Venture Capital for Social Enterprise

SCP’s Approach to the Social Capital Market

We started Social Capital Partners in September 2001 to fill a gap in the voluntary and CED sectors. After a year of research we had come to the conclusion that this “market” required a new type of funding organization that was designed expressly to invest in social enterprises – businesses that integrate social goals with making a profit.

Social Capital Partners (SCP) would act much like other venture capital companies do in the mainstream investment sector. We would identify early stage companies with great business ideas and good management teams; we would provide them with patient risk capital; we would offer management support to help them grow; and we would measure their performance looking for above-average returns.

The main difference of course would be that the majority of SCP returns would be social as opposed to financial. The financial results would still be important but we would balance them with a social bottom line.

In the early stages we took a relatively narrow definition of social enterprise. We focussed almost exclusively on businesses that were creating employment for what you might call “identifiable at-risk groups.” These businesses employ street-involved youth and mental health consumers, for example, who have significant and perhaps obvious employment barriers.

As we became more “plugged in” to the CED sector, however, we realized that this narrow definition excluded many traditional CED businesses that defined their activities by geography rather than by type of employment barrier.

So over time we learned to broaden our definition. Although we still must be convinced that a business is providing employment to individuals with employment barriers, we are more willing to leave it up to the social entrepreneurs themselves to describe how and why their business will accomplish this goal.

How SCP Makes Investment Decisions

For SCP, making investment decisions is a multi-step process. To pass each step, a business concept requires an increasing commitment from both SCP and the would-be portfolio company.

Step 1: Review of Concept
The process usually starts when an entrepreneur telephones SCP to share a business concept and determine whether it fits our investment criteria. Generally, as long as the concept is not
completely unrelated to SCP’s mandate, we encourage the entrepreneur to submit a 2-page executive summary of the business: what it is, the need that it fills in the market, and how the business will succeed and grow. The summary also provides a brief description of how the business will fulfill its social mission by employing an at-risk group.

To pass this step, SCP must be convinced that the business could be economically viable and grow large enough to provide significant job opportunities (a dozen or more) in the target community. We eliminate many plans at this step because we cannot see how the business will grow significantly or achieve long-term sustainability. Sustainable businesses, by our definition, cover all the costs required to run the business (employees, materials, management) by selling a good or service to customers, and don’t rely on any grant revenue.

**Step 2: Business Plan Review**

Entrepreneurs who pass our initial screen we then ask to submit a business plan. (Since most have already completed a plan, this step does not constitute significant extra work.)

The SCP management team then reviews the plan and sometimes consults with advisors who have a particular expertise in the business area. We will also have a meeting or phone conversation with the entrepreneur to ask some preliminary questions about the business.

We review business plans for the quality of the business model, robustness of the social mission, and the opportunity for growth. Successful business plans usually have a unique, scalable business model that shows strong integration of the social mission into the overall business strategy. We stack each business plan against other opportunities that we are considering at the time to determine where best to spend our time and effort.

Many plans do not make it past this step. Unsuccessful plans generally show one of two weaknesses. A careful review of the plan often reveals that the social mission is an “add-on” to satisfy SCP’s investment criteria rather than an integral part of the business. Alternatively, we may decide that the business plan is simply not strong enough to be sustainable or scalable over the long term.

**Step 3: Due Diligence**

If we continue to be interested in the enterprise, we move to due diligence. During this step we work with the social entrepreneur to gain a hands-on understanding of the enterprise and management team. This involves intensive face-to-face meetings between SCP and the entrepreneurs and an in-depth analysis of both the financial and social plans of the business.

Generally speaking, the most important factor that we test for is the capability of the management team. Certainly we may wish to confirm that the business and social models are strong. But above all else we are testing whether the team behind the project can actually pull it off.

Successful companies tend to have a great leader who is responsible for driving the vision of the business. This person should be supported by a strong team of employees, advisors, and community partners who combine skills on both the business and social bottom lines.

Unsuccessful companies are often run by teams who see the business as a side project or as a consulting engagement. Other warning signs include the lack of financial expertise on the management team and poor financial monitoring and reporting systems.

**Step 4: Alignment & Deal Structure**

One of the most important ways to ensure the success of a relationship between SCP and a portfolio organization is to gain up-front alignment between our respective business and social mission issues.

SCP works closely with its portfolio organizations to help them thrive. When the portfolio organization is located in a distant community, SCP relies on its partner to understand the unique needs of that particular community. Therefore, SCP insists on gaining this alignment not only with the management team but also with potential employees, board members, community partners, and other stakeholders.

*Just as a private sector company can choose from a myriad of financial instruments, a social enterprise must have access to different forms of capital, depending on its needs...*
To do this, we discuss and define mutual goals. Of course, unlike a traditional venture capital organization, SCP stipulates performance in terms of both financial and social goals. The social goals often include a commitment to outcome measurement, to hiring a certain proportion of employees from a target population, and to providing a certain level of social support for employees. We also negotiate the fine points of the financing such as the structure and terms of the agreement.

Once we get to this step in the process we are generally quite interested in making an investment. Nevertheless, a deal may get derailed by a lack of strong support from the board of directors or other key stakeholders for the terms that we are suggesting, or by the discovery of significant misalignment between the goals of the company and those of SCP.

Step 5: Investment & Ongoing Working Relationship
Once alignment has been assured and the deal has been structured, we make the investment and the ongoing working relationship begins. Throughout the relationship SCP provides hands-on support to portfolio organizations in several areas such as strategy development, social outcome measurement, finance, public relations, and marketing. We offer this support through our staff and through partnerships with such organizations as The Monitor Group, a management consulting firm that provides pro-bono support to some SCP portfolio companies.

SCP also becomes involved in the governance of the enterprise. We take a seat on the board and receive regular updates on both the financial and social outcomes.

Step 6: Monitoring & Reinvestment
Like most venture capital organizations, SCP prefers to arrange financing in rounds. Receipt of each subsequent round of financing is based on the ability of the enterprise to meet the social and financial goals upon which we agreed. These goals can be adjusted to allow for unforeseen circumstances, but a successful track record is necessary to obtain future rounds of financing. We may also encourage a company to find additional financing sources in order to reduce the dependence on SCP.

Challenges Facing SCP & the Social Enterprise Sector
During the relatively short time that SCP has been operating we have identified several key issues that appear to govern the speed at which social enterprises grow in Canada. We are far from having all the answers, but we have been around long enough to perceive some important and challenging trends.

A Dearth of Great Social Entrepreneurs
People who have spent their lives in traditional private sector organizations often underestimate the skill and effort required to work in a charity. In the same way, it seems that charities and CED organizations often underestimate what it really takes to start a business. Some organizations expect to simply “hang out their shingle” and start making money.

The fact is, entrepreneurs eat and sleep at their business in the early stages. They have a visceral understanding of their products, they skillfully manage their employees, and they know where every penny is at every moment.

Our early experience has taught us that running a social enterprise is among the most challenging jobs in our economy. To do this job well one must have all the business skills and dedication of a private sector entrepreneur combined with the patience and emotional IQ of a social worker. Moreover, a social entrepreneur must be willing to take on the overwhelming workload required to start and grow a business without the prospect of a financial payback that is afforded a traditional entrepreneur.

This combination of skills and desires is exceedingly rare in our economy yet the success of a social enterprise often hinges on finding such a person.

It will be crucial to use government money as a springboard to financial vehicles that will help attract other, non-government investors to the sector & meet the unique capital needs of social enterprises.
Thus, we believe that one of the single most important roles that SCP and other CED funding organizations can play is to provide incentive for those rare social entrepreneurs to get into the game. SCP is working on several ideas around how to engage these individuals, but we are far from having all the answers. Needless to say, we believe that funders and CED organizations must get creative about where they look for talent and about how they support and compensate these entrepreneurs when they find them.

A Lack of Sophisticated Business Models
A second challenge that we see in the Canadian social enterprise market is a lack of sophistication around the types of business model being employed. In order for a social enterprise to be successful it must generate a competitive advantage that goes beyond “social marketing,” that is, selling on the basis of the enterprise’s social goals.

Too often, we are approached by organizations looking to start a business in a crowded or inhospitable market where they have little or no competitive advantage beyond their social mission. It is difficult to see how such businesses will ever gain scale or sustainability.

Certainly, social marketing has some potential. However, in order to be successful in competitive markets over the long term, social enterprises must have a business model that creates advantage by leveraging unique assets or competencies.

We have seen some great examples of businesses that use the unique assets of their community to create successful and scalable businesses. In our portfolio, Inner City Renovations of Winnipeg (ICR) forged partnerships with nonprofit housing corporations to create a foundation of revenue and a strong track record upon which the company could build. In another example, Renaissance of Montréal matched the needs of low-income customers for affordable, quality clothing and appliances with its mandate to find jobs for individuals with employment barriers to create a successful thrift store chain.

This is not to say that a good business model is sufficient to make an enterprise successful. Both ICR and Renaissance have other challenges that continue to threaten their sustainability, not the least of which is balancing the unique demands of the social mission with the bottom-line requirements of a business. However, each has the opportunity to survive and grow because they employ a business model that plays to the strengths of their employees and their community. In other words, a good business model gives your enterprise a fighting chance.

Limited Sources of Capital
A great deal of conversation in the CED sector today revolves around the availability of capital for CED initiatives. Needless to say, in order for social enterprises – and other CED initiatives – to thrive they need patient capital. Several organizations (including CCEDNet) are working hard to ensure that the money earmarked for the Social Economy in the 2004 federal budget gets used in a way that has a positive, long-term impact on the sector. SCP continues to support these efforts.

In our opinion, what is important about this discussion from a social enterprise perspective is that we look not only at the amount of money available and how it is distributed but also at the types of financing vehicle that are ultimately facilitated.

We believe very strongly that there must be a full spectrum of financial vehicles available to social enterprises and CED initiatives. In the same way that a private sector company can choose from a myriad of financial instruments such as bank loans, venture capital, and private and public equity, a social enterprise must have access to different forms of capital, depending on its needs (e.g., unique types of grants, loans, and equity). We also believe that this financing must ultimately come from a variety of different sources.

Thus, it will be crucial to use government money as a springboard to create new financial vehicles that will help attract other, non-government investors to the sector and meet the unique capital needs of social enterprises.

Social Capital Partners was created to be one of these new financial vehicles and to help fill at least one of the gaps in the social capital market. We are still in the early stages but we do believe we are breaking some new ground along the path to a more vibrant social enterprise sector in Canada.

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(left & previous page) Inner City Renovations, Winnipeg. SCP has supplied ICR with $75,000 in equity and $25,000 in unsecured debt to enable it to build towards breakeven. Photocredit: Milestone Project Management.