of the corpus is distributed to DGR-status social enterprises to use for impact.

IMPACT

Through the deal negotiation, investors saw the following as relatively high priority issues:

Social impact	**High Priority**	• The most important factor for all investors was that STREAT was effective in achieving its social goals – and that the acquisition would increase the overall impact.
Board seats and appointments	**Medium Priority**	• Originally, STREAT wanted to maintain full control of board appointments. Whilst none of the investors sought seats on the board, they pushed back against this request, and ensured that board appointments would be made by a vote of the owners according to level of ownership. Whilst no investors were actually interested in seeking a position on the board, they did want to ensure there was a formal means for raising issues.
Return on investment	**Medium Priority**	• For investors it was important that there was an expectation of a return, however they were happy to accept a lower return for the given level of risk. They trusted STREAT's judgement about the valuation, and saw Paul Steele's assessment as credible. The strategy information they received was seen as sufficient. • Private Ancillary Funds (PAFs) are committed by legislation to spend at least 5% of their corpus each year. Since they were investing a proportion of their corpus in the business, it was important to them that the return exceeded 5% pa. John McKinnon, for example, was hoping for at least 7% to provide some leeway. Higher was seen as a bonus.

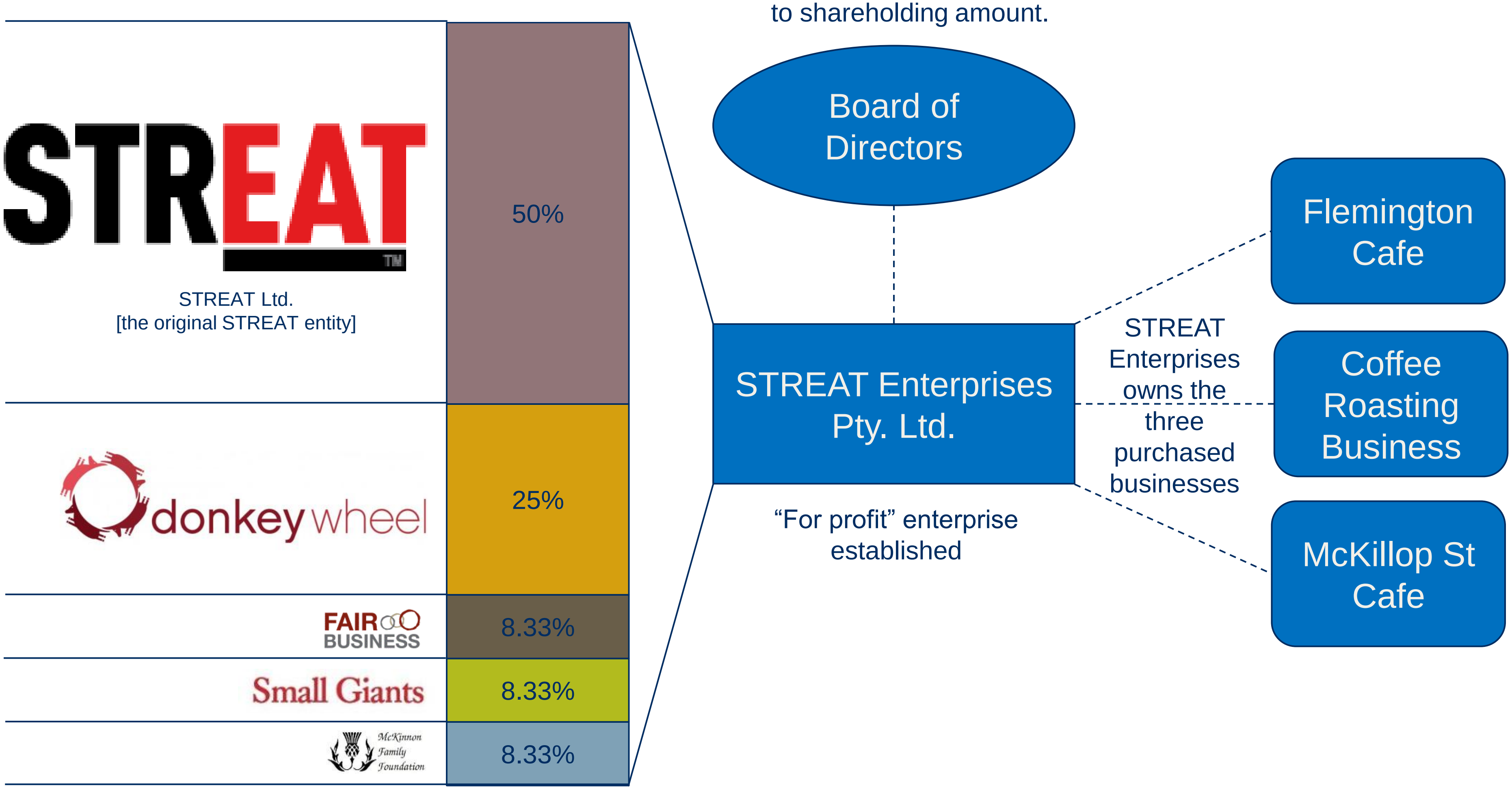
Through the deal negotiation, investors saw the following as relatively low priority issues:

Issue	Priority	Comments
Control over decision-making	**Low Priority**	• Many of the investors see themselves as “active partners” in some of their partnerships i.e. their investment is both financial and advisory. However, with STREAT they were happy to be passive investors because they trusted Bec’s judgement on to how best to run the enterprise. • In deal development, STREAT had originally considered 51% ownership by STREAT Ltd to ensure majority control. This was informed particularly by Bec’s observations of another organisation, where the founder had lost control of the organisation, and as a result the organisation had drifted away from its mission. However, Paul Steele pushed her to reduce this to 50%. He suggested that this would be a valuable gesture of trust for potential investors. It meant that the worst case scenario for voting would be an impasse.
Risk	**Low Priority**	• Investors acknowledged the risky nature of the returns, however they were prepared to accept the premium not just because of the social impact, but because of the ability of this deal to promote similar activity in the future. To most investors, the continued involvement of Fair Business (re-investing despite selling the business) was a substantial factor that mitigated the risk.
Exit	**Low Priority**	• Investors were not very concerned about the ability to exit. Although this meant that their investment was riskier, they were committed to supporting this venture to succeed.

Following negotiation, each investor signed the shareholder agreement and the deal was completed.

$300k from investors had purchased 50% of the equity in STREAT Enterprises Pty. Ltd. – with STREAT Ltd. holding the other 50%.

Board oversees activities of company. Board appointments voted on by owners, according to shareholding amount.



Contents

For STREAT. the key to a successful transition was identifying the main risks and mitigating them.

STREAT identified five key risks:

1. Staff leaving
2. Customers leaving
3. Not having the internal capability to expand successfully
4. Losing grant funding
5. Reduced clarity in how it communicated its impact

STREAT identified the biggest risks in the transition and sought to mitigate them. (1/5)

1 RISK: Staff leaving

There was a risk that the existing staff at SRC would leave. Bec saw this as particularly concerning because she knew that in cafés, customer loyalty is heavily driven by the rapport developed with 'front of house' / 'customer facing' staff. Also, given the amount of transition required, it would be challenging to find the time to attract new staff.

- **STREAT sought to reduce uncertainty around their jobs** which Bec judged would be one of the largest drivers for people to leave. As a result, she offered every person in the business a new contract.
- **STREAT promoted awareness amongst staff of the social impact.** She believed that once STREAT's clients were put into these sites, existing staff would see the value first hand, and would be more motivated.
- **STREAT wanted to ensure that it was clear that this was not a hostile takeover.** Alex and Bec made a joint announcement to all staff, making sure that all staff knew what was happening and when.
- **STREAT needed to prove its credibility.** Particularly, it had to demonstrate that it had the capability to run cafés. These were the first cafés STREAT would run and the move from a cart-based business to a café-based business was a large one. Importantly, STREAT transferred two of its most trustworthy, capable and hardworking staff to be the managers of the two new cafés.

STREAT identified the biggest risks in the transition, and sought to mitigate them. (2/5)

2 RISK: Customers leaving

STREAT was worried that customers would leave because they were loyal to Social Roasting Company, and would not transfer that loyalty to the STREAT brand.

- **STREAT made a big push on PR and media.** Although some customer churn was to be expected, STREAT aimed to cover for it through attracting new customers.
- **STREAT wanted to make sure that existing staff had the chance to meet and build rapport with STREAT staff.** Bec ensured that social events were organised – "It's hard to be angry with people you like!" They also ensured that STREAT staff maintained visibility around the new cafés – by having herself (and other staff) spend time working out of the cafés. Staggering the transition (Flemington first, then McKillop St) made this easier.
- **STREAT wanted to ensure that customers knew this was not a hostile takeover.** Alex and Bec co-wrote a letter to all customers explaining why the acquisition was happening, and also sharing the social impact that would be achieved under the STREAT brand. This letter was attached to every menu, and a poster-sized version was put in the front window. From the responses of people to the letter ("What is their face saying?"), the conversations she overheard, and the direct feedback to staff, Bec judged that this letter made a really big difference to customers. Following on from the strong feedback to this initial communique, Bec continues to write monthly to customers.

STREAT identified the biggest risks in the transition and sought to mitigate them. (3/5)

3 RISK: Having the internal capability to expand successfully

Bec was aware that the expansion plans were ambitious. At the time, it was running a "cart-based business", with 2 carts, and a trading income of around $500k pa.

With this acquisition, it would be running cafés for the first time. With the addition of these two cafés and the coffee roasting business, its turnover would rise to over $1.5 million.

- **Bec ensured the expansion did not affect the stability of the organisation.** Bec focused on ensuring she had a stable core team and a stable culture. She was confident this was the case and kept an eye on it throughout.

- **Bec sought a new staff member that would bring experience in scaling up a business – ideally in hospitality.** After seeking advice from a mentor she was introduced to Jen Miller who had previously been the National Franchise Manager of Hudsons Coffee and had helped them grow from 2 to 40 stores. Bec offered her a role as General Manager of Operations to oversee the expansion into the cafés.

STREAT identified the biggest risks in the transition and sought to mitigate them. (4/5)

4 RISK: Losing grant funding

Whilst the financial modelling for STREAT indicated that it could be financially self-sustaining by FY14/15, Bec was aware that its expansion plans included a substantial amount of funding from grants over the next three years.

However, she was concerned that if current and potential funders saw that STREAT was able to grow through an equity approach, they would no longer be willing to provide funding.

- **Bec re-engaged STREAT's supporter base.** She hosted lunches for past supporters and funders – "Come to lunch, let me show you what we've done, and what the impact will been". Through these meetings, the response from funders was overwhelmingly positive. None indicated that they would be less prepared to provide funds into the future. Some commented that they "should give [STREAT] another grant this year". Others spoke about how they appreciated that the work was pioneering in the sector: "That's fantastic, this is where the sector needs to go". STREAT were also overjoyed when the Ian Potter Foundation provided a major grant specifically to help further leverage the investment.
- **Bec learnt that grant funding and investment could co-exist.** One investor (McKinnon Family Foundation) contacted STREAT after the investment had been confirmed to see whether it was interested in receiving a grant. The proposed grant was of the same size as the investment! John McKinnon pointed out that when it comes to considering grantees, it makes sense to locate it alongside where the corpus has been invested – as it increases the likelihood of the investment succeeding.

STREAT identified the biggest risks in the transition and sought to mitigate them. (5/5)

5 RISK: Losing clarity on its impact

Previously STREAT could claim that 100% of its profits were being used for “stopping homelessness”.

However, now 50% of profits from the newly acquired business are used for “stopping homelessness”, and 50% support the social impact being achieved by the other investors.

- **Bec saw it as important to “get on the front foot” with this communication.** She put together a document that accompanied announcements of the acquisitions. This outlined who the investors were, highlighted that they were all using the returns for social impact, and explained what impact they would be having with their share. As she says, “we now consider this broader impact as part of STREAT’s impact”.
- **Bec made it clear that STREAT was very careful in its selection of investors.** She recognised that this may have been harder to manage if any of the investors were pursuing purely commercial interests. In her communication, she outlined that because STREAT aims to maximise its social footprint, it had decided that it was important to source “ethical capital from like-minded investors”. She explained that she had proactively searched for investors who positively contribute to society, and the environment.

Having mitigated these risks, STREAT has successfully managed the transition of the cafés and coffee roasting business.

- **The transition has been smooth.** Fair Business allowed STREAT to trade under the SRC brand for a couple of months, to help with transition. They became publicly STREAT cafés in June 2012. Sales across the cafés remained consistent throughout the transition and have now started to rise as hoped. Revenue forecasts are on track with projections, and STREAT is confident it will be able to provide a return of at least 7% to investors.

- **The new trainees commenced at these sites in July.** As a result of this expansion, the organisation increased the number of youth it engaged with, and in 2013 STREAT will further increase this to support 50 trainees per annum, double its previous capacity.

- **Through the experience of this acquisition, STREAT is revising its strategy for expansion.** It will have an increased emphasis on growth through the acquisition of existing businesses. Also, it is continuing to look for other options to utilise social financing – such as to purchase a second roaster to expand the coffee roasting business.

Contents

There are Lessons for social enterprises and for investors.

Lessons for social enterprises

- Through equity financing, social enterprises can raise capital for expansion
  at a reduced risk, and benefit from a network of like-minded investors.
- Through preparation, social enterprises are better able to take opportunities that present themselves.
- Use intermediaries – they have an important role to play in equity financing and other social finance deals.
- Understand the risks early – so that you can put in place a mitigation strategy.

Lessons for investors

- By investing in social enterprises, investors can enhance their social impact
  by utilising their corpus as well as their disbursements.
- Ensure that the agreement documents comprehensively capture the issues regarding the deal.

Through equity financing, social enterprises can raise capital for expansion at a reduced risk and benefit from a greater network.

Lessons for social enterprises

- **Lower risk.** When social enterprises borrow to expand, they accept the risks involved. They are tied to repayment schedules regardless of how well the business performs. In an equity deal such as this, the risks of enterprise failure are shared between the operators and the investors. They only need to pay a dividend to owners when the venture has been profitable.

- **The establishment of a greater network.** One of the less expected benefits for STREAT in this deal was how the investors became a supportive network for the organisation. More so than grant investors, these investors care about the ongoing health of the business. STREAT's experience in this expansion was that these investors became useful as a sounding board and as morale support. Into the future, they may also be able to add value through connections and expertise.

Through preparation, social enterprises are better able to take opportunities that present themselves.

Lessons for social enterprises

- Often it seems like great opportunities can “fall out of the sky”. However, if a non-profit is not properly prepared, it may not be able to take advantage of these opportunities.
- In this deal, although Fair Business initiated the opportunity, STREAT was fully prepared to proceed with it. This was for three reasons: it had strategic clarity, the board was ready to accept the proposal, and it understood its financial situation. It had also completed an SROI which meant that it could describe clearly the extent of the social impact investors could expect.
- Social enterprises that are seeking to grow their social impact must ensure that they are prepared in these ways, so that when an opportunity presents itself, they are able to take it.

7 Intermediaries have an important role to play in equity financing and other social finance deals.

Lessons for social enterprises

In this deal, Paul Steele played the role of an intermediary. Some of the benefits of his involvement:

- **Attract investors.** The network around a social enterprise is often small and it can be hard to find investors. Having an intermediary to champion the deal makes it more likely that appropriate investors can be found.
- **Provide support to the social entrepreneur.** Structuring a deal like this can be challenging and Bec valued both the morale support and Paul's experienced advice.
- **Provide due diligence.** Investors seek reassurance that the social enterprise and the deal have been comprehensively tested and verified. If an intermediary is seen as credible, they can provide the stamp of assurance. In this deal, Paul Steele's credibility was important to investors who trusted his assessment of risk and return.
- **Building capacity to enable these kinds of expansions.** To expand in the way STREAT did requires some important capabilities as noted. Many social enterprises do not currently have these capabilities.

However, through interviews with investors, one of the challenges identified was that Paul was, at times, unable to negotiate sufficiently between stakeholders. Having an intermediate that is sufficiently independent can ensure that negotiation occurs in a way that is satisfying to each party. In this deal, Paul was seen by some investors as being 'too close' to Bec to be sufficiently helpful in negotiation.

7 Understand the risks early – so that you can put in place a mitigation strategy.

Lessons for social enterprises

- Social finance and equity financing have clear benefits for social enterprises. Particularly, they can raise capital for expansion at a reduced risk, and benefit from a network of like-minded investors.

- However, there are also substantial risks. The buyer might not be able to properly assess the financial situation. The buyer and seller might fail to negotiate a fair price for the purchase. Insufficient investors may be attracted. Agreement might not be reached between investors on the details of the deal. Finally, the organisation may not be able to handle the expansion.

- By identifying these risks early, and putting in place a strategy to mitigate them, social enterprises will increase the likelihood of the deal succeeding.

7

By investing in social enterprises, investors can enhance their social impact by utilising their corpus as well as their disbursements

Lessons for investors

- Many philanthropic funds invest their corpus in traditional assets (such as property, stocks or government bonds) – often through a third-party investment manager. They then disburse an amount each year in grants, to help community organisations have an impact. In Australia, Private Ancillary Funds are required to disburse 5% of their corpus each year.

- In this deal, investors chose to invest their corpus in STREAT, rather than in traditional commercial assets. This meant that they were able to have an impact through their investment, as well as their corpus.

- If more investors took this approach, they would be able to increase their impact.

Ensure that the documents of agreement comprehensively capture the issues regarding the deal

Lessons for investors

- Deals such as these can be quite complex. There are many important issues that agreement needs to be reached on – such as board appointments, voting rights, social return, financial return, and extent of liability.
- However, because in the non-profit sector these deals often involve close supporters as investors, there is a risk that the importance of documents such as contracts are overlooked.
- It is critical to ensure that all investors consider the issues of the deal, and that they have robust conversations with the organisations involved. Independent intermediaries and pro-bono legal support will also be useful to provide a critical perspective.

Contents

Methodology and interviews

- The research carried out was primarily via semi-structured interviews with key stakeholders and practitioners supported by desk-based research.
- The following people were interviewed and/or provided information through the development of this case study
  - Alex Shead (CEO, Fair Business)
  - Claire Kearney (Business Manager – Employment, SVA)
  - Jen Miller (GM Operations, STREAT)
  - John McKinnon (Director, McKinnon Family Foundation)
  - Kaj Lofgren (Director of Strategy, Small Giants)
  - Kevin Robbie (Executive Director – Employment, SVA)
  - Paul Steele (CEO, Donkey Wheel)
  - Piers Ramsay (GM, Fair Business)
  - Rebecca (Bec) Scott (CEO, STREAT)