MaRS White Paper Series

# Social Entrepreneurship

## Social Venture Finance

MaRS

# Enabling Solutions to Complex Social Problems

Social entrepreneurs recognize social problems and use creative approaches to design, establish and manage ventures to make social change and achieve a positive economic return. This series of white papers explores issues of importance to the emergence of a strong social venture marketplace in Ontario.

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# Table of Contents

# Introduction

Social entrepreneurs are mobilizing talent and capital from both the public and private sectors to address complex societal challenges. However, the marketplace for these ventures is emerging and traditional investment vehicles struggle to accommodate the investment opportunities presented by the social entrepreneurs in their efforts to combine a positive economic return with a social impact mission. As a result, many promising social ventures fail to achieve their true potential due to limited access to resources.

In recent years, the need to identify and apply innovative methodologies to address complex social issues has picked up momentum among public and private leaders globally. Some of the forces driving the need for innovation in this area include the call for action on climate change, poverty reduction and an aging population with the corresponding pressure on the health-care system.

MaRS Discovery District, generously supported by the Government of Ontario, recently completed a scan of the global social finance landscape - with input from local and global thought leaders and practitioners - to determine the opportunities and challenges supporting the growth of social ventures in Ontario. These innovative enterprises combine a strong social purpose with sound business principles, rather than being solely driven by the need to maximize profit. Supporting the development and success of social ventures is a key component of the Government of Ontario's Innovation Agenda and Poverty Reduction Strategy.

As a non-profit innovation centre, MaRS connects science, technology and social entrepreneurs with business skills, networks and capital to stimulate innovation and accelerate the creation and growth of successful Canadian enterprises. MaRS also helps distinct groups such as entrepreneurs, researchers, investors and policymakers communicate and collaborate in new ways. By providing a unique platform and an enabling environment, MaRS can help social ventures become Ontario success stories: financially self-sufficient organizations that are able to deliver strong and measurable social impact for the communities they serve.

This introduction to social venture financing will be the first in a series discussing the opportunities and challenges in the social finance ecosystem.

## Key Findings

- The social finance marketplace is new and emerging.
- Social ventures can emerge from both the private and the non-profit sector.
- The capital for social venture funds can come from various traditional and non-traditional sources. Investors will gravitate to the type of investment vehicle defined by their social and capital investment return expectations, which may be market rate, charitable or a mix of the two.
- Some of the key challenges impeding the growth of the social marketplace include: the limited capital available to social ventures, the lack of familiarity with social finance among entrepreneurs and capital providers, social entity structural issues, the difficulty in defining and applying metrics and the nascent nature of the marketplace.
- Social entrepreneurs and technology entrepreneurs face many of the same challenges in scaling a venture. There is an opportunity to apply best practices from innovators in both sectors with the goal of achieving the optimal scale appropriate for a venture.

## The Emerging Social Finance Marketplace

Investors and entrepreneurs who take an early risk in an emerging marketplace will come out the winners, as evidenced by the success stories in the technology and life sciences field. A recent presentation by the Monitor Institute detailing the four phases of industry evolution (Figure 1), provides a framework for the development of the social finance marketplace in Canada.

Globally, the United States and the United Kingdom have been leaders in the evolution of the social venture marketplace and their evolution can be categorized at the marketplace-building phase. Based on consultations completed for the study, the Ontario marketplace is more nascent and can be classified as emerging from the uncoordinated innovation stage and entering the marketplace building stage as some centres of activity are beginning to coalesce.

In addition, there are parallels between the evolution of the technology sector in Canada (which includes information technology, clean tech and life sciences) and the opportunity for knowledge transfer between the technology entrepreneurs and social entrepreneurs.

**...The question is whether the bar will be set high enough – whether pioneering leaders will provide the talent, discipline and resources that will be needed to create a coherent marketplace with high standards for impact... Katherine Fulton, Monitor Institute**

## What Exactly Defines a Social Venture?

Social venture capital is a form of venture capital investing that provides capital to businesses deemed socially and environmentally responsible. These investments are intended to provide attractive returns to investors and to provide market-based solutions to social and environmental issues. Rather than being simply driven by the need to maximize profit, social ventures blend the value of social impact with financial gain.

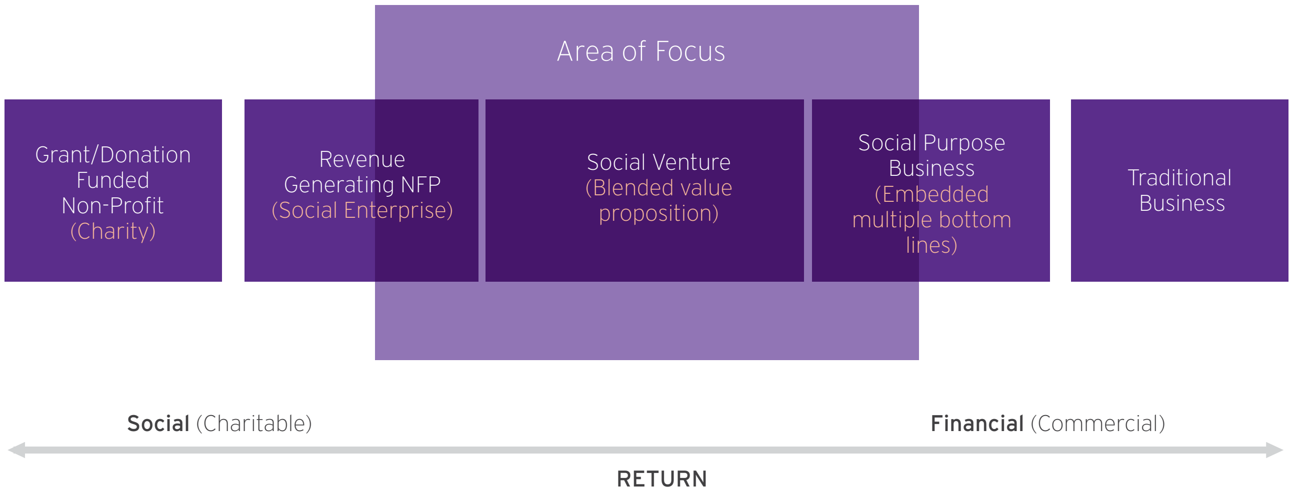
### Figure 1 Phases of Industry Evolution [1]

IN ONTARIO TODAY

| Uncoordinated Innovation | Marketplace Building | Capturing the Value of the Marketplace | Maturity |
|---|---|---|---|
| • Disparate entrepreneurial activities spring up in response to market need or policy incentive<br>• Disruptive innovators may pursue new business models in seemingly mature industries<br>• Characterized by lack of competition except at top market | • Centers of activity begin to develop<br>• Infrastructure is built that reduces transa supports a higher volume of activity | • Growth occurs as mainstream players enter a functioning market<br>• Entities are able to leverage the fixed costs of their previous investments in infrastructure across higher volumes<br>• Organizations may become more specialized | • Activities reach relatively steady state and growth rates slow<br>• Some consolidation may occur |

1 Katherine Fulton, Monitor Institute, 2008 http://www.linktv.org/video/3142

## Figure 2 Social and Financial Return Continuum




Social ventures have emerged in the economy in two ways: as social enterprises ("SE") from the non-profit sector, and as social purpose businesses ("SPB") from the for-profit sector. Figure 2 details how these investment opportunities fit along the social-financial return continuum.

### (a) Social Enterprises (SEs)

This model of social venture has emerged from the non-profit and voluntary sector as organizations seek to become more self-sufficient and financially sustainable. SEs are revenue-generating entities that are owned and operated by a non-profit organization. Since there are no shareholders in a non-profit organization, the profits are fully reinvested into the work of the organization.

The emergence of revenue-generating activities has created a new operating model where business principles, market characteristics and values (competition, diversification, entrepreneurship, innovation and a focus on the bottom line) co-exist and work with traditional public sector values of responsiveness to community and serving the public interest. Non-profits are adopting an enterprising approach not only to be more financially sustainable but also to enhance their missions and increase their impact.

In order to distinguish SEs from traditional fundraising/revenue-generation activities within a non-profit organization, the BC Centre for Social Enterprise suggests that the SE must have a goal or a mission beyond simply generating funds for its parent organization and must demonstrate, through its business model, some behaviour that will benefit the community in which it operates.

The ReStore retail outlets of Habitat for Humanity provide an excellent example of a Social Enterprise. Quality used and new surplus building materials are sold for a fraction of the market prices, helping the environment by providing a retail channel to re-use valuable construction materials. The proceeds from the retail outlet fund the construction of new Habitat for Humanity homes within the local community.

The typology of an SE is further defined by Tessa Hebb[2], the Managing Director of the Centre for Community Innovation at Ottawa's Carleton University. She defines three dimensions as critical to the classification of an SE:

(i) Their degree of financial self-sufficiency;

(ii) The degree of social transformation aspired to and achieved;

(iii) The degree of innovation employed in the achievement of the mission.

2 Dr. Tessa Hebb et al, Financing Social Economy Enterprises, Ottawa Carleton Centre for Community Innovation, 2006

## (b) Social Purpose Businesses (SPBs)

Social Purpose Businesses are commercial for-profit entities, created by entrepreneurs to address social issues that maintain their social purpose at the core of their operations, while existing in the market economy. Many successful examples of SPBs can be found internationally focused on a range of societal challenges, ranging from environmental impacts through clean tech to poverty reduction through microfinance initiatives. **(See IceStone case study)**

The return continuum in Figure 2 enables the distinction between Social Enterprises, Social Purposes Businesses and the increasing involvement of traditional companies in adopting social or environmental causes as part of their community outreach programs. As important and altruistic as these Corporate Social Responsibility ("CSR") initiatives are, they are typically not embedded into a for-profit company's core mission.

## What Type of Ventures are Emerging in Ontario?

Currently, the majority of Ontario's ventures pursuing social aims fall into the non-profit category, as this is where social problems have historically been addressed. In addition, the current legal structure for non-profit entities significantly limits the scaling of business activities within those entities, preventing access to traditional investment capital.

We will discuss the limitations of the legal structure below as part of an overview of some of the hurdles that need to be overcome in order to continue the maturation of the Canadian social finance marketplace.

## Case Study

IceStone®

DURABLE SURFACES MADE OF RECYCLED GLASS & CONCRETE

**IceStone (www.icestone.biz)**, a New York-based company, developed an innovative process for manufacturing highly durable concrete surfaces made from recycled glass and cement. Not only does the product rival the likes of granite but it also offers builders and other consumers an alternative to products that are environmentally unsustainable. The founders of IceStone are so dedicated to making a positive impact, that aside from their environmental focus they also hire vulnerable populations for living-wage jobs in their factories. Take away IceStone's social mission – something intrinsic to its purpose – and the company would be a different entity altogether.

# What Types of Funds Invest in Social Ventures?

Social venture funds typically invest in enterprises that provide a strong social impact: areas such as health, environment, education, housing and microfinance summarize the typical investment focus area for funds. Social venture funds generally fall into three categories:

## Figure 3 Types of Venture/Community Development Funds

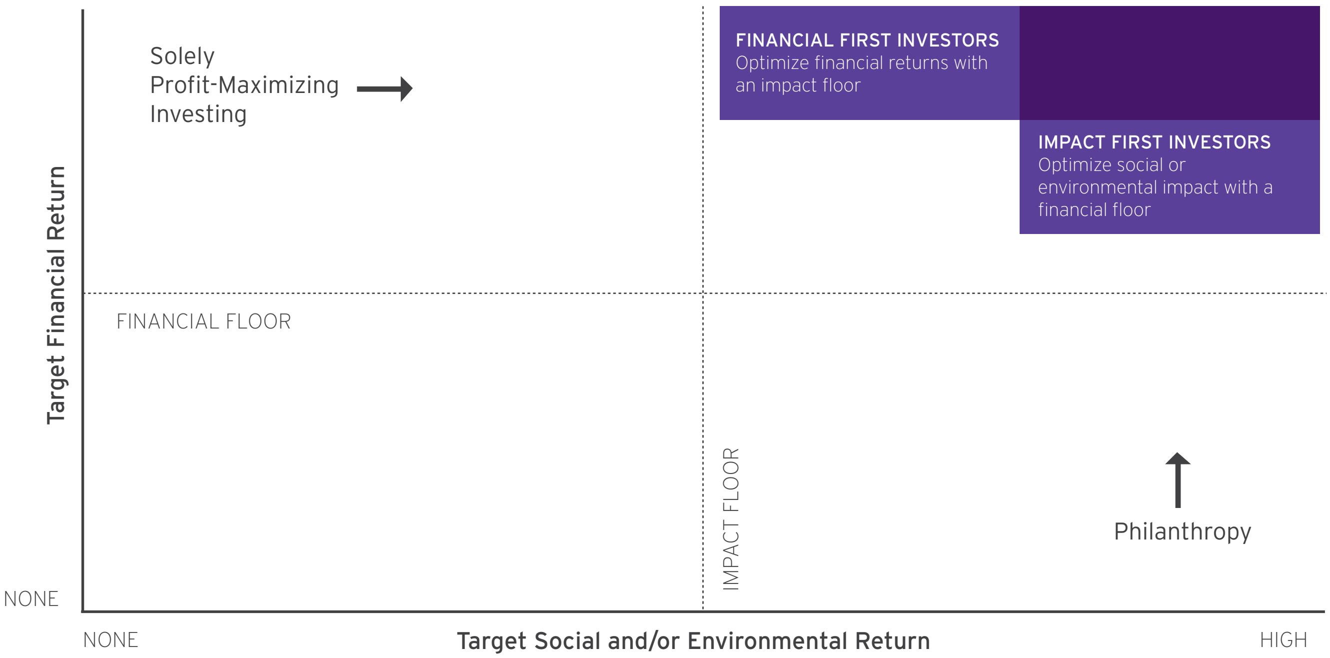
| Type of Fund | Characteristics |
| --- | --- |
| Regional | • The funds are focused on applying a social venture capital model to regional development and are often driven by government mandate or by specific individuals who have a deep desire to support their region.<br>• These funds are generally part of a long-term comprehensive strategy to nurture the social venture community in the region.<br>• As this type of fund is typically constrained from a geographical perspective, the fund may use a broad definition for the type of social venture that will fit its investment mandate. |
| Sector-Specific | • The fund may be supported by tax incentive strategies and will often look to leverage existing community investment programs.<br>• These funds, typically seed and early-stage investors, focus on one or more specific sectors (determined by their fund size).<br>• These funds are most like conventional venture capital funds and rely on deep sector expertise, partner and customer networks in order to uncover and nurture the most successful investments.<br>• The geographic focus of these funds is fairly large to maximize quality deal flow, while balancing the need to be relatively close in order to provide the portfolio companies with the necessary support to successfully scale the enterprise. |
| Opportunistic | • These funds seek the best deals from a broad range of sectors and can include any deal (except for a small set of off-limit areas).<br>• Investment occurs at the growth stage where the core team and business model have been proven (typically >$2 million in revenue and assets).<br>• Funds have a broad definition of social venture, including cleantech ventures and those that produce, sell or distribute sustainably produced goods.<br>• These funds will have broad geographic coverage (national, continental and global). |

Social venture funds are emergent in the social finance marketplace and, therefore, have limited track records. The financial returns will likely be lower than a more traditional venture capital vehicle, with the returns offset by the social benefits that the ventures are generating.

Figure 4 represents the minimum balance social venture funds would aim to achieve between financial returns and social returns, ideally aiming at the "investment nirvana" signified in the top right-hand corner. The opportunity for a fund essentially lies where "meaning intersects with a strategic interest". Managers who have raised some of the early venture funds have typically aligned their funds' focus with the interests and return expectations of investors who have provided the fund's capital.

For example, a fund manager raising capital from traditional institutional investors in private equity, such as pension funds and strategic investors, would likely target in their fund mandate a higher financial return with a somewhat lower social return. A fund manager targeting higher social returns would likely seek out foundations, high net worth individuals, family offices and Corporate Social Responsibility ("CSR") allocations within larger corporate organizations as part of the fundraising strategy.

## Figure 4 Target Returns for Social Venture Funds[3]




3 *Investing for Social and Environmental Impact: A Design for Catalyzing an Emerging Industry*, Katherine Fulton, Monitor Institute, Jan. 2009

# What are Some of the Challenges Faced in the Social Finance Marketplace?

There are many challenges facing innovators in this emerging space. Thought leaders provided a comprehensive list of issues and gaps that need to be addressed in order to move forward in the "marketplace building" phase detailed in Figure 1. Some of the issues discussed include:

## Figure 5 Challenges Facing the Evolution of the Social Finance Landscape

| Issue | |
|---|---|
| **Lack of Capital and Experienced Investors** | • There are limited sources of capital for entrepreneurs to approach. Many of the funds are considered to be demonstration vehicles and have a community focus.<br>• In Ontario, there are some community development funds and a very limited number of venture capital funds that provide either equity capital or loans to social ventures. |
| **Fund Structure** | • The current rules for charities in Ontario and Canada are very restrictive to scaling revenue-generating activities within a charitable entity.<br>• The United States and the United Kingdom have developed "hybrid" corporate structures that allow not-for-profit (eg. foundations) and for-profit (eg. corporations) to invest side-by-side in a venture.<br>• In the US, the L3C model provides a vehicle that is uniquely suited to accepting Program Related Investments (PRI's) from foundations: investments from the foundation's endowment capital that correspond with the mission and programs.<br>• In the UK, the community interest company (CIC) is a distinctive corporate entity that describes a company working for the benefit of the community. It has the advantage of the "company" legal form, which is familiar and well understood by the business community and is flexible enough to adapt to most organizational structures. |
| **Developing the Skills of the Social Entrepreneur** | • Many of the opportunities for social ventures come from the non-profit sectors where traditional business skills are not necessarily embedded in education and experience. Many community-based entrepreneurs have managed smaller businesses that have not historically achieved significant scale. |
| **Early Nature of Marketplace** | • There are a limited number of examples of local social ventures: if we borrow a thesis from the early history of the venture capital industry, with more capital available to social ventures delivering reasonable financial returns and solid evidence of social impact, then more entities will emerge to absorb the capital. |
| **Lack of Metrics** | • Social impact measurement is costly to do with analytical rigor and needs to be analyzed on a case-by-case basis.<br>• There is a tension for funders: they want metrics but are realizing there is a significant cost to achieve the quality metrics they would desire.<br>• Broad measures of social impact have limited value and can create inappropriate targets.<br>• Investment-first investors in the social capital market require impact measurements that are simple and easy for the average investor to understand, while impact investors (philanthropic grantors) will require more sophisticated social measurement tools to quantify the impact of their investment. |

One of the key learnings from the consultations is the parallel challenge faced by all entrepreneurs, including those on the social venture side. All business leaders must be able to develop and articulate a compelling business plan, raise various types of capital, hire and retain the best management team, scale their business and provide a successful exit for their investors. In the case of the social venture, the exit would be measured using both financial and social metrics.

Most early-stage technology and social ventures are risky by definition. Many of the best practices developed in the more mature technology sectors to reduce or manage risk can provide solutions to mitigate some of the risks associated with social ventures. Typical strategies include using partnerships to scale their businesses, building a strong advisory network, recruiting management teams with deep sector experience and successes and developing and implementing strong intellectual property (IP) strategies. The resulting success stories will accelerate understanding and learning in the sector and as a result should lead to further ventures and funds. The story of Ethiopian coffee, discussed below, is a simple and elegant example of the application of a strategy from the technology toolkit (in this case an IP strategy) to help address a complex social issue. **(See Ethiopian coffee farmer case study)**

The consultations also revealed one success factor that is unique to social ventures and critical to the achievement of their social impact benefits: Partnerships with the social agencies already at work in the community where the social venture operates can help deepen the impact and strengthen the performance of both the venture and the larger community agencies supporting the social mission. **(See Social Capital Partners case study)**

## Case Studies

Social CAPITAL PARTNERS

Working with the community to maximize social impact.

Social Capital Partners is a Toronto-based not-for-profit organization that believes market forces can be more effectively utilized to solve structural social challenges in Canada. In support of this belief, SCP provides growth financing and advisory services to successful businesses that integrate a social mission into their employment strategy by expanding career opportunities for disadvantaged populations. One of the programs provided by Social Capital Partners involves partnering with franchisors, like Active Green + Ross, whereby Social Capital Partners will lend individuals the funds to acquire a franchise at attractive loan rates and, in return, the franchise owner agrees to establish a social hiring and retention program as a core part of their HR model.

In order to ensure success for the franchise's operation as well as the individual being hired, Social Capital Partners works closely with community service agencies such as the YMCA to make the recruiting process effective for the franchise owner and to provide high quality after-employment support programs to ensure the individual is successful on the job. This work has resulted in changing the way Active Green + Ross locations recruit new staff – both corporate dealers and the franchisees SCP has loans with. Community service agencies can also leverage their work with and references from the franchise owners to better serve their community and expand the number of businesses willing to use their programs and services to source 'job ready' candidates for their business. The result is a win/win for the social venture, the social agencies and also for the members of the social community they both serve.

**To read more, see www.socialcapitalpartners.ca**

### HOW AN IP STRATEGY CHANGED THE GAME FOR ETHIOPIAN COFFEE FARMERS

Ethiopia is the birthplace of coffee and is widely recognized as producing some of the finest coffees in the world. Coffee makes up approximately half of all Ethiopian exports and directly supports the livelihoods of millions. Many of the large coffee chains were able to charge premium pricing for the finest beans produced by Ethiopian farmers. However, due to a global over-supply of commodity coffee over the last decade, the price for all Ethiopian coffee beans was pegged at the low commodity market price.

In 2004, the Ethiopian Intellectual Property Office Director took a bold step and implemented an IP strategy based on the belief that IP rights protection played a significant role in the economic boom experienced in developed countries. The government registered trademarks for three of their finest coffees – Harrar, Yirgacheffe, and Sidamo – in 29 countries. Ethiopia selects the global distributors for its coffee and establishes the conditions for sale. These licenses, issued free of charge to coffee companies, have allowed Ethiopia to charge premium market prices for their coffees and major buyers, such as Starbucks, are now licensees and vigorous supporters. The IP (premium coffee) and the IP tools (trademark, brand, license) used by the Ethiopian government has resulted in the doubling of the price for fine Ethiopian coffees and has already led to visible economic improvement in Ethiopia.

To read more, see **www.ethiopiancoffeenetwork.com** and **www.lightyearsip.net**

# Call to Action

Doing "social good" is an emerging and embedded decision criterion in how consumers and corporate entities buy and supply goods and services. Once this marketplace matures further, there will be additional success stories and mainstream investors will be attracted to the investment opportunity in the same way they were when innovations in technology ventures were first successful.

Jed Emerson[4] , a one-time social worker who is now the Managing Director at Uhuru Capital and founder of blendedvalue.org, suggests we embrace the concept of blended value, which he defines as follows: value is what gets created when investors invest and organizations act to pursue their mission. Traditionally, we have thought of value as being either economic (and created by for-profit companies) or social (created by non-profit or non-governmental organizations). What the Blended Value Proposition states is that all organizations, whether for profit or not, create value that consists of economic, social and environmental value components—and that investors (whether market-rate, charitable or some mix of the two) simultaneously generate all three forms of value through providing capital to organizations. The outcome of all this activity is value creation, which is itself non-divisible and, therefore, a blend of these three elements.

A first step in the development of success stories for this social finance marketplace is to a raise a pilot fund that will take the early investment risk and demonstrate the efficacy of the social venture model to social innovation. The MaRS leadership team is preparing to launch a social venture capital pilot fund, which would provide a platform to catalyze further investment in the social finance area in Ontario and Canada.

To ensure success, social entrepreneurs must have access to education, mentoring and support. Talent is now migrating between the non-profit and for-profit sectors and coordination and collaboration between the two will grow and be critical, along with engagement of public sector resources that are the foundation of financial support for many organizations in the non-profit sector. Many of the lessons about investing in and delivering scale from the technology sector can be applied successfully to the non-profit sector and likewise private companies will benefit from the knowledge and experience of the non-profit sector at identifying and solving social problems. MaRS provides a unique platform to converge both social and technology entrepreneurs, thereby unleashing the potential to develop innovative solutions to complex social problems. This work is already underway through SiG@MaRS, providing support and mentoring to social entrepreneurs and their teams.

In conclusion, social venture capital is a strongly emerging force in global markets. Although still nascent in Canada, investment support for Social Enterprises and Social Purpose Businesses holds tremendous promise to catalyze a new generation of social change agents. The Government of Ontario, working with MaRS, has the opportunity to assume a leadership role in this field.

4 www.blendedvalue.org

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