

The Five Critical Factors of Social Enterprise Profitability

Social Capital Partners

Summary

What are boards, investors and management teams to do when there is tension between the financial and social bottom lines of social enterprises? And are there ways of optimizing the financial performance of the business without negatively impacting the social performance?

This article describes some of the learning Social Capital Partners has gleaned from seven years of investing in employment-based social enterprises. We identify what we believe to be the five most important factors that determine whether a social enterprise will be profitable or require some form of subsidy.

Introduction

Employment based social enterprises are a unique business model with 2 bottom lines --- the social bottom line of helping disadvantaged populations find meaningful work that can lead to a sustainable livelihood, and the financial bottom line of running a viable, sustainable business that provides valuable products and services to an appreciative customer base for a healthy financial return.

But what are boards, investors and management teams to do when there is tension between these two bottom lines? And are there ways of optimizing the financial performance of the business without negatively impacting the social performance?

In this article we attempt to use the learning that Social Capital Partners (SCP) has gleaned from seven years of investing in employment based social enterprises to help answer these questions. We identify what we believe to be the 5 most important factors that determine whether a social enterprise will be profitable or require some form of subsidy and divide these factors into two sub-groups:

- 1) the “business” factors -- those factors or choices that normally only affect the financial bottom- line; and
- 2) the “trade-off” factors --- those factors where optimizing the financial bottom-line will negatively impact the social bottom-line and vice-versa.

We have also provided a framework and some tools that can help boards and management make conscious choices with respect to these factors that hopefully will create better alignment between the social objectives they have and the financial constraints they must operate under. By using this framework we hope that all critical stakeholders will have more realistic upfront expectations on what a given employment based social enterprise can accomplish on each of its bottom lines.

The Five Factors

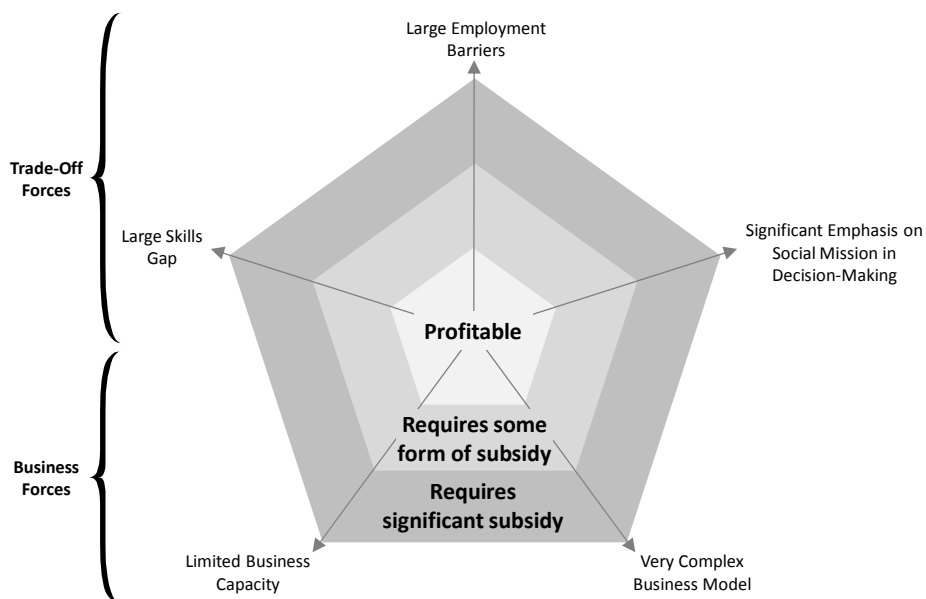
There are obviously many choices or factors that influence the financial performance of a social enterprise, but it has been our experience that the following five in particular have a disproportionate impact on its financial success:

- 1) The inherent business capacity of the social enterprise;
- 2) The complexity of the business;
- 3) The size and nature of the employment barriers of the people being hired;
- 4) The skills/training gap which is the difference between the skills of the people being hired and the skills required to make the business successful; and
- 5) The degree of emphasis on the social mission in the day to day decision making process.

The first two of these factors we refer to as the business factors because they usually affect only the financial bottom line of a social enterprise and not the social bottom line. The last three factors we refer to as the trade-off factors because optimizing the financial performance of a social enterprise with respect to these factors will generally involve a reduction in the social outcome and vice-versa

We have attempted to illustrate the financial impact of these factors in Figure 1 below. A certain set of choices with respect to these factors will significantly increase the probability that the social enterprise will be profitable while a different set of choices will virtually guarantee that the business will need some form of ongoing subsidy. We will be referring to this diagram throughout the article. Our belief is that the boards of a given social enterprise should consciously choose where to position themselves on this web given their financial situation and social objectives and make choices to achieve the desired outcome.

Figure 1: Profitability / Subsidy Spider Web



The Business Factors

1) *Inherent Business Capacity*

Our belief is that, all other things being equal, social enterprises with significant business capacity will perform financially better than those with limited business capacity. That seems like an obvious enough conclusion, but it is one that often is either implicitly or explicitly discounted by charities or non-profits starting a social enterprise. There is sometimes a perception in the non-profit world that starting a business will automatically result in a profit and that management who have demonstrated the capacity to operate a non-profit successfully will automatically demonstrate that same capacity in a social enterprise. It doesn't always work that way.

What do we mean by inherent business capacity? First of all we would divide it into two component parts – the operating capacity and the financial capacity. By operating capacity we mean that management possesses all the requisite skills to successfully run the business. That means its management and personnel know how to source its product or service, how to add value to it in a way that its customers will pay for, how to sell and market it profitably, and how to recruit, train and motivate quality employees. By financial capacity we mean that the business always knows its financial situation, has good controls over its assets and liabilities and has the ability to raise capital to finance its growth. In general a social enterprise (or for that matter any business) has to be good at both in order to be financially successful.

The good news for non-profits contemplating starting a social enterprise is that even though they won't necessarily have the requisite operating capacity internally to run the business it is not that hard to acquire. It's been our experience that there is a pool of management talent that wants to find more meaning in their career and is intrigued by the idea of managing a business with a social purpose. The bad news is that often these people cost more than the non-profit is used to paying and many non-profits are reluctant to hire people from outside their organization that they might have to pay significantly more than their executive director. Unfortunately, often that means they hire people who are not as qualified and lack the relevant industry experience and then are disappointed when the social enterprise doesn't perform financially as well as they expected.

Having the appropriate operating capacity, however, will not ensure financial success. A social enterprise (or for that matter, any enterprise) must have the appropriate financial capacity as well. There is a saying that businesses are just as likely to go bankrupt from too many sales as from too few. That's because uncontrolled growth when a company does not have good controls over its assets and liabilities and is not on top of the cash flow impact can easily destroy it, even when it is producing a high quality product or service.

An investment we made in a café, catering and food services social enterprise was a good example of this principle. It was managed by a very talented former executive chef from a large hotel chain who, along with his team, consistently produced high quality food offerings that its customers valued and enjoyed. It had the requisite operating capacity. It didn't however, have solid financial systems in place.

Its problems began when its growth took off. The company landed a couple of large contracts and the number of employees tripled over a three-month period. This kind of growth is challenging even for a company with a very solid financial foundation in place – it can be back-breaking for

one with a poor foundation. The company did not have good controls over its assets (food being the primary one), could not produce timely, accurate financial information to aid its pricing decisions, and couldn't accurately forecast its cash flow. Management actually believed the company was doing well when in fact it was financially imploding. It didn't have the requisite financial capacity to know that it was suffering serious losses on its increased business so that, by the time the true picture was understood, the company was in receivership.

2) Complexity of the Business Model

By complexity of the business model we essentially mean the degree of difficulty involved in operating the business successfully. Does it require specialized industry knowledge or expertise? Is the quality of the product or service being offered of significant importance to the customer? Is there a high degree of customization required in making the product or delivering the service? Does it need specialized systems to operate effectively? The more "yes" answers to questions such as these the more complex the business will be to operate and the more difficult it will be for a given social enterprise to be financially successful.

An example of a complex business model in our portfolio is Inner City Renovation (ICR). ICR is a renovation company that renovates housing and commercial projects in Winnipeg. It's a complex business for a whole host of reasons. For instance, every renovation job is different and so there is a high degree of customization required; to win business involves submitting a fixed price bid which requires a significant expertise in costing a job and then executing based on those costs because the business can't afford surprises. Virtually every job involves sub-contracting portions of it to qualified electricians and plumbers that have to be priced appropriately and managed so they deliver their services exactly when required, the quality and timing of the work is of huge importance to the customer and there are significant negative repercussions to the business if these expectations are not met. The point is that this is a difficult business to operate successfully and requires specialized knowledge and expertise to do so.

This factor is strongly correlated to inherent business capacity. The more complex the business model, the more essential it will be for a social enterprise to invest in the hiring of external resources with specialized industry knowledge and expertise. It will be very risky for the business to do otherwise. At ICR, individual renovation jobs are managed on-site by foremen who have years of experience in the construction industry. This is obviously not a business where a non-profit starting a social enterprise could simply hire some of its own best staff to operate it.

One way that some charities and non-profits have chosen to reduce this complexity factor is by partnering with franchisors. Recently we have been following that strategy at Social Capital Partners (SCP) as well. Franchising is essentially a way of turning what otherwise might be a complex business model into a "cookie-cutter". In return for paying a franchise fee, the franchisee receives a systematized business model that they don't have to figure out themselves.

Ben and Jerry's Partner Shops are a good example of this. They offer charities that want to provide employment opportunities for at-risk youth the opportunity to operate a Ben and Jerry's franchise without being charged a franchise fee a win-win for both parties. It makes sense for Ben and Jerry's because community service is part of their mission, it enhances their reputation and they still can make money through the provision of the ice cream that's sold by the charitable social enterprise. It's also a great deal for the selected charities as the franchise model significantly

reduces the financial risk by reducing the business complexity. It effectively allows them to operate near the centre of this strand of the web in Figure 1.

The Trade-Off Factors

3) Size and Nature of Employment Barriers

The social purpose of employment focused social enterprise is to employ disadvantaged groups. The mission is to enable them to acquire real-life skills that allow them to become economically successful members of society. Obviously there are wide differences in the definition of “disadvantaged” as well as huge variations in the job-readiness of different segments of these disadvantaged populations. The choice that a social enterprise makes of which type of disadvantaged population to hire and their relative job-readiness will have a large influence on whether the social enterprise will be financially successful.

For instance, it is generally harder to make a business work if the target employee group is “at-risk youth” than if it is new immigrants. Intuitively this makes sense. At-risk youth have very limited job experience and often have unstable family and housing situations. That’s a difficult combination to immediately transform into a successful, productive, performing employee. New immigrants, on the other hand, often have years of successful job experience in their home country and usually more stable housing and family situations. What they lack sometimes are the necessary language skills as well as a local network to help them identify relevant job opportunities. These are often easier difficulties to overcome in terms of becoming a productive employee more quickly.

The job-readiness factor within a given target employee group is also a very important factor in the likely financial success of the business. For instance, within the at-risk youth population, there will be some that have overcome many of the barriers mentioned above and all they really need is to be given an opportunity in the form of a job to set them on the right course. There will be others who still have multiple barriers to overcome. It is obviously easier to have a financially successful business (one closer to the centre in Figure 1) if the employees hired are from the job ready segment of a given disadvantaged population rather than ones with multiple barriers still to overcome, however; it would be a greater social success story if people with multiple employment barriers were the ones being successfully employed (meaning positioning the company more to the outside on Figure 1). These are the trade-offs that stakeholders of social enterprises must think about in deciding who they employ.

4) The Skills/Training Gap on Hire

This factor refers to the inherent difficulty of the job for which the target employees of the social enterprise are being hired. The more difficult the entry-level job is, the more training that is required before an employee reaches an acceptable level of productivity. A significant training requirement obviously will have a negative impact on profitability.

This factor is a prime example of the kinds of trade-offs social enterprises face in deciding where to position themselves on the web in Figure 1. It is easier to make the business financially successful if the jobs being hired for are what are sometimes referred to as “McJobs.” In such cases, the gap between the skills of the people being hired and the skills needed to make the business work are not huge and so an employee can meet the required performance standards fairly

quickly. However such jobs are not nearly as beneficial from the social mission perspective because the skills the employees are learning are not highly valued in the real world and so, arguably, they are not making significant progress towards economic independence.

In SCP's portfolio, we have examples of businesses with different skill gaps. TurnAround Couriers is a bicycle company that employs at-risk youth recruited directly from youth shelters. There is not a huge skills gap or training requirement in this business – the youth can be taught relatively quickly the skills needed to perform their jobs well. That makes it easier to make the business financially successful.

On the other hand, Inner City Renovation (ICR) in Winnipeg is a renovation company that employs urban aboriginals – the majority with limited formal education or skills training. In this business, there is a much longer training period needed before an employee can master the skills required to achieve similar productivity levels to employees in more traditional renovation companies. As a result, Inner City Renovations endured high start-up losses in its early years as this skills gap was being bridged.

Perhaps the optimal situation for a social enterprise is where it can offer entry-level jobs where the training requirements don't require a huge up-front investment as well as providing attractive career opportunities for their employees where, over time, they can learn new skills and earn significantly more income than is possible in the entry-level job.

A good example of this in the SCP portfolio is the Active Green + Ross franchises that we finance. Active Green + Ross is a car service company. An entry-level employee (in this case mainly at-risk youth) does not need significant training in order to perform basic tasks like changing oil. That means that the business does not need to make a disproportionate investment compared to their competitors to make their entry-level employees productive. Yet, over time, the entry level employees can work their way to becoming a licensed mechanic which requires significant skill and provides attractive compensation and long-term financial sustainability. This is the best of both worlds scenario – attractive job opportunities without disproportionately high “skills gap” investments.

5) Degree of Emphasis on Social Mission

Employment focused social enterprises are double bottom line businesses with both a social mission (provide work for disadvantaged groups and significantly improve their long-term employability prospects) and a financial mission (generate revenue through the sale of products and services). As we have seen in the discussion of the previous two factors, the management of social enterprises often face choices that promote one mission at the expense of the other. This final factor refers to the degree to which the management of a given social enterprise chooses to consistently emphasize the social mission over the financial mission in its day-to-day decision making (or vice-versa). Their bias on this factor will significantly affect the financial performance of the company.

There are numerous examples in a social enterprise where these tough choices come into play. For instance, how many chances should an underperforming employee receive before being let go? From a social mission perspective the whole point of the employment strategy of the business is to hire people who need extra support and training in order to be effective employees. This would dictate a very lenient policy with respect to termination. On the other hand, the business suffers if

after multiple opportunities a given employee is not able to perform his or her responsibilities effectively. Moreover, if there are no consequences to consistent poor performance it sends a message to all employees that performance is not important, which is obviously not an appropriate way to prepare employees for their long term economic independence and success. This would dictate a less liberal termination policy. There are not right or wrong answers to issues like these. The point is the degree to which an enterprise has a social or financial bias in its choices will affect its profitability.

An example of an issue where SCP (along with our partner Community Ownership Solutions¹) was required to make a choice between the financial and social missions of a business happened with ICR. In its initial year of operation ICR lost more money than we planned. We decided in order to improve its future financial performance we would reduce the percentage of target employees in the company from 75% to 50-60%. In effect, we reduced the number of employment opportunities inside the company for the people we were trying to help. It did succeed in improving the financial performance, but, at the expense of the social mission. Strategically we wanted to move ICR more to the centre of the web and that necessitated the requirement to make choices that emphasized the financial over the social where those choices involved trade-offs.

Positioning in the Profitability/Subsidy Spider Web

The decisions that social enterprises make with respect to these five factors will determine where they will be located on the web in Figure 1. Social enterprises that are located near the outside edge of each of the five factor “strands” will require substantial ongoing subsidy if they are going to continue to operate. Training businesses or workshops that hire people with significant employment barriers and large skills gaps are examples of the types of businesses found here. The objective of these businesses usually is not to make money – it’s to provide a sense of dignity, pride and purpose to people who are unlikely to be able hold a full-time job in a more conventional company. This overriding goal takes precedence over making the business financially successful and so there is a bias to the social goals in most business decisions.

Social enterprises at the centre of the web, however, can and should be financially self-sufficient. They are hiring the job-ready segment of disadvantaged populations, people who are ready to help themselves but just need someone to give them a chance. The entry-level positions are not overly challenging and thus don’t require a massive investment in training and support before employees can be productive. Moreover, they have management teams with the requisite business capacity to succeed in a business that is not overly complex to operate. They are also prepared to sometimes choose the financial bottom-line over the social bottom-line when difficult trade-offs have to be made.

Lessons from Business Factors

The distinction between the business and the trade-off factors is crucial to understand because it is much easier to advise boards of directors and management teams on the best way to think about the business ones. Simply put, our advice is to do everything possible to choose businesses that are not overly complex to operate and to build management teams that have the inherent business capacity to operate them effectively. Put another way, our advice would be to try to be as close as possible to the centre of the web with respect to these two forces.

¹ Insert background reference to Community Ownership Solutions – perhaps even an online reference
socialcapitalpartners.ca

Why is this advice easy to give? There are three reasons:

1. Unlike with the trade-off choices optimizing the financial results of the social enterprise with respect to these choices does not come at the expense of the social mission. For instance, there is no social compromise required when a social enterprise moves closer to the centre of the web in Figure 1 by improving its inherent business capacity. However, there is a social cost involved if it does so for instance by hiring a lower percentage of target employees or choosing only job-ready target employees. Any social enterprise looking to improve its financial performance should first exhaust improvement opportunities from the business forces.
2. Social enterprises are easier to scale if the business model is not overly complex and good systems are in place. A frequent implicit criticism of the social enterprise, is that the business models are difficult to scale and replicate. Often the reason is because of these business forces. If a business lacks good systems, and is complex to run or has a management team without experience and knowledge of the industry it is going to be more difficult to grow. Less complex models and good management teams will make scaling and replication much easier.
3. Having good management with relevant industry experience in a less complex business model means that the board of directors and management can spend more time on making the social mission work. Whenever we have invested in social enterprises without those characteristics we have spent a disproportionate amount of board and management time on getting the business to work as opposed to the social mission of creating long-term sustainable livelihoods for the people employed. Ironically by optimizing the business forces more time and effort gets devoted to the social mission.

Lessons from the Trade-Off Factors

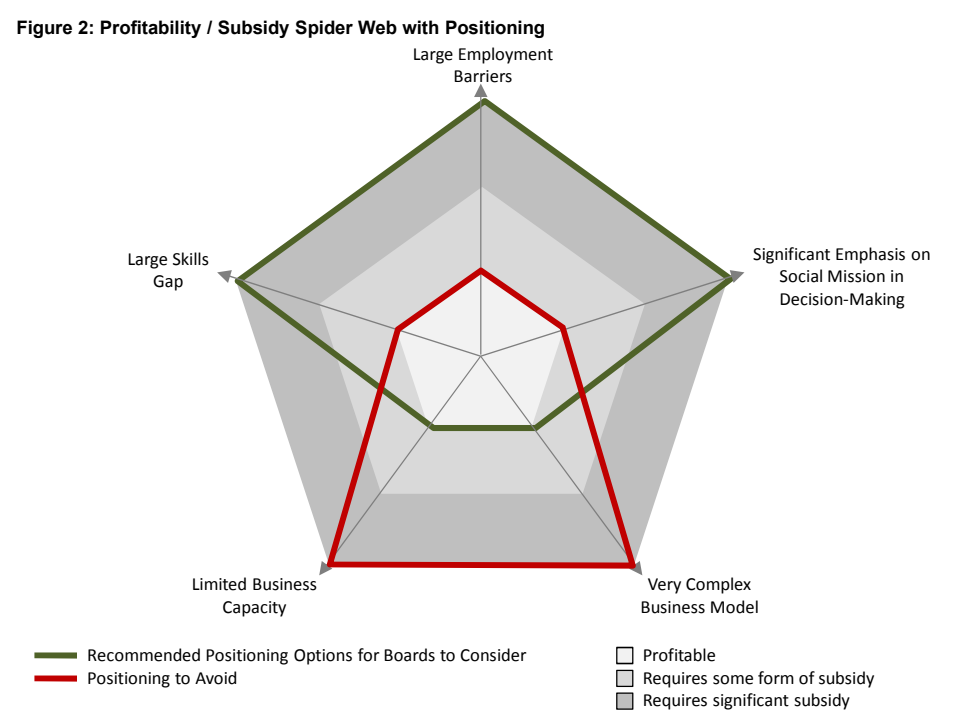
The advice we would give with respect to the trade-off forces is much more difficult because we don't believe there is a "right" answer. As we have suggested in the name, the very nature of these factors usually involves making progress on one part of the mission at the expense of the other. It is up to the board and management to determine the right balance.

The one piece of advice we do feel safe in giving is that the board can and should make conscious choices about these trade-offs and understand the likely consequences. The choice will often be dictated by the financial goals and constraints that the social enterprise is operating under. If the board determines the company has to be financially sustainable then it should make choices with respect to who it hires, the types of jobs provided and the degree of influence of the social mission consistent with the centre of the web. If, on the other hand, the business can be subsidized it can make a different, more "social" set of choices consistent with the outside.

One other critical point is that an understanding of these issues allows boards and management to check for alignment in their strategy and goals. For instance if they want their social enterprise to be profitable yet they plan to hire people with significant employment barriers into difficult jobs in a complex business without having significant business capacity, they are going to be disappointed. In effect their financial goal is to position the social enterprise at the centre of the web when an analysis of the five factors indicates they will definitely end up on the outside.

We try to illustrate these recommendations in Figure 2. The red dotted circle represents the viable positioning options that we believe the boards of social enterprises should consider when determining their strategy. Whether they are more towards the centre or the outside edge should be influenced by whether they must be financially sustainable or can be financed with some form of subsidy.

What a board wants to avoid is positioning their social enterprise in the green circle. This can happen almost inadvertently with a complex business model and where the management team possesses limited business capacity. Often this leads to the board trying to improve their disappointing financial results by financially optimizing the trade-off choices by hiring fewer target employees with fewer employment barriers into less skilled jobs. They effectively dilute the social returns of the business instead of improving the financial performance by improving their business capacity and or simplifying their business model.



Social Enterprise Scorecard

One of the tools we now use to help guide our investment decisions and to ensure they are aligned with our strategy is shown in Table 1. On this social enterprise scorecard we assign a ranking of 1 to 5 to each of the 5 choices (actually shown as six in the Table as we score separately the operating and financial capacity) as a way of predicting the likely financial success of a potential investment. As you can see from the Table, a lower score on each of the factors increases the likelihood that the social enterprise will be profitable. As a guideline we believe a cumulative score of 10 or less means the business will be profitable, 11-15 indicates some form of subsidy will be required and higher than 15 should necessitate a significant subsidy.

Because it is our goal at Social Capital Partners to invest in profitable social enterprises, we now try and invest in businesses that score 10 or less on this grid. We have always believed profitability

to be critical for social enterprises to grow significantly and attract enough financing to make the social enterprise model less of an anomaly and more of a mainstream way of doing business. We are therefore willing to trade-off some social returns (hiring people with large employment barriers for instance) in favour of profitability in our investment decision-making.

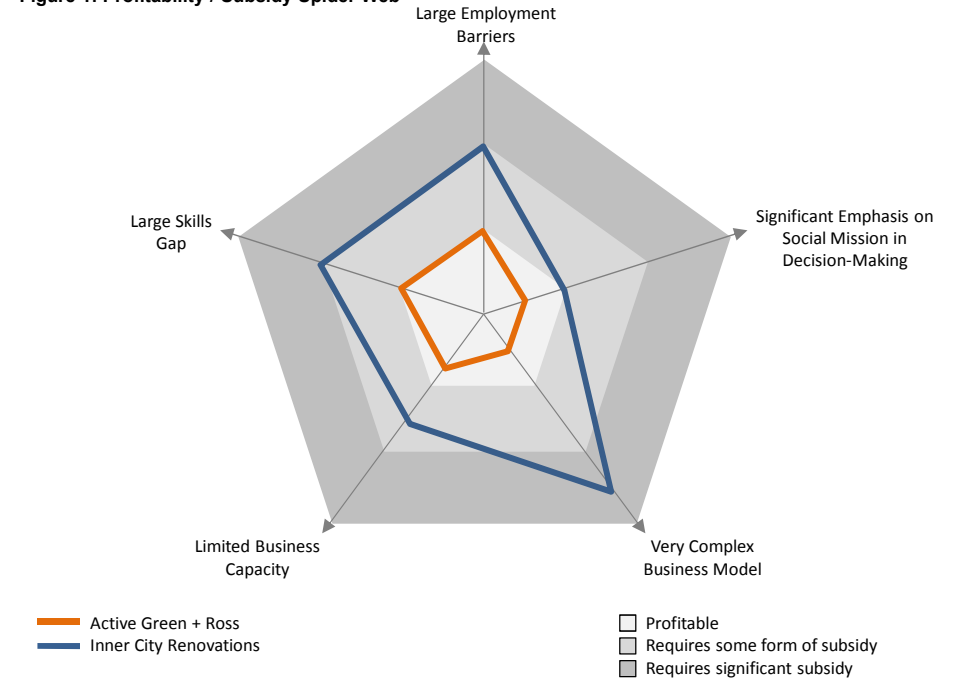
In the table we compare our “score” from the very first social enterprise investment we made in Inner City Renovations before we had a real understanding of the five factors to our most recent one in a franchisee of Active Green and Ross. As you can see from the table the Active Green and Ross franchise scores significantly lower on our scoring grid suggesting that it has a much higher probability of being financially profitable and fits our requirement of scoring 10 or less.

The Inner City Renovation score of 21 means that it would no longer fit our investment strategy. That doesn't mean it isn't a successful social enterprise. In fact, it's been hugely successful. It now requires only a small subsidy, has provided meaningful employment to the urban aboriginal population in Winnipeg and has changed numerous lives for the better. It has proven to be much more cost-effective than other strategies the government has deployed to help this population. It's just that we are clearer about our investment strategy now and thanks to the tools we have described in this article it's easier to align our investment decisions with our strategy.

Table 1. Social Enterprise Profitability Grid	Active Green + Ross	Inner City Renovations
Social Mission Factors		
1) Employment barriers 1 = slightly barriered 5 = highly barriered	2	4
2) Skills / Training Gap 1 = negligible 5 = significant	2	4
Financial Mission Factors		
3) Business Model Complexity 1 = systems in place / proven model 5 = complex business / start-up	1	5
4i) Operational Capacity 1 = strong 5 = weak	1	3
4ii) Financial Capacity 1 = strong 5 = weak	2	3
5) Emphasis on Social Mission 1 = difficult trade-offs made or profitability matters 5 = social always wins	<u>1</u>	<u>2</u>
AGGREGATE SCORE ?12 Should be profitable 13-20 Likely to require subsidy >20 Likely to require significant subsidy	9	21

This is shown more visually in Figure 4 below. Here we have plotted the scores of AG&R and ICR on the Profitability/Subsidy Spider Web. AG&R's scores on each of the strands are low enough to keep it in a reasonably tight area around the centre. Plotting ICR's scores on the web results in it covering a much wider area. The smaller the circle the more likely a social enterprise is to be profitable.

Figure 1: Profitability / Subsidy Spider Web



Conclusion

We hope we have conveyed in this article, that as in conventional business, the financial results of an employment focused social enterprise are not random. Instead, they are significantly influenced by the choices related to five critical factors that every employment focused social enterprise must make. We believe one of the most important responsibilities of social enterprise boards, investors and managers is to make choices with respect to these factors wisely and consciously.

Those choices are not that difficult to make (although they can be difficult to execute) with respect to the two business factors we have identified. In almost every case it will be sensible to improve the organization's business capacity and to systematize it wherever possible which should improve its financial results. The choices with respect to the three trade-off factors we have identified are more difficult to make because there is no "right" answer. The most appropriate choice for any given organization will depend on its social goals and the financial constraints under which it operates. Hopefully this article has provided the framework and some tools to make those difficult choices easier to make.

We don't believe that this framework is a finished product. The factors we have identified are based on our learnings from the social enterprise investments we have made over the last seven years. We expect these findings will continue to evolve and, more importantly, that other organizations in this field can help refine this model to make it more useful. Ultimately we believe we will all be better investors and operators of social enterprises if we make conscious choices with respect to the tradeoffs between the financial and social missions of the business and we finance them accordingly.