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Loan funding in the arts

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Loan funding
— introduction

Grant funding has come under sustained pressure and arts organisations have struggled to resource their activities. Funders have challenged the arts to use alternative sources of funding, including loans, to develop and grow. This would, in theory, help organisations generate new sources of earned income. The arts could then be less reliant on grants enabling more arts activity to take place.

Organisations that are really good at getting grants are oriented towards it. Their staff understand how to write grant applications and what grant funders expect. Their business plans are likely to centre on the requirements of their big grant funders. It can then be a struggle for them to reframe what they do to suit a new type of funding, and trustees or directors can feel rightly very nervous of taking on loans.

This resource provides an introduction to loan funding for arts organisations.

What is a loan?

A loan is a specific type of debt that is usually a fixed amount of capital (also known as the principal) provided by the lender at an agreed interest rate with monthly repayments over a predetermined period of time. Other types of debt your organisation may already use are overdrafts, credit cards or credit facilities with suppliers.

Loans can be secured or unsecured. A typical example of a secured loan is a mortgage. Here, the borrrower receives a sum of money but provides a deposit and a building as security should they fail to repay the loan. Security is one of the main ways lenders can reduce their risk and provide lower interest rates to customers, so guarantees or secured assets are important. This is partly why mortgage rates can be much lower than credit card rates.

Loans can be provided by a bank, a business, an individual or an alternative lender.

Lending and Risk

From the lender's point of view they are getting a fixed return for their loan, so their ability to take risks is limited.

For example
A lender might get back the intial amount borrowed plus earn, say 5% per year the money is borrowed (5% A.P.R.). From this they will have to pay their administrative costs and perhaps interest to whomever they have borrowed the money from.

They will make a number of loans from their funds, building up a 'loan book' that is made up of a variety of different clients. They cannot afford for many of these loans to fail to be repaid. Their estimate of how likely default is will influence what they set the interest rate at, and what terms and conditions they apply to the loan.

As the lender will not benefit from the 'upside' of the business (such as share in the increase in value of a property or business) they are unwilling to take much risk. To mitigate their risks, they will apply certain criteria.

Creditworthiness

Each lender will apply specific criteria to its potential borrowers to ensure they fit its borrower profile. These are sometimes described as the five C's of lending: character, capacity, capital, collateral and conditions.

CHARACTER	The lender will want to know if the borrower has had credit before and if it has been repaid on time. It will also look at the experience of the management team and their industry experience.
CAPACITY	Can the business demonstrate using its financial documents and business plan that it can repay the loan? The lender will assess the ability of the business to generate a profit and look for a history of positive cash flow. This will involve looking at historical financial statements and bank statements, profit margins or surplus that the business is generating, the strength of the business concept and plan ensuring it is clear how the income is generated and that forecasts seem realistic and balance logically with the expenses.
CAPITAL	Is the business able to put its own money into the activity (or is it reliant on 100% coming from the lender), does the business have reserves to draw on, has or will it put in 'sweat' capital through work invested in developing the project.
COLLATERAL	Is there anything to guarantee the loan, covering more than the value of the loan? This can be assets (things of value owned by the business) such as property, cash or equipment. A guarantor can also be used, this can be an individual or business.
CONDITIONS	What the loan will be used for, market conditions in the industry, general financial environment.

Loan funding

When should loan funding be used?

Loan funding is typically used:

- for an **income generating business idea** which is going to require an upfront amount of cash to launch, but will provide a reasonably predictable income (not wholly speculative)
- to **purchase assets to provide an income** or **cost savings,** for example purchasing a space instead of renting it
- to **purchase equipment** that will then be used over a period of time (but where the cost is incurred up front)
- to provide **working capital** to allow a profitable business activity to scale up
- to **bridge a gap** between when a grant funded programme starts and when the grant is paid.

Case studies

Case study #1

Unforgettable: short-term loan plus equity to finance social enterprise

A mixture of £750,000 of loans and equity were invested in Unforgettable Ltd over five years. The social enterprise (guaranteed by shares with a 'mission lock' via a charitable trust) is a website addressing the needs of people with dementia, which includes advice and support for carers and the retail of goods and services such as GPS shoe insoles and time orientation clocks. A mix of money was used from organisations that lend, invest and give grants, including Bridges Ventures and investment from the management team.

Case study #2

Soho Theatre: short-term loan to launch new income generating subsidiary

Following a period of research and development through a government funded Knowledge Transfer Partnership, £300,000 was loaned to Soho Theatre over four years to set up a digital content subsidiary and produce a pilot run of digital comedy content. The loan was provided by Arts Impact Fund, which offers unsecured loans to arts and culture organisations delivering demonstrable social impact.

Case study #3

Village Underground: long-term loan to buy property

Village Underground is an innovative art project set in Shoreditch, London, that supports a community of creative practitioners, businesses and organisations through provision of facilities and workspaces — including transforming several derelict ex-London Underground carriages into rented workspace. Village Underground also flourishes as an arts and music venue, and has hosted musicians from Annie Mac to Mary J Blige. A co-investment by Arts Impact Fund, Big Issue Invest and Triodos Bank to Village Underground in 2017 supported their expansion to an additional venue in East London, which will help transform the former Savoy cinema in Dalston into the Hackney Arts Centre.

Case study #4
Borrower doesn't have a track record

Organisation was worried that its new income generating venture could fail, so decided to start a new company to avoid exposing the existing organisation and its assets to liability.

Problem: lender won't lend to the new company as it has no track record and no assets so is too risky.

Solution: look for investors who are willing to bear a higher risk, look for start-up lenders, provide guarantees, set up new organisation as a subsidiary of the existing one.

Case study #5
Borrower doesn't have good credit

Organisation wanted to borrow to scale up, however existing organisation was insolvent and had some overdue credit.

Problem: lender concerned that loan may be used to pay off existing creditors and then project will be under-financed, also concerned about ability of business to deliver profitability.

Solution: directors pay off short-term debt and convert it into long-term debt, get costs under control, look for investors, create strong business plan.

Think about...

Are you looking for working capital, to purchase equipment, to purchase property?

Have you got at least two years worth of accounts (financial statements provided to companies house, bank statements)?

Have you done a cashflow forecast that shows you can afford the repayment including interest for the duration of the loan period?

Have you got any collateral / guarantees?

Have you got a business plan that clearly explains how you will use the funds, who will manage this and how the income will be generated to repay the loan?

Links

- **Creative Industry Finance**
  Social enterprise supporting the development of arts and creative organisations
  www.creativeindustryfinance.org.uk

- **Good Finance**
  Case studies on social investment in the arts
  www.goodfinance.org.uk

- **Arts Impact Fund**
  Soho Theatre case study and others
  artsimpactfund.org

- **Triodos case studies**
  www.triodos.co.uk

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