Venturesome
an initiative of CAF

The 3 Models of Social Enterprise:

Creating social impact through trading activities

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 3 Models Framework

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

- **Model 1** – 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
- **Model 2** – Engage in a trading activity that does have direct social impact, but manage a trade-off between producing financial return and social impact
- **Model 3** – 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

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 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.

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[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'.

Model 1

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 (e.g. creating employment) – but these are incidental to the predominant purpose of that trading activity (i.e. 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 1 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 1, therefore, the financial risk of the investment is disconnected from the likelihood of achieving social impact.

Examples of Model 1 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
- "Ethical" bottled water companies – which give a percentage of their profits to developing charitable projects (e.g. Belu Water, Thirsty Planet)
- A hedge fund which gives a slice of its profits to its charitable foundation (e.g. Children's Investment Fund)

Model 2

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 1, social impact is integral to the very nature of the trading activity of Model 2. Even if no financial return is achieved, some social impact will occur by virtue of the existence of the trading activity.

Furthermore, Model 2 firms may be capable of providing a risk-adjusted commercial rate of financial return. For example, a Model 2 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 1 firms because other factors (financial or otherwise) may or may not increase the risk of Model 1 or Model 2 firms not achieving their financial and social outcomes.

Examples of Model 2 include:

- Fair trade businesses
- Microfinance institutions
- Ethical Property Company
- Venturesome Fund

<u>TEST</u>: *Can you increase the social impact of the firm by decreasing the financial returns?* If yes, then it is a Model 2 type organisation.

Model 3

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

Such organisations clearly operate in competitive markets – both with other Model 3 firms and with substitutional products, e.g. coal-powered electricity generation.

The level of financial returns that Model 3 businesses are able to achieve may be acceptable to a fully commercial (financial return only) investor. However, it is likely that more Model 3 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 3 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 these 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 too low) from Model 2 opportunities where the financial return is being genuinely sacrificed.

Examples of Model 3 include:

- Wind farms
- Organic vegetable box schemes
- FareShare 1st

TEST: *Can you increase the social impact of the firm by decreasing the financial returns?* If no, then it is a Model 3 type organisation.

Using the 3 Models Framework

The 3 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.

Observations about the 3 Models

(i) *Social impact integrated into Models 2 and 3*

We believe that Models 2 and 3 fundamentally differ from Model 1 because the social impact of these firms is integral to the business model itself. In other words, even if a Model 2 or Model 3 type firm fails to achieve any financial return, it will still have *some* social impact by virtue of its trading activity (e.g. 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 1 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 1 propositions more demanding to assess. In Models 2 and 3, the risk of *not* achieving social returns is mitigated by the possibility of getting some money back. In Model 1, no social return at all can be achieved until a profit has been made.

(ii) *Striking the right balance in Model 2*

Model 2 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 2 type firms, therefore, need to be carefully managed, to achieve an acceptable balance between social and financial return both 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 2 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 e.g. organic food. However, this social / environmental / ethical stance does not always represent a direct benefit to the consumer of the product e.g. fair-trade goods, and so such trade-offs may be vulnerable to increases in consumer price sensitivity.

Nevertheless, Model 2 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, very few new premium coffee products in the past twelve months have *not* had a fair-trade or organic certification.

Model 2 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 who 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.

(iii) *Separate motivation from performance*

Model 1 businesses are *motivated* by making financial return, but they may not do so e.g. the charity second hand clothes shop that makes a loss. Model 1 businesses may generate substantial profits but fail to deploy them for any social impact e.g. the grant-making foundation which fails to spend even (say) 20% of its annual income.

Model 2 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 e.g. (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 3 businesses may be motivated to achieve a social impact or motivated to achieve a financial return; they may achieve either, both or neither, e.g. 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 3 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.

Maximise efficiency of capital

The 3 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 (i.e. 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 3 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 1 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 2 and 3 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 (i.e. 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.

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 3 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 (e.g. using grant money to absorb first losses in a subordinated debt instrument)
- Creating new financial instruments which share financial risk and reward (e.g. quasi-equity) or connect financial reward to achievement of social outcomes
- Increase access to capital (e.g. 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 (e.g. 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]

Examples of how to use the 3 Models Framework

The following illustrate how the 3 Models Framework might help shape a discussion around particular issues.

(i) Deciding to invest or not

A grant-making foundation (which is itself a Model 1) has to decide whether or not to invest in a social enterprise. The social enterprise is operating a Model 1 business i.e. it seeks to make profit in a commercial market and give those profits to support its beneficiaries. Should the foundation invest?

Using the 3 Models Framework, the factors to be considered may include:

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

- 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? e.g. seed-funding the creation of a new market which has social benefits.
- And ultimately, is the 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?

(ii) 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.

(iii) 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.

(iv) Thinking about consumer preferences in evolving markets

Model 2 type firms must trade-off financial and social returns. But could a Model 2 type firm transform into a Model 3 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 3 type firm (where financial and social/environmental returns move together in lock-step).

(v) Knowing when to use commercial or philanthropic money

One potential danger for the unwary social investor is Model 1 type firms presenting themselves as Model 3 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 3 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.

Conclusion

At Venturesome, we began to think about the 3 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 3 Models) is inherently more profitable than another. So, for example, a well-run Model 2 type firm may be more profitable than a poorly run Model 3 type firm. Both Model 2 and Model 3 type firms may make profits in certain markets, whereas a Model 1 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; and
- keeping the focus on the actual achievement of positive social change.

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