# Common Growth Fund Process: Expenses-Based Investment & Convertible Loans for Social Enterprises (UK Law Context)

This process outlines the journey of the common growth impact fund specifically designed to provide flexible financing – either through direct expenses-based investments (e.g., revenue-share agreements, grants with repayment clauses, or highly bespoke financing tied to operational expenses) or convertible loans – to social enterprises, **within the specific legal and regulatory context of the United Kingdom.**

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## Phase 1: Fund Conception & Formation

1. **Define Impact Thesis & Financial Objectives:**
    - **Core Impact Focus:** Clearly articulate the specific social and/or environmental problems the fund aims to solve (e.g., poverty alleviation, access to education, climate change mitigation, healthcare equity). **Crucially, for a UK charity, these must align with its registered charitable purposes as defined by the Charities Act 2011.**
    - **Target Beneficiaries:** Define the specific communities or groups that will benefit from the social enterprises supported.
    - **Financial Return Spectrum & Trustee Duties:** Determine the expected financial returns. UK charity trustees have a **fiduciary duty** to act in the best interests of their charity, which generally means maximising financial return on investments. However, the Charity Commission's guidance (CC14) explicitly allows for "social investments" where trustees use money or property with a view to *both* achieving their charity's purposes directly through the investment *and* making a financial return. This allows for **concessionary returns** where justified by the direct charitable benefit.
        - **Key Distinction:**
            - **Pure Financial Investment:** Goal is primarily financial return, with EoC 7 measures and Redi Index being secondary and

        - not compromising financial return (unless a financial risk to reputation etc.).
        - **Social Investment (as defined by Charities Act 2011):** Explicitly dual purpose – both direct social impact purpose (with EoC 7 measures and Redi Index )and financial return. The financial return may be below market rate if the direct charitable benefit justifies it. Trustees must be satisfied the investment is in the charity's best interests, considering both aspects.
    - **Uniqueness of Funding:** Emphasize the fund's commitment to "expenses-based investment" or "convertible loans" as a core differentiator, highlighting the flexibility and suitability for social enterprises. This aligns well with the "social investment" concept.
2. **Market Research & Gap Analysis:**
    - Identify the specific needs of social enterprises that are currently underserved by traditional capital in the UK.
    - Analyze existing UK social investment funds and other charitable funders to identify niches or underserved sectors where this flexible financing model can have maximum impact.
3. **Legal Structure & Governance:**
    - **Fund Vehicle (for the Foundation itself and/or the fund):**
        - **Charitable Incorporated Organisation (CIO):** A popular choice for charities as it provides corporate status and limited liability for trustees, and is regulated solely by the Charity Commission.
        - **Charitable Company Limited by Guarantee:** Registered with both the Charity Commission and Companies House. Offers limited liability.
        - **Charitable Trust:** Simpler to set up but trustees have personal liability.
        - **For the "Impact Fund" itself, if a separate entity:** While the foundation itself makes the investment, if it sets up a separate fund entity (less common for direct investment by foundations, more for pooled funds), this might take the form of a **Limited Partnership (LP)** (with the foundation potentially being an LP) or a **Community Benefit Society** (if it involves community share offers).
    - **Jurisdiction:** The UK (England & Wales, Scotland, or Northern Ireland) is the

primary jurisdiction for UK charities.
   - **Governing Document Review:** The foundation's **governing document** (e.g., trust deed, articles of association, CIO constitution) must permit making investments of this nature. Trustees must review and potentially amend it.
   - **Impact Governance:** Establish a clear governance framework for impact measurement and decision-making, possibly including an Impact Advisory Committee to ensure alignment with charitable purposes.
4. **Team Formation:**
   - **Investment Team:** Members with expertise in social enterprise models, financial analysis, due diligence, and structuring flexible financing. Crucially, they must also understand UK charity law and the nuances of social investment.
   - **Impact Management Team:** Specialists in impact measurement, monitoring, and social science to ensure robust impact assessment, aligning with UK impact reporting standards.
   - **Legal & Operations:** Professionals to handle fund administration, Charity Commission compliance, HMRC implications, and legal aspects.
5. **Fundraising Strategy:**
   - **Target Investors:** If the foundation is pooling capital for an external fund, focus on LPs aligned with the impact and financial thesis, who understand the unique risk/return profile of expenses-based or convertible debt. This includes other UK foundations, institutional investors, family offices, and potentially individuals.
   - **Messaging:** Clearly articulate the *why* behind expenses-based/convertible models – their suitability for social enterprises, potential for deep impact, and responsible capital deployment, explicitly referencing how these fit within the UK's social investment landscape.

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## Phase 2: Investment Sourcing & Due Diligence

1. **Sourcing & Pipeline Generation:**
   - **UK Social Enterprise Ecosystem:** Leverage networks in the UK social enterprise ecosystem (e.g., Social Enterprise UK, Big Society Capital, local councils, community hubs, accelerators).
   - **Collaboration:** Partner with other UK social investors or charities.

2. **Initial Screening:**
    - **Mission Alignment:** Does the social enterprise clearly align with the fund's impact thesis and, crucially, with the **charitable purposes of the foundation**?
    - **Social Enterprise Model:** Is it genuinely focused on social/environmental outcomes? Is it structured appropriately (e.g., CIC, CBS, charitable company)?
    - **Stage Appropriateness:** Is the enterprise at a stage where expenses-based or convertible financing is most appropriate?
    - **Team Strength:** Assess the leadership team's vision, commitment, and execution capability.
3. **Comprehensive Due Diligence:**
    - **Financial Due Diligence (Tailored):**
        - **Expenses-Based:** Deep dive into operational costs, unit economics, cost efficiencies, and the ability to generate future cash flows to cover the "repayment" or "share" of expenses. Focus on **burn rate, cost-benefit of impact, and efficiency of capital deployment.**
        - **Convertible Loan:** Assess revenue projections, cash flow stability, potential for future equity rounds, and valuation considerations for conversion.
        - **Tax Implications (HMRC):** Carefully consider the tax implications for the charity. "Non-qualifying investments" can lead to the charity losing tax exemptions. Trustees must ensure the investment falls under "approved charitable investments" or "approved charitable loans" for tax purposes, or seek specific HMRC approval if it's a novel structure. HMRC guidance states that a loan will normally be accepted as for the *financial* benefit of the charity if it carries a commercial rate of interest, is adequately secured, and has reasonable repayment terms. For "social investments" with concessionary terms, trustees must clearly document how the investment directly achieves the charity's purposes.
    - **Impact Due Diligence:**
        - **Theory of Change:** Evaluate the enterprise's clear and logical path from activities to desired impact outcomes.
        - **Impact Metrics:** Identify specific, measurable, achievable, relevant, and time-bound (SMART) impact indicators, possibly aligning with

UK-specific frameworks or the UN SDGs.
        - **Additionality:** How does the fund's investment enable impact that wouldn't otherwise occur?
        - **Impact Management Systems:** Assess the enterprise's internal systems for tracking and reporting impact.
    - **Operational & Legal Due Diligence:**
        - Review legal structure, governance, contracts, intellectual property. Understand the social enterprise's specific legal form (e.g., CIC, CBS, charitable company).
        - Assess operational capacity, scalability, and risks.
        - Understand UK market size, competitive landscape, and regulatory environment.
4. **Structuring the Investment:**
    - **Expenses-Based Investment:**
        - **Revenue Share/Expense Reimbursement:** Agreement to receive a percentage of future revenue or reimbursement based on specific operational expenses being covered, potentially with a cap or defined term. Ensure these terms are justifiable within the charity's purposes and potential financial return expectations.
        - **Performance-Linked Repayment:** Repayment (or "success fee") tied directly to achieving specific impact or financial milestones.
        - **Blended Finance:** Potentially a grant component alongside a recoverable investment part, clearly distinguishing between the two for accounting and regulatory purposes.
    - **Convertible Loan:**
        - **Key Terms:** Loan amount, interest rate (can be low or zero if the direct charitable benefit is strong), maturity date, discount rate for conversion, valuation cap, and trigger events for conversion.
        - **Impact Conversion Clause:** Potentially link conversion terms to achieving specific impact milestones, providing an incentive for impact performance.
    - **Covenants & Reporting:** Define financial and impact reporting requirements, use-of-funds restrictions, and other protective covenants tailored to the social enterprise's model. **All terms must be documented to justify the investment as either a "pure financial investment" or a "social investment" under Charity Commission guidance.**

5. **Trustee/Investment Committee Approval:**
    - Present a comprehensive investment memorandum covering financial analysis, impact assessment, risk mitigation, and proposed terms.
    - Crucially, the memo must clearly articulate how the investment meets the foundation's charitable purposes and the **trustees' duties regarding investment**, explicitly addressing the balance between financial return and social impact as per Charity Commission guidance.
    - Secure approval from the foundation's Board of Trustees or a delegated Investment Committee.

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## Phase 3: Post-Investment Management & Impact Measurement

1. **Disbursement of Funds:**
    - Structured disbursement based on milestones or immediate operational needs.
2. **Active Portfolio Management:**
    - **Strategic Support:** Provide non-financial support (mentorship, strategic advice, network connections) to help the social enterprise grow and achieve its goals. This is often a significant value-add from foundations.
    - **Operational Monitoring:** Regular check-ins to monitor financial performance, operational progress, and address challenges.
    - **Adaptive Approach:** Be prepared to adjust strategies or provide further support if the social enterprise faces unforeseen challenges, given the nature of flexible financing and the foundation's charitable mandate.
3. **Impact Measurement & Management (IMM):**
    - **Regular Data Collection:** Work with the social enterprise to collect agreed-upon impact metrics.
    - **Verification:** Periodically verify the impact data through site visits, beneficiary surveys, or third-party assessments where appropriate.
    - **Learning & Adaptation:** Use impact data to inform strategic decisions for both the fund and the social enterprises, allowing for adaptive management and demonstrating how the investment directly furthers the charity's aims.
    - **Reporting:** Regularly report on both financial and impact performance to the Charity Commission (in annual returns where relevant) and to the

foundation's own board and stakeholders. This includes quantitative data and qualitative narratives demonstrating the fund's contribution to positive change, specifically highlighting the charitable benefit achieved.

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### Phase 4: Repayment / Conversion & Exit

1. **Repayment/Conversion Triggers:**
    - **Expenses-Based:** Repayment triggered by revenue thresholds, specific project completion, or defined timeframes.
    - **Convertible Loans:** Conversion triggered by a qualified equity financing round, maturity date, or pre-defined conversion events.
2. **Structured Exit / Recycle Capital:**
    - **Repayment:** Receiving the agreed-upon repayments from expenses-based financing.
    - **Conversion to Equity:** If the convertible loan converts, the foundation now holds an equity stake.
    - **Equity Exit (if converted):** Exiting the equity stake through:
        - Acquisition by a larger entity (impact-aligned or mainstream).
        - Secondary sale to another impact investor.
        - Buyback by the social enterprise itself.
    - **Loan Maturity:** For loans that do not convert, receiving full principal and interest (if applicable) at maturity.
    - **Consideration of Charitable Purpose at Exit:** Even at exit, trustees must ensure the decision is in the best interests of the charity. If an exit is delayed for impact reasons, the justification must be clearly documented.
3. **Capital Recycling:**
    - Reinvesting returned capital into new social enterprises, perpetuating the fund's impact cycle and continued pursuit of the charitable mission.
4. **Knowledge Sharing & Learning:**
    - Document lessons learned from successful and less successful investments, including a clear analysis of both financial and charitable impact.
    - Share insights with the broader UK social investment and charity sector to contribute to best practices for financing social enterprises, particularly with flexible models, and to inform Charity Commission

guidance.