BUSINESS STRATEGY REVIEW
INSIGHTS FOR GLOBAL BUSINESS

Social financing

John Walker examines the financing opportunities and challenges facing social ventures.

Comments

Social ventures have at their core a strategy to deliver explicit social impact in combination with sustainable business growth, recognising the power of business in tackling social issues around the world. Consider Frogtek, a venture that provides software-based business tools on mobile platforms to micro-entrepreneurs in emerging markets. Or Embrace Innovations, a healthcare technology company providing innovative and affordable medical devices for emerging markets, whose first product is a low-cost infant incubator. Both of these ventures clearly had social purposes from an early stage in their organisational development, and both found access to investment capital fundamental in growing their models.

Over the last century, principles around business financing have given rise to extended concepts — such as equity, debt, and combined variants such as convertible debt and mezzanine financing. In the respect that they require capital for growth and to expand activities, social ventures aren't any different to traditional ventures and these traditional investment techniques all have applicability in financing a social venture. Social ventures do, however, demand the application of innovative investment approaches designed to combat and circumvent the intrinsic challenges of the sector. For example, equity returns are limited in social ventures as exit markets, whether through IPO or other secondary investors, are not mature. Alternative methods that provide investor liquidity are attractive and examples of revenue-sharing or success-based returns that deliver cash to the investor are becoming more and more frequent.

In developed markets, venture investors depend on their capability to assess and quantify risk in their prospective investments. A thesis underpins the fund mandate, covering which markets and industries they predict will experience high growth and where the fund principals' networks can help identify investment opportunities and support portfolio companies. However, social ventures, including both radical business models in domestic markets, as well as more standard product/services models in developing countries, exacerbate the challenge of assessing risk, given the unique nature of cultural and business resource issues and investor networks that often have not yet reached the level where they can substantially benefit a portfolio business.

In addition, investors usually depend upon comparable investment activity that helps validate and support an investment thesis around market opportunity and valuation levels. That backup and peer justification doesn't exist in many social venture markets, where activity is far more sporadic and those markets have yet to demonstrate clear trends in delivering investor returns. All of this limits the availability of investor capital in social ventures.

Infused with partnership

One important facet of social ventures is that, in recognising this dearth of capital, entrepreneurs subsequently identify business growth strategies that avoid specific cash infusion. Securing partnerships that offer direct economic benefits to both parties is, in effect, the equivalent of capital infusion, but without the actual need to value either company or transfer capital — it is the explicit transfer of financial resources that requires firm commitment and measurement. Typical examples of these partnerships are a real estate company offering a reduced rate lease in return for free or reduced rate operational resources, or a major electronics product company offering mobile equipment in return for access to data acquired through operation. Either is equivalent to the transfer of capital, but without having to complete difficult negotiations over valuation or precise returns. Compounding challenges around the direct investment is measuring social impact. Terms such as double bottom line and triple bottom line have grown around the need to recognise positive impact as key to generating value alongside financial returns. An assessment of social impact potential requires a holistic approach, considering various elements of impact through workforce development, product and service delivery, and market development. Notably, in the US, industry standardisation methods have been pioneered by B-Lab with the GIIRS and IRIS systems.

Growth capital

The rate of expansion in the social enterprise sector is dependent on the influx of investment capital. With businesses not offering market rate risk adjusted returns sufficient to attract traditional venture capital, other sources of capital are necessary. Numerous sources of start-up capital do exist, from business school competitions, to accelerators, to angel investors. And there are many funds that specialise in financing established businesses in specific markets that have proven business models and market traction. It is the capital segment in-between that limits overall market activity, typically in deal sizes from $200,000 to $2 million. Businesses at that stage of growth still demand tolerance of unique market risks that domestic funds are not equipped to assess and tackle.

Early-stage investment funds

In traditional markets, multiple investor funds offer such capital, but in the social venture sector there are notably few funds that specialise at this stage. One element that limits fund creation is the principle of aggregating social investors around a common social impact mandate. The Bottom of the Pyramid (BoP) has received the greatest direct investment but this still comprises a relatively small amount of the overall market. Significant impact and activity could be generated with the creation of new investment fund vehicles that aggregate investor capital around a common social impact mandate and offer growth capital to social ventures that have established a business concept but have yet to generate strong traction in the marketplace.

Leveraging philanthropic capital

With regard to the actual capital, the social venture sector has a number of sources: individual and institutional investors, the government and the philanthropic sector. With governments, many initiatives are already well established, such as CDFIs, and others are just coming online, such as Social Impact Bonds. However, it is the philanthropic sector where most potential for increased capital allocation is perceived. Beyond standard grant-based financing, foundations can offer a variety of different investment tools and approaches that could significantly increase the level of capital active in the sector.

In the US, the IRS-defined Program-Related Investment (PRI) concept enables foundations to place capital as investments into organisations rather than grants and for it to still count toward the mandatory payout. For entrepreneurs, this source of capital is advantageous in that it requires lower than market rate interest or return targets — and for the foundation, a principle attraction is that the returned capital can be recycled into other charitable activities.

However, the level of current PRI activity is relatively small compared to overall grant activity. It is crucial that the market develops innovative approaches to leveraging this philanthropic capital into social ventures. This may be through integrated deal structures, where the financial investor is assured sufficient upside opportunity and downside protection to fulfil their return goals, and the social investor sufficient confidence that their capital will be invested in pursuit of key charitable goals. Or it may be best achieved through encouraging foundations to join the investment discussions alongside financial investors so that through coherent deal processes both can determine a mutually compatible solution that secures the necessary capital for the social venture under the appropriate controls and return objectives.

Reaching sustainability

The economics currently around social investment don't generally provide for the typical fund approach of management fees financing a team to source and evaluate deals. The dynamic that has developed in the market is of accelerators and incubators as the key identifiers of entrepreneurial talent and business potential. Those accelerators are almost exclusively non-profit organisations, using philanthropic capital to execute a search and selection process and support entrepreneurs in developing and building their business models. Examples of these accelerators are Echoing Green, Unreasonable Institute and Endeavor Global, each of which uses a unique approach in assessing talent and supporting their selections. Business school competitions and initiatives, such as the Global Social Venture Competition (GSVC), are also identifiers of talent and providers of capital. The traditional venture sector has already proved the value of accelerators, such as Y-Combinator. The challenge for the social venture sector is how to achieve the long-term sustainability of these accelerators. Existing so far on committed and passionate donors, many accelerators have yet to identify models that provide inherent sustainability. Certainly, copying the traditional sector in attaching an investment instrument to their model can have benefits, but this probably results in more opportunistic capital rather than forming the basis of a dependable long-term financing strategy for the accelerator.

The financing of social enterprises is in its infancy. But, as their impact and reach develops, more sophisticated means of providing finance will emerge and traditional financing approaches will be better tailored to fit their needs.

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