The three models of social enterprises:

Creating social impact through trading activities: Part 2

Venturesome

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charities aid foundation

CAF

Venturesome is a social investment fund, an initiative of the Charities Aid Foundation (CAF). Venturesome provides capital to civil society organisations, operating in the space between providers of charitable grants and providers of bank loans at market rates. Since launch in 2002, over £12.5 million has been offered to some 200 organisations. In addition to accumulating practical deal experience, Venturesome has endeavoured to have a central role in building a robust social investment market, adopting an open-book approach to share knowledge and build experience, but also ready to operate in competition so as to raise standards.

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Contents

1 Introduction

In Part I, we outlined a possible topology[1] for categorising different social enterprise business models[2]. In Part II, we share some of the thinking and discussion within Venturesome that has been prompted by the Three Models Framework and try to give examples from our practice to illustrate this thinking.

1 Model One = 'profit generator model'; Model Two = 'trade-off model'; Model Three = 'lock-step model'
2 The Three Models of Social Enterprises: Creating social impact through trading activities, Part one 2008 P Cheng, J Ludlow, Venturesome. Available for download at: www.venturesome.org

2 Observations about the Three Models

2.1 Social impact integrated into Models Two and Three

We believe that Models Two and Three fundamentally differ from Model One because the social impact of these firms is integral to the business model itself. In other words, even if a Model Two or Model Three type firm fails to achieve any financial return, it will still have some social impact by virtue of its trading activity (eg disabled people are employed, farmers in Africa do make more margin for their crops, the financially excluded do get access to capital etc).

At Venturesome, we are regularly contacted by entrepreneurs and organisations seeking investment in Model One businesses, where the profits (if any) are to be used to fund work with a social purpose. We are investors primarily seeking social impact (albeit through using instruments that provide a financial return), and so find Model One propositions more demanding to assess. In Models Two and Three, the risk of not achieving social returns is mitigated by the possibility of getting some money back. In Model One, no social return at all can be achieved until a profit has been made.

2.2 Striking the right balance in Model Two

Model Two businesses are managing a trade-off and this is a difficult task. These firms are often competing with rivals who pay less attention to their social and environmental impacts. This may give these competitors greater flexibility in their operations, which may be a source of competitive advantage for them. Model Two type firms, therefore, need to be carefully managed, to achieve an acceptable balance between social and financial return for customers, investors, employees and other stakeholders/beneficiaries.

For example, Venturesome has worked with a number of charities who have found significant difficulty in managing the trade-off – one charity withdrew from a local authority contract because it was loss-making and it wished to renegotiate a fair rate of compensation for its service, whereas another charity struggling to manage the trade-off persisted with the contract at a loss and fundraised from its supporter base to subsidise the work.

Model Two type firms are increasingly able to use their social or environmental impact as a competitive advantage, especially in consumer markets where a premium is now sometimes justifiable for such benefits eg organic food. However, this social/environmental/ ethical stance does not always represent a direct benefit to the consumer of the product eg fair-trade goods, and so such trade-offs may be vulnerable to increases in consumer price sensitivity.

Nevertheless, Model Two firms have the potential to change the market in which they operate to a point where the delivery of social impact becomes a barrier to entry in the market, For example, how many new premium coffee products in the past twelve months have not had a fair-trade or organic certification?

Model Two businesses may continue to have a role in a market after the point where a social or environmental standard becomes the market norm – this role is one of benchmark or standard setter. For example, CAF Bank was founded in 1985 to offer a higher rate of bank interest to charities and community groups which at that time were paid rates and charged fees at commercial business levels. CAF Bank has performed very well and has demonstrated a commercially viable model, which has attracted strong competition into this segment of the banking market, from other specialists and clearing banks. But it continues to play an important role in setting the standard for the fees and interest in the charity market – an important role at a time of increasing economic turbulence.

In the future, we may see more trade-offs made by mainstream businesses as the case for corporate social responsibility (CSR) shifts from being a moral argument to a business one, with both buyers and sellers having greater expectations for social, ethical and environmental impact. There seems to be a growing sense within the business community that, if approached in a strategic way, CSR can now become a source of a company's competitive advantage and innovation.

2.3 Separate motivation from performance

Model One businesses are motivated by making a financial return, but they may not do so eg the charity second hand clothes shop that makes a loss. Model One businesses may generate substantial profits but fail to deploy them for any social impact eg the grantmaking foundation which fails to spend even (say) 20% of its annual income.

Model Two businesses are motivated to achieve a blend of financial and social returns and need to take a robust view on the balance between the two that they are motivated to achieve. However, they may not achieve a financial return and they may not achieve a social return eg (i) the manufacturing business that aims to employ people who have been unemployed for a long period, but staff turnover has been very high and the need to maintain production has led them to recruit staff already employed by other firms or (ii) the same business that is also losing money.

Model Three businesses may be motivated to achieve a social impact or motivated to achieve a financial return; they may achieve either, both or neither, eg the community-owned wind farm project seeking to provide the community with renewable energy delivers to its equity investors an IRR of 12% pa. An example of a Model Three business failure might be a local organic vegetable box scheme that goes bankrupt due to intense competition.

So, we may distinguish between the three models by looking at the motivation of management, governance, or investors in a business. But we believe that no particular model is inherently more profitable than another, nor does one particular model inherently deliver more social impact. We might design thematic funds focused on a discrete area of social need to help demonstrate this separation between motivation and performance.

3 Maximise efficiency of capital

The Three Models Framework adds to the tool kit that social investors may draw on to analyse how the flow of capital can effect social change through market-based mechanisms (ie organisations with trading activities). Other commentators have described how charitable capital might be applied more efficiently for social impact by adopting socially responsible investment ('SRI'), mission-connected investment ('MCI') and programme-related investment ('PRI'). We believe that the Three Models help investors to differentiate between potential investments with an apparent social benefit, and to think through the risks and returns of these opportunities.

Funders need not rely solely on investing in Model One businesses (financial risk of trading failure) then using the profits as grants to traditional charities (risk of not achieving social impact).The recognition of the existence of Models Two and Three allows a more optimal distribution of both (a) financial risk of trading failure; and (b) the risk of not achieving social impact, because the two risks are more closely connected.

A more efficient use of capital requires a better understanding of risks (to both financial and social returns) and subsequent matching of risks with investor expectations. If capital can be more efficiently invested (ie return on capital, social and / or financial can be improved) across all three models, then more overall social impact can be achieved with the same given level of investment.

Of course, many social problems are not amenable to market-based solutions, and there will always be charities (with no trading potential) which require grant income for ongoing revenue and capital costs. Grant money, particularly if unrestricted, is clearly precious. It will always have an essential role in the funding of civil society organisations and, of course, profit-generating activities will in turn be required to fund these organisations.

Yet grant-dependent charities will also be beneficiaries of a more holistic social capital market if philanthropic capital employed elsewhere is made to work harder. Or to put it another way, there should perhaps be a civic duty on those organisations that can earn income to do so in order to free up scarce grant money for those organisations that inherently cannot engage in trading activities. In this way, the supply of capital for social purposes may be increased.

4 Thinking differently about social impact

The traditional view is that charities address social problems and that businesses do not. Increasingly, however, businesses are coming to see the social impact dimension of their core activities as a key competitive differentiator.

Conversely, social investors who are in the business of investing money to achieve social benefits, are beginning to see that economic forces can shape social problems (through market failures, misalignment of price incentives etc). Such investors should be using a calculation of risk and reward which is different to purely commercial investors.

We might use the Three Models Framework to shape a new debate around how social investors can focus on achievement of social impact through a variety of creative ways such as:

- leveraging additional, new money for social causes by reducing risk for third parties (eg using grant money to absorb first losses in a subordinated debt instrument)
- creating new financial instruments which share financial risk and reward (eg quasi-equity) or connect financial reward to achievement of social outcomes
- increase access to capital (eg by matching investors to different types and rates of return)
- stimulating the creation or development of a new commercial market based upon addressing societal needs (eg biodegradable plastic)

In the words of Jed Emerson and Mark Kramer: *"It is time to think anew. We must recognise that we are all part of a connected planet. The value we create through the trajectory of our lives, in the course of our workweek and our involvement in civic causes, is a blend of social, economic, and environmental components. We must search for ways to maximise all of those components simultaneously, not in juxtaposition, if we are to make a difference in the world."*[3]

The following illustrate how the Three Models Framework might help

3 Maximizing Our Missions, 2007 Jed Emerson and Mark Kramer.

5 Examples of how to use the Three Models Framework

shape a discussion around particular issues.

5.1 Deciding to invest or not

A grantmaking foundation (which is itself a Model One) has to decide whether or not to invest in a social enterprise. The social enterprise is operating a Model One business ie it seeks to make profit in a commercial market and give those profits to support its beneficiaries. Should the foundation invest?

Using the Three Models Framework, the factors to be considered may include:

- Does the social enterprise support its beneficiaries effectively, regardless of the origin of the funds it uses to do so?
- How competitive is the market in which the business operates?
- Does the management team have sufficient skills to operate in that market?
- Are there non-financial factors in favour of investing in this business (for example, seed-funding the creation of a new market which has social benefits)?
- The ultimate likelihood of the social enterprise making profits greater than, less than or similar to the likelihood of the foundation making profits in its commercial investments?

5.2 Developing specialised portfolios

Arguably, each model of social enterprise requires a different approach to investment and monitoring. Fund managers could create specific funds focussing on a particular model type of social enterprise. Such funds would provide clarity of positioning for both investors and investees.

5.3 Focussing on outcomes rather than legal forms

A social investor's ultimate focus should be on an organisation's potential for social impact. The legal form which that organisation takes should be a tool in support of its ability to generate social impact. Legal forms such as a company limited by shares, a company limited by guarantee with charitable status, a Community Interest Company (CIC) or a limited liability partnership are merely means to an end. They do not necessarily imply actual social impact, any more than they imply business effectiveness.

The official UK Government definition of 'social enterprise' as *"a business* *with primarily social or environmental objectives whose surpluses or profits are principally reinvested for that purpose in the business"* misses the point. An organisation might meet that definition and yet have no social impact at all.

An organisation that defines itself by its means of production and not the quality of its product is, at best, rather old-fashioned (and, at worst, a sham).

5.4 Thinking about consumer preferences in evolving markets

Model Two type firms must trade-off financial and social returns. But could a Model Two type firm transform into a Model Three type firm over time?

For example, a clothing firm that pioneers the use of organic cotton is making a trade-off between financial and social returns. The firm could use non-organic cotton which would be cheaper, but less environmentally friendly (non-organic cotton crops represent one of the heaviest uses of pesticides in the world).

Suppose, however, that the market eventually changes so that consumers end up preferring to buy only organic cotton clothing (and are prepared to pay more for it)? In such a scenario, an 'ethical' clothing firm continues to use organic cotton and should make money by doing so. In short, it should have evolved into a Model Three type firm (where financial and social/environmental returns move together in lock-step).

5.5 Knowing when to use commercial or philanthropic money

One potential danger for the unwary social investor is Model One type firms presenting themselves as Model Three type firms – either knowingly or unknowingly.

This typically happens when a social entrepreneur is confused about how his business model actually works, and is anxious to attract all sources of funding (whether from fully commercial or entirely charitable 'investors').

In such situations, the Three Models Framework may provide a useful guide so that the social investor may categorise a potential investment. Once the potential investment has been categorised, the investor is then in a position to think in a more structured way about the likelihood of achieving social and financial returns from the proposed investment – and whether or not commercial or philanthropic money should be used to make that investment.

6 Conclusion

At Venturesome, we began to think about the Three Models as a result of our own confusing experience of working with social enterprises. We encountered a range of organisations solving social problems by trading in a market – some of whom did define themselves as social enterprises, others saw themselves just as charities and others just as businesses. This led us to think harder about what it was we were looking for in our investments (a blend of social and financial return, weighted towards social impact) and where we might invest to achieve this.

We believe that no particular model (out of the Three Models) is inherently more profitable than another. So, for example, a well-run Model Two type firm may be more profitable than a poorly run Model Three type firm. Both Model Two and Model Three type firms may make profits in certain markets, whereas a Model One firm may not make any profit at all.

Equally, we also believe that no particular model is inherently more socially impactful than any other. Each model is merely a means to an end, and not an end in itself. As such, every 'social enterprise' should ultimately be judged on its actual impact.

The emerging social investment market is an exciting place, with new organisations and approaches appearing almost daily. We hope this paper is a useful contribution in:

- helping to give some definition to that segment of demand that trades products and services
- keeping the focus on the actual achievement of positive social change

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