The Three Models of Social Enterprises:

Creating social impact through trading activities: Part 1

Venturesome

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Introduction

Within the emerging social investment market, the same words frequently mean different things to different people. In particular, the label 'social enterprise' can be especially problematic. In part, this is because there is no shared understanding of the underlying business models beneath the 'social enterprise' umbrella.

For investors, as the number of organisations labelled as 'social enterprises' proliferates, it is becoming increasingly urgent to agree, and then to adopt, a common methodology for disentangling the assessment of financial risk from the likelihood of an investment achieving social returns.

Others have already written about ways in which social enterprises may be categorised and described[1]. We wish to contribute to this ongoing discussion by outlining Venturesome's current thinking about this issue.

This paper introduces a conceptual framework which we hope both investors and investees will find useful as a guide to thinking through how different business models create social impact – and the consequences of this for generating financial returns.

The Three Models Framework

We believe that there are three fundamental ways that social impact[2] can be created through trading activities:

1.1 Model One: Engage in a trading activity that has no direct social impact, make a profit, and then transfer some or all of that profit to another activity that does have direct social impact (the 'profit generator model')

1.2 Model Two: Engage in a trading activity that does have direct social impact, but manage a trade-off between producing financial return and social impact (the 'trade-off model')

1.3 Model Three: Engage in a trading activity that not only has direct social impact, but also generates a financial return in direct correlation to the social impact created (the 'lock-step model')

It is important to note that these three models are statements of fact, not judgment. In abstract isolation, no particular model is better than or preferred to any other. In practice, a business adopting one model may

1 For example, "*Sustainable Funding: a basic theoretical introduction*", Nick Wilkie (2006); "*Social Enterprise Typology*", Kim Alter (2007)

2 For the purposes of this paper, we use the phrase '*social impact*' to denote positive change in society. We acknowledge that the terminology is imprecise and that others may prefer phrases such as 'social outputs', 'social outcomes' or 'social returns'

produce better overall returns than an example of another model due to specific factors such as the quality of the management team, the market environment, or the strength of competing organisations.

Model One – 'Profit Generator'

In this model, the trading activity itself is primarily seeking a financial return only. As such, it is deemed to have no direct social impact.

Of course, the trading activity may have desirable effects (eg creating employment) – but these are incidental to the predominant purpose of that trading activity (ie to make a monetary profit).

Only after a profit has been made is social impact possible. It can be seen, therefore, that a social investment in Model One involves two 'bets' – (i) that the business will in fact make a profit; and (ii) that the profit generated is then effectively used to achieve social impact.

In Model One, therefore, the financial risk of the investment is disconnected from the likelihood of achieving social impact.

Examples of Model One include (but are not limited to):

- for-profit businesses with CSR programmes
- charitable foundations investing their endowments in mainstream financial markets
- trading subsidiaries of charities (eg Oxfam shops)
- 'ethical' bottled water companies – which give a percentage of their profits to developing charitable projects (eg Belu Water, Thirsty Planet)
- a hedge fund which gives a slice of its profits to a charitable foundation (eg Children's Investment Fund)

Model Two – 'Trade-off'

In this model, the trading activity itself does have direct social impact, but a balance has to be struck between generating financial returns and creating social impact. The firm could increase its social impact by decreasing financial returns, or vice versa. In other words, there is a trade off.

Unlike Model One, social impact is integral to the very nature of the trading activity of Model Two. Even if no financial return is achieved, some social impact will occur by virtue of the existence of the trading activity.

Furthermore, Model Two firms may be capable of providing a risk-adjusted commercial rate of financial return. For example, a Model Two firm may be able to attract commercial investors with an acceptable rate of financial return, while at the same time achieving a level of social return which is acceptable to its other stakeholders. Such firms are, therefore, not necessarily riskier than Model One firms because other factors (financial or otherwise) may or may not increase the risk of Model One or Model Two firms not achieving their financial and social outcomes.

Examples of Model Two include:

- fair trade businesses
- microfinance institutions
- firms that employ the disabled, ex-offenders or other disadvantaged people
- Ethical Property Company plc
- Venturesome

TEST: Can you increase the social impact of the firm by decreasing the financial returns? If yes, then it is a Model Two type organisation.

Model Three – ‘Lock-step’

In this model, not only does the trading activity itself have direct social impact, but that social impact increases or decreases in lock-step and in parallel with financial returns.

Model Three type firms are scarce, and it may be that outside of their discrete activity, there is a trade-off taking place, eg the visual impact of wind farms on rural areas.

Such organisations clearly operate in competitive markets – both with other Model Three firms and with substitutional products, eg with a wind farm, coal-powered electricity generation.

The level of financial returns that Model Three businesses are able to achieve may be acceptable to a fully commercial (financial return only) investor. However, it is likely that more Model Three opportunities will exist where the financial return that is produced is below the risk-adjusted commercial rate. For example, organic food businesses fifteen years ago were Model Three firms, but could not yet produce a commercial rate of return because the organic food market was still in early stage development. As such consumer markets mature and become mainstream, commercial rates of return become feasible.

It is important to distinguish Model Three opportunities where the market is immature or below scale thereby giving rise to lower financial returns (e.g. because the consumer market is very niche, and scale of production is very low) from Model Two opportunities where the financial return is being genuinely sacrificed.

Examples of Model Three include:

- cooperatives
- wind farms
- Abel & Cole Organic Food
- Justgiving.com
- FareShare

TEST: Can you increase the social impact of the firm by decreasing the financial returns? If no, then it is a Model Three type organisation.

Using the Three Models Framework

The Three Models Framework is not intended to be prescriptive. Some readers will no doubt disagree with our analysis, while others will develop the thinking further with examples from their own experience. We welcome the start of this debate.

In Part 2, we will explain in more detail how the 3 Models Framework has shaped the thinking about social enterprises within Venturesome.

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