Social Businesses in Israel – How will Policy affect the role of Philanthropy?

Attracting New Financial Resources through the "Social Yozma Fund"[1]

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INTRODUCTION

Social businesses are a relatively new phenomenon in Israel. In a broad sense, these are organizations that strive to achieve a concrete social mission or outcome under a business model of operation[3]. The development of the field in Israel is parallel to and influenced by the development of the social enterprises economy worldwide - especially in Europe and USA.

As a new phenomenon in Israel, gaining visibility in the last decade, it has yet to be clearly regulated by law. One major question arises regarding the need for regulation of social businesses in Israel - **do they require a unique corporate structure?** This is a concrete question under debate among practitioners from the social business sector.

One prism[4] through which this question is worth examining is narrow, yet significant: We may ask whether and under what conditions the creation of a unique corporate structure might

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[1] The Hebrew word "Yozma" means Initiative or entrepreneurship. The Social Yozma Fund is a newly launched governmental fund for investment in social businesses in Israel. Its development was inspired by the success of the first Yozma Fund that was launched in the early 90's to inject financial resources to promote the development of the high-tech sector in Israel.

[2] I would like to thank Noah Drezner, Jackie Goren, Ora Bloom, Neta Ziv and Benny Gidron for their comments and remarks on earlier drafts.

[3] For a more detailed description, referring to social enterprise in Israel go to: http://www.beitberl.ac.il/english/research/iserc/definition/pages/default.aspx. It is also recommended to follow the mapping project of ICSEM in which Israeli researchers are participating: http://www.iap-socent.be/icsem-project

[4] This one prism is part of a larger project addressing the questions if social businesses in Israel should be supported by varied governmental incentives, and if so, which incentives and to what extent. A designated corporate structure might be a basic tool to flag out the social businesses and to target incentives towards them.

attract new financial resources (“new money") to solve social problems in Israel. I posit that the goal of attracting new financial resources to the developing social business sector in Israel is important as long as its focus is on achieving positive social change in the lines of reducing the inequality gap: addressing varied needs regarding welfare, health, education, housing, transportation, etc**.**

In this short paper, I will offer some insights as to the need of a unique corporate structure by reviewing the new "Social Yozma Fund" (SYF), for social investment, recently launched by the Israeli government, and its' attempt to achieve this goal of attracting new money to the field.
I will also refer to a recent study conducted at the Institute for Law and Philanthropy at the Tel Aviv University regarding attitudes and preferences of philanthropists and investors about their social investments. Since the governmental fund (the SYF) may be interpreted as a signal and may have an effect on the role for philanthropic investments in this emerging field, it is interesting to review it in the light of findings from the mentioned study.

In part one below I briefly describe the phenomenon of social businesses in Israel and the definition of social business formulated at the cross-sector roundtable discussions directed by officials at the Prime Ministers’ office[5]. The definition was integrated into the mode of operation of the SYF, in the sense that the fund may invest only in social businesses that are compatible and meet the terms of the definition. Following this I will also briefly address the required distinction between philanthropic-social-investments and for-profit-market-oriented-social-investments (sometimes referred to as impact investments). In part two, I will review two

[5] For further discussion of the nature and role of the cross-sector roundtable see on the Division of Government and Society (Policy Planning), Office of the Prime Minister:
http://www.pmo.gov.il/policyplanning/shituf/Pages/roundtable.aspx (Hebrew).

main attributes of the SYF that seem to contribute to its success in attracting new financial resources to the field: (1) The SYF's financial structure and (2) The corporate forms that are approved for SYF's investments. Drawing on the SYF and the study mentioned above I will conclude by highlighting a few general points to note for further development and conceptualization of social business and for further policy based research.

PART ONE

SOCIAL BUSINESSES

The phenomenon of social businesses in Israel is expanding and gaining momentum. There is a growing trend among social organizations (non-profits) to develop an income generating venture to complement the mainstream operations of the organization and to fulfill its social goal (these could be termed "purpose with profit" ventures). Many organizations operating in the field are supporting populations excluded from the employment market, such as youth at risk, people with disabilities and asylum seekers. They work to develop an enterprise allowing training and employment for the target populations. For example: the Women's Courtyard at the Port is a fashion store. Its primary purpose is to serve as a platform for vocational training for young girls at risk. Other examples such as Elad Theatre, aim to strengthen population in the Israeli periphery based on income generating ventures offering a variety of affordable cultural activities that are underdeveloped in the periphery (music, film, theater, arts etc). The common approach for these ventures or enterprises is to aim at generating sufficient revenues to achieve sustainability or even to gain some profit.

The trend to develop a venture or enterprise with a defined, specific, clear and declared social value and mission is also rising among entrepreneurs who are not operating from within a social organization. In such cases, the entrepreneurs emphasize the uniqueness of their business model that places the social goal or purpose **up front or in line** with the financial bottom line of the enterprise. This trend to integrate a defined and declared social goal or purpose is also arising in the field of technological entrepreneurship. Entrepreneurs develop their products with the aim to benefit disadvantaged or marginalized populations and to improve the quality of life. For example, products granting independence and protection to people with cognitive or communication disabilities such as Talkitt which is a translating App for people with speech disabilities or disorders[6].

The extensive diversity of social businesses described above may offer a wide range of attractive investment opportunities for different types of capital and funding resources.

LACK OF CORPORATE STRUCTURE

The rapid growth of ventures that combine generating income and profit with positive social value creation (also referred to as social impact or SROI) raises difficulties and ambiguities regarding different policies and regulations. The difficulty is reflected, among other things, in the absence of a designated corporate structure or form that allows, facilitates and even encourages the establishment and operation of a hybrid model. **In the term "hybrid" here I mean the combined goals: to create a positive social impact alongside financial returns for investors.**

Indeed, the valid corporate regulations are insufficient to apply to the new phenomenon. The Israeli law recognizes two main types of relevant corporate structures, both inadequate and unsuitable for social businesses. The common corporation for business activities– the limited liability company – is obliged under law to maximize profits. The profits are intended for distribution among shareholders of the corporation. Indeed, nothing prevents these corporations from creating a positive social impact of a general or specific kind, however,

[6] These enterprises might seem to align with the global trend of triple-bottom-line-enterprises. What might differentiate some of them and justify their inclusion within the social business concept are acknowledged market failures that hinder the possibility of raising capital. For example: a limited potential customer base for enterprises that aim at supporting specific disability segment in the market.

management is generally required to maximize profits and is hardly allowed leeway for making decisions favorable of a social objective while putting a certain risk on financial returns.

On the other hand, Israeli law recognizes corporation forms for non-profits for public benefit (known as “Amuta”or "Corporations for Public Benefit"). Distribution of financial gains is prohibited in these types of corporations and it is commonly acknowledged that their formation is intended to primarily achieve a defined social purpose. Indeed, such a corporation may engage in income generating practices (such as sale of products or services) but in the absence of distribution of profits, the major sources of funding for these corporations are philanthropic grants and donations.

In contrast to corporation forms such as the CIC in England or the L3C or Benefit corporation in the U.S., Israeli law has not yet recognized a designated and unique corporation form for social businesses of hybrid character – combining a precise social mission "locked" in articles of incorporation, with the aspiration to create a profit permissible for distribution among shareholders.

Although this type of corporation is yet to be lawfully acknowledged, an ongoing process of cross-sector round-table discussions between government representatives and representatives of the business and social sectors has given rise to an agreed upon definition for social businesses. The definition adopted includes enterprises incorporated as a non-profit social organization (Amuta) or as a limited liability company. The enterprise must realize the social objective as part of its core activities and operations and it may generate profits. Opposed to a regular limited liability company a social business incorporated as such is limited as to profit distribution – it may distribute only up to 50% of its profit[7].

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[7] Based on the cross-sector roundtable, which is a forum for discussion between sectors that chose in 2012 to address this issue of social businesses in Israel. A sub-committee of the round table presented recommendations

SOCIAL YOZMA FUND

Based on these definitions the Israeli government launched the "Social Yozma Fund", a fund for social investments to promote the creation of employment opportunities for excluded populations such as youth at risk, people with disabilities and rehabilitating prisoners. The fund, recently launched is to be managed and operated by two different private social investment funds chosen by tender. The financial structure of the fund consists of a government grant and requires the fund operators to raise additional philanthropic grants and market for-profit investments[8] as complementing resources (similar to private-public fund models). It is important to note the unique financial model in which the governmental and philanthropic grants are designed to effectively reduce the risk involved in investing in social businesses and to ease the attraction of for-profit market investments. Under these circumstances the Social Yozma Fund makes a good opportunity to examine the tendency of "new money" to flow to the field and the role for philanthropic investments within it.

SOCIAL INVESTMENTS

The common premise underlying the development of the phenomenon of social businesses in Israel is that it is an effective channel to attract new financial resources ("new money") for social causes in Israel. Traditionally, social causes that aren't publicly funded, find financial support through philanthropy - grants and donations from Jewish communities in the Diaspora, or Israeli high-net-worth funders and the general household donations. This being the case, attracting new financial resources suggests additional investments beyond philanthropic contributions, namely, capital that is normally invested in the business or financial

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regarding the definition of social businesses and other related issues such as removing obstacles and examining benefits. The recommendations were approved at the roundtable in November 2012. See here: http://www.pmo.gov.il/policyplanning/Documents/igeret11.pdf (Hebrew)

[8] The investments are structured as loans with a predefined interest rate.

sector. Attracting "new money", which is traditionally invested in the business or financial sectors requires, according to the internal logic of these sectors, offering financial returns on the investment; hence the need for the hybrid model integrating social value creation with a permissible financial return.

Contrary to the traditional non-profit (Amuta) allowing distribution of profits in a social business is aimed, therefore, at attracting investors expecting an economic gain on their investment, but not necessarily the maximization of the financial gain.

Differentiating the sources of finance for social businesses (in Israel) can be confusing. On the one hand social businesses are supported by social investments of philanthropic nature – that is donations or grants with no expectation of the financial return to the grantor. On the other hand social businesses invite "impact investments" with expectation of a financial return on the investment.

Confusion between social investments of philanthropic nature with social investments of business nature is also revealed in light of the results of a recent study by the Institute for Law and Philanthropy at the TAU. In this study we asked philanthropists, social investors and social entrepreneurs about their attitudes and preferences towards social investments – of a philanthropic nature compared to those of business nature. We ran a survey at the Jewish Funders Network Conference which took place in Tel-Aviv on March 2015. We collected some 250 responses from philanthropists and professionals in the field (fund managers), investors (socially oriented) and social entrepreneurs. The data we collected focused on practices of philanthropy in Israel, preferences towards tax incentives compared to matching, funding for social enterprises and attitudes towards impact investing with lower-than-market–rate returns.

Relating to the issue at hand we first asked respondents whether they consider an impact investment with lower-than-market returns as a philanthropic strategy or a market investment.

Approximately 67% of respondents answered that they perceive it as a strategy for philanthropy (even though it is an investment that in itself bears financial returns).

Next, we presented a case study in which respondents needed to make a choice. Their first option was to donate a sum of money. The second option was to make an investment which would yield a return. Under the circumstances of the case presented it was made clear that the return would be lower-than-market-rate by the same amount they could donate if they chose the first option. To be sure, the respondents could assume that they are giving away the same amount in each of the options - either by a classic donation or by a lower return on investment.

Results showed that 62% of all respondents - philanthropists, social investors and social entrepreneurs favored the low-return investment over the classic donation. Moreover, and more significant, the study shows that this preference increases as respondents tended to assume that an investment with lower-than-market-returns, is actually a philanthropic strategy. Thus, prior to presenting the case study respondents were randomly primed with a reading excerpt. For half of the respondents the trend of impact investment was presented as an opportunity for philanthropy and a call for philanthropists to invest in, participate and support the development of the infrastructure in this sector. The other half of the respondents were primed to consider the trend of impact investment as a market strategy or an asset class within the investment sector with no regard to philanthropy whatsoever.

Analysis of the respondents' preference whether to donate or invest, in accordance with the reading excerpt they were primed by, showed that priming respondents to consider impact investment as an opportunity for philanthropy increases the tendency for the preference of a low-return investment, rather than a donation. 73% of respondents primed to consider impact investing as opportunity for philanthropy preferred to investment for a lower-than-market return rather than donate, compared to only 52% who preferred this option, among respondents primed to consider impact investing as a market strategy.

Respondents may have weighed the value of a tax benefit for a donation against an evaluation of risk and return on the investment option. Under this type of consideration expecting the actual return on investment to be higher than the value of tax-benefit-on-donation, the decision to invest instead of donate might be considered a reasonable one.

Even so, it seems that some of the practitioners in the field, tend to perceive impact investing as a philanthropic act, despite the fact that such an investment carries a financial return in itself (while classic philanthropy does not offer a financial return[9].) One hypothesis that might explain this conceptualization is that the willingness to forgo some profit is easier if perceived as a gift rather than a loss on investment. Another explanation could be that perceiving impact investing as philanthropy may raise expectations to collect tax benefits related to philanthropy (regarding the delta, difference or loss between actual gain and the expected market rate of return).

In any case another possible conclusion to consider is that the more practitioners tend to perceive impact investing as an act of philanthropy the more they tend to choose a for-profit mechanism for their philanthropic acts[10].

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[9] A donation may be supported by a tax benefit for the donator but is quiet different than actual profit on the investment.

[10] We must ask, whether policies, programs and benefits for impact investment have the power to frame impact investing as a philanthropic strategy or a market strategy. Further research may be needed to reveal if incentives that are commonly associated with philanthropy (such as a tax benefits for philanthropy), will divert philanthropic funds to the upraising sector and if incentives related to financial investments (such as tax benefits for R&D investments) will increase the flow of "new money" to this sector. At this point, the answer remains unclear but we must consider the question at hand in designing the tools for social investments.

So the question remains – what are the attributes in the SYF that might support the flow of new financial resources to promote Israel's social goals and what is the role for philanthropy?

PART TWO

1. SYF FINANCIAL STRUCTURE

As mentioned above, the SYF was designed as a resource pooling vehicle and is based on the principle of co-funding as a strategy to attract new financial resources to the field. At the base of the financial structure lays a government grant, on top of which SYF operators must raise both philanthropic and for-profit capital. Through this structure government grants and philanthropic donations take the roll of mitigating risk for for-profit investments. Actually investors were offered interest at (risk adjusted) market rate on their investments.

Both private social investment funds chosen by tender to manage and operate the SYF attest that this financial model did in fact contribute to the success in attracting new financial resources to the SYF. The fund operators reached out to new capital sources that were not previously active in the Israeli social investment scene: overseas philanthropic endowment funds, wealthy individual investors, the National Lottery and private financial institutions (such as a bank) in Israel[11].

Questions may arise as to the signal government conveys to philanthropy, based on this financial structure mentioned above[12]. On the one hand classical philanthropic grants mitigating risks might be considered as "lighting the way" or leading it for more for-profit capital to follow. On the other hand one might ask if this is a sustainable model for the long term and may it not create expectations for unrealistic gains from social investments?[13] It is

[11] The data was collected by Interviews and conversations with fund management.

[12] The financial model chosen made a clear distinction between philanthropic grants and for-profit investments by setting conditions to enable offering market rate interest, therefore leaving no need for deliberations as to the status of lower-than-market –rate investments as philanthropic or not

[13] Also, en ethical question may arise as to the grants-subsidizing-private-gains model. See here: https://www.cafonline.org/pdf/Returns-Policy-What-the-next-decade-holds-for-social-investment.pdf

important to note though that the SYF management expects that success will prove no need for the mitigating-risk-grants in the future.

2. SOCIAL BUSINESS CORPORATE STRUCTURE

Other than the SYF's financial structure SYF managers state that the social business corporate structure, specifically designed for the SYF has also played a role in attracting new resources.

As mentioned above the definition for social business, adopted at the cross-sector roundtable discussions lays at the base of the SYF investment model. The SYF may invest in two main types of corporations that are ad-hoc considered social business[14]:

1. Non-profit social organizations incorporated as "Amuta" in which the distribution of profits is totally prohibited;
2. A limited liability company with a concrete social mission locked in the incorporation documents and with a **limit on profit distribution**: the company may distribute only up to 50% of its profits.

How does the chosen corporate structure affect the attraction of new resources? The fund is in its infancy stages so it is early to draw final conclusions regarding this issue. Even so, we can already suggest some implications:

1. SYF may administer investments in social businesses either as debt or as equity. Including non-profit social organizations incorporated as an "Amuta" as a social business will enable these types of organizations to receive a loan. This is not something to think little of since the credit market for non-profits in Israel is very underdeveloped and far

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See p. 2, 12.

[14] Other than the corporate structure it is important to note that the SYF is tightly restricted regarding the social causes in which it may invest. It is bounded to enterprises that promote employment for marginalized groups such as rehabilitating prisoners, youth at risk and people with disabilities.

from routine. Non-profits tend to avoid credit investments and there aren't many institutions offering credit on the supply side. Only recently a fund administering credit for small-business established a pipeline for NGO/Non-profits credit but it's relatively new and has not yet made a significant amount of transactions[15]. Developing a credit market for non-profits and supporting capacity building among nonprofits to consume credit is considered as a role for investment of philanthropic nature – patient capital that may do with a lower-than-market-interest rate. But it is also agreeable to aspire to develop credit products for non-profits as regular market investments[16]. Acknowledging the tendency to consider lower-than-market-rate social investments as a philanthropic strategy, as revealed in our study mentioned above, a mixed-resources fund might be an appropriate vehicle to promote the development of this market. It might provide a good opportunity for each type of social investor to carefully explore its designated role and limits. It's an opportunity to lay the ground for the development of capacity and expertise, through knowledge sharing, the goal being for each type of social investor to assume a specific role in the future chain of credit products. All this in hope that in the long run philanthropic resources will support non-profits' early credit needs, while the for-profit investment market will come to offer sophisticated products for sophisticated borrowers in the sector.

2. In absence of a corporate structure that allows for the distribution of profits the SYF would have had to be satisfied with an investment model based solely on credit products. Given the quite high risk new businesses bare, a model based mainly on profit

[15]Data collected by interview with project manager at KIEDF. As for the importance of the development of a credit market for social organizations see: https://www.cafonline.org/pdf/Returns-Policy-What-the-next-decade-holds-for-social-investment.pdf. p.4

[16] For example the Golden Lane Housing Charity Bond, listed on the London stock exchange. See here: http://allia.org.uk/latest-news/2014/09/08/pioneering-retail-bond-in-the-final-for-investment-deal-of-the-year/

from the interest rate is too narrow, risky and less attractive than an equity investment model that enables distribution of profits with the potential to outweigh or compensate for loses that the SYF might encounter. Allowing for both types of corporate structures - non-profit and profit-sharing to be considered as social businesses regarding the SYF investments, will enable both credit and equity investments and the adoption of a more diversified investment model, which in turn is more attractive to the new financial resources being pulled in.

The SYF is expected to give momentum to the rising sector of social businesses in Israel, at least for employment inclusion social goals. **Yet a close observation of the policy developments underlying the SYF, raise a few points worth noting, which may have implications of general nature as to conceptualization of the social business and other such hybrid forms**.

3. It is important to note for once that limiting the rate of profit distribution up to 50% on any hybrid model of social enterprise may come to be a daunting restriction from a for-profit-investment point of view. This is because social businesses and other hybrid models, especially those offering social services may bare extra social costs that may hinder the profit in the first place. For example social businesses may employ a social worker, or over-employ within the target population as part of the rehabilitation scheme, they may incur excessive expenses for accessibility needs etc. The excessive expenses may have a decreasing effect on profits. Under these circumstances, restricting the rate of profit distribution may be considered an unnecessary extra burden. Limiting profit distribution may be a good proxy for ensuring the candid intent to pursue a social mission. Even so, this point may lead us to conceptualize and define social businesses and other hybrid models based on their social expenses rather than on their income or profits.

4. It seems that the SYF deliberately focused on "purpose with profit" types of social businesses with a focus on solutions for a social problem in Israel: promoting employment opportunities for specific populations excluded from the job market. Generally speaking purpose with profit type of social businesses or other hybrid models usually offer services to excluded populations (vocational training for example) or turn to a relatively small market (rehabilitating prisoners) and generally don't have the potential to scale. They also suffer from an inherent trade-off: although they may have the potential for profit, in most cases it is limited by the excessive social costs as mentioned above. It is safe to assume that this trade-off makes it a less attractive market investment opportunity, especially if it is combined with a limit on profit distribution as mentioned above. Therefore it seems that supporting social businesses of this type is practically considered at this point in time and development of the field as a role for investments of a philanthropic nature.

5. In contrast it seems that the SYF did not intend to include social businesses of the "profit with purpose" type mentioned above. That is, social businesses operating in the fields of technology and products that have the potential to scale, which are not necessarily focused on social issues in Israel and may have less of a trade-off between the social mission and the prospect to profit. Again, generally speaking it is important to note that social businesses or other hybrid models of this kind may still encounter market failures: they may target a small market segment or may be in need of patient capital that is not available regularly on the financial markets for tech-investments. When it comes to the corporate form, it seems that the restriction on profit distribution rate may not suit these types of social businesses at all. In order to open up the for-profit financial markets for them and to refrain from shifting philanthropic-nature investments towards

them, we might need to consider yet another type of social business in which profit distribution is unlimited[17].

It is important to note the complication resulting from the two last points in conjuncture with the findings of the research mentioned above. Thus, the expectation of profit distribution with the notion of a philanthropic act (due to lower than market rate profits) might bring about further expectations for philanthropic type benefits, such as tax credits or deductions, in order to encourage these types of investment in the first place. Indeed, the notion or conception of a for-profit investment as a philanthropic act creates a great challenge for policy aimed at attracting new resources to the social sector.

CONCLUSION

The Social Yozma Fund, launched by government and managed and operated by two private social investment funds has achieved, in its preliminary stages, the goal of raising capital from new resources to support social goals in Israel. It seems that the financial structure of the fund and the ad-hoc designated corporate structure for fund investees are both positive incentives in way of achieving this goal.

[17] This poses a different set of questions, as to the profit distribution limit as a signal to the market and proxy for ensuring pursue of the social mission. Eliminating this signal raises the need for other signs for trust in that the social value is real. The question is if locking it in the incorporation documents would be enough and if there is a need for a public body for supervision and control or if the market forces are enough. Also, the differentiation between the two types of limited liability social business is intended to attract different types of investors and may require different types of incentives and benefits.

Yet both incentives place some dilemmas and uncertainties regarding the expectations of profit from social investment and the conception of for-profit-investment in social causes as a philanthropic act, in situations when returns are lower-than-market–rate.

Policy makers facing these dilemmas and uncertainties should attempt to understand the impact different policies may have on the flow of different types of financial resources. These considerations should also lie at the base of any attempt to enact a unique corporate structure. Considerations must conclude with corporate structures and related incentives that would precisely tie the different financial resources with the different financial needs of different types of social businesses operating in Israel.