THE DILEMMAS OF SOCIAL ENTREPRENEURS AND INVESTORS

WHAT IS A SOCIAL ENTERPRISE?

A common dilemma of both social entrepreneurs and investors, and others in the social sector as well, is the concept of "social enterprise". The two words appear contradictory and yet are juxtaposed. An enterprise is a company established for commercial purposes. A social enterprise would then be a business that aims to make profits and also aspires to do good to beneficiaries in society.

The question then arises: Should the organisation not maximise the good that it does by making less or no profits? On the other hand, if the organisation is a business and aims for low profits, would it be doing justice to its shareholders? Charities, VWOs and nonprofits are established with the singular aim of maximising the good that they do, with no thought of making money out of it.

Social entrepreneurs can get schizophrenic over the twin objectives of making money and doing good. Investors in social enterprises are in the same boat and they also have to resolve their conflict over maximising financial returns versus achieving the most social impact from their investments. Is a social enterprise an oxymoron that should not exist?

For a long time, there has existed the dichotomy of pure social organisations and commercial enterprises. In recent years there has emerged a hybrid called a social enterprise, with different shades of the balance between profit and social objectives. Thus there is now a continuum of private organisations, with purely social organisations such as charities, VWOs and nonprofits on one end, purely commercial enterprises on the other end, and the newly emerging social enterprises in between. These three private sectors, together with the public sector, form the four sectors in an economy. The social enterprise sector is called the Fourth Sector, and its existence is becoming well established worldwide.

How is the dilemma resolved? It is simply striking a proper balance between the profit and social objectives. The primary objective must be to maximise social impact. Attempting to maximise profit while declaring to do good would not define a social enterprise. Instead it would be a commercial enterprise with corporate social responsibility (CSR) programmes.

The Nobel Peace Prize winner Muhammad Yunus calls such enterprises "social businesses", emphasizing the profit objective and removing possible confusion over "enterprise". But his definition of a social business is rather restrictive and may be too idealistic for social entrepreneurs. He requires that the founders of a social business do not benefit from the profits gained by the business. They only take salaries, and in fact the salaries are to be heavily discounted, as much as 50 to 70% below market rates.

It would not be realistic to expect that all young social entrepreneurs will accept such a business model. For an investor, this would not be acceptable too, since entrepreneurs should be motivated and rewarded for successfully growing the business, which results in increased social impact.

Hence investors such as SE Hub Ltd subscribe to the UK Department of Trade definition, which states that the majority of profits gained are either ploughed back into the business or donated to charity. When the enterprise achieves profitability, a small part of the profits can be used for bonuses or dividends. Also, market-rate salaries are acceptable, so long as they are reasonable and commensurate with founder capability and affordability of the enterprise.

FINANCIAL SUSTAINABILITY

What is the raison d'être for a social enterprise, and why should it aim to make any profit at all?

Charities, VWOs and nonprofits depend on donations, grants and sponsorships to fund their activities. The more funds that they raise, the more social programmes they can run. If they cannot raise funds and run out of reserves, they have to close down.

On the other hand, a viable social enterprise with sustainable profits will be able to permanently do good. In addition, profits ploughed back can be used to grow the business or improve the quality of the programmes. They just need to focus on their activities and not be distracted by annual fund raising efforts. Of course the profits should be moderate, to reflect the social mission.

Some social entrepreneurs have a schizophrenic attack or deep sense of guilt when they are asked to increase the prices of the products or services to achieve viability. They feel that they would be exploiting their beneficiaries and may be pricing above the affordability level of the beneficiaries. They have to change their mindsets and understand that doing less good over a long term could be better than doing more good and not survive the short term. When they become sustainable, they can tilt the balance towards doing more good.

Admittedly there are many instances where prices have to match affordability and be set at below cost, or cases where the products or services have to be offered free of charge. These organisations have no choice but to be charities, VWOs or nonprofits. In any society there are needed and important roles for such organisations.

Not every social organisation has to mindlessly strive to be a social enterprise. Social entrepreneurs and investors have to keep this in mind and not endeavour to create business models that seem to achieve sustainability but do not really work. Achieving break even for a start up commercial enterprise is difficult enough, not to mention a social enterprise with low profitability and slow growth.

Even with a viable business plan, some social entrepreneurs are so passionate and eager to do the most good right from the start that they lose sight of keeping the business afloat, and the enterprise often flounders beyond rescue.

SE Hub Ltd takes pains to impress upon social entrepreneurs that “enterprise” should come before “social” at the start up stage. As the enterprise progresses towards financial sustainability, “social” can progressively take greater importance to eventually become the prime objective. Putting the cart before the horse can lead to failure, or require the social enterprise to morph into a charity.

BUSINESS PLAN

Entrepreneurs should appreciate that drawing up a business plan is for their own good, and it is not just for the sake of fund raising. The exercise helps to clear up their own minds on the alternative models and roll out plans, and to choose the best strategies that are reasonable and realistic, in relation to the resources available.

Pricing has to take into consideration costs, affordability and prevailing market rates. A strategy could be to have two-tier pricing, with lower prices targeted at the more deserving beneficiaries. Such beneficiaries could be additionally subsidised by community or government agencies, or corporate sponsors. Also, prices could be progressively lowered as the enterprise scales up, achieving efficiencies and economies of scale. Given high operating costs such as labour and rental costs, social enterprises face a challenging dilemma in balancing social objectives against constraints.

Even identifying the best way to help target beneficiaries can turn out to be a dilemma. For example, an entrepreneur decided to help ex-offenders become self-employed by setting up a fast food franchise and training them to be franchisees. After developing the business plan and obtaining in-principle approval for investment funding, the entrepreneur discovered that the target ex-offenders did not want to be franchisees under the control of the franchisor.

Identifying the social needs correctly, together with verifying the desired outcomes, is an important first step integral to drawing up the business plans.

FUNDING

After the plans are done, entrepreneurs have to decide whether to seek investment or grant funding. Most grants are on a reimbursement basis, requiring funding from themselves or friends and family at the start up. Investors provide funding upfront and usually add value by providing mentorship, business advice and networking assistance.

Social entrepreneurs need to meet with grant givers and investors to understand their funding objectives, criteria, terms and conditions and limits. Some entrepreneurs harbour the fear that an investor would take over control of the enterprise and drive it towards maximising profits. While this can happen in the venture capital investment industry, it should not be the case for social investors as their priority is social impact.

INVESTORS' DILEMMA

The social investor's dilemma of balancing financial returns with social impact can be resolved by stakeholders having clear objectives and expectations. The main objective would be to invest in social enterprises that generate significant social impact. Financial returns of 5 to 10% on a portfolio basis should be acceptable. This compares with expectations in the venture capital industry of higher than 15% compounded returns from each investment and 100 or 200% return on a portfolio basis.

A more troublesome dilemma faced by the social investor is the need to divest from a social enterprise subsequent to the investment. This enables the investor to recycle its funds to help other social enterprises.

In the venture capital industry, the common exits are through an IPO or trade sale of the enterprise. However it would take many years, if at all, for a social enterprise to scale to a size that would make it attractive enough for an IPO or trade sale. Even so, the low profitability itself makes it not attractive at all.

The solution adopted by SE Hub Ltd is to invest in the form of a term loan instead of purchasing shares (equity) of the enterprise, when it is assessed that the social enterprise has little possibility to IPO. On maturity of the loan, the capital would be fully returned with the interest earned.

Venture capital investors do not invest in the form of a loan, as their return would be capped at the interest rate, which would be too low compared to their return expectation. A term loan should satisfy the return and exit objectives of a social investor. The interest rate can be between 5 and 10%, to match the return expectation.

A loan would not dilute the entrepreneurs' shareholdings. An initial grace period can be built in, so that repayment would start only when the cash flow of the enterprise allows.

Most social enterprises have little collateral and most, if not all, social entrepreneurs baulk at giving personal guarantees. A social investor is not a bank. The only reason why a loan is chosen instead of equity is due to the exit issue. Thus, the investor should be prepared to take equity risks in the loan, and not ask for collateral or personal guarantees. The investor should have conducted careful due diligence to mitigate the risks in every investment, no matter how it may be structured.

In some cases, although rare, the social investor may have a buy-back arrangement with the entrepreneurs. As the social sector matures, and as large corporations increase social responsibility, another exit would be a trade sale of the investment to a large corporation. The corporation could find that adopting the investee incubated by the social investor would be a better choice versus other corporate social responsibility programmes that they may have.

SOCIAL IMPACT

A huge dilemma faced by both social entrepreneurs and investors is the measurement of social impact. The problem lies in the fact that social impact is almost always subjective and the social sector and academia have not yet found a practical and acceptable methodology to measure social impact.

Social entrepreneurs need to periodically measure the social impact that they generate to assess whether they are doing good effectively and efficiently. Social investors need to measure the impact that will be generated by potential investees to evaluate and select the best investment opportunities.

Failing the emergence of a widely accepted and practical method of impact measurement and management, the interim solution would be for investors and investees alike to settle on proxies and estimation methods such as cost-benefit analysis.

A frequent question that is faced by investees and investors alike in Singapore is on the degree of social impact that can be achieved, particularly when compared with what can be done in less developed countries. Clearly the bottom of the pyramid in Singapore is nowhere as low as those in many developing countries. It is valid to suggest that a dollar spent in such other countries will generate much greater social impact than a dollar spent in Singapore.

Nevertheless, there is no escaping the need to spend the dollar in Singapore. What SE Hub Ltd and its investees focus on is whether their dollar spent will generate greater social impact than spending it in other ways in Singapore. But the dilemma remains as to how to make valid comparisons.

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