How Can Early Stage Social Businesses be taken to the Next Level

Dasra

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As the idea of social businesses has gained traction in recent years, more funding has become available to invest in market based solutions to some of the most pressing social issues. In November 2010, J.P. Morgan and the Rockefeller Foundation released a report which estimates that the impact investing industry presents an investment opportunity of between US$400bn and US$1 trillion with profit potential between US$183bn and US$667bn. Yet in their observations from the 2011 World Economic Forum’s Global Agenda Council on Social Innovation, the Schwab Foundation pointed out that at this stage “the market is not ready to absorb commercial capital on anything close to the order of magnitude being talked about”. At

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1. Impact Investments: An Emerging Asset Class, J.P. Morgan, November 2010
the same time, according to Beyond Profit Social Enterprise, 50% of social businesses do not find funding due to lack of a firmly established business models, lack of knowledge on how to fundraise, inability to find like-minded investors, and a lack of investors who are willing to fund startups\(^3\). Asad Mahmood summed up the situation by pointing out that “there are fairly limited investable ventures”\(^4\).

There is a clear mismatch between two sides of the social enterprise spectrum—investors and entrepreneurs. Understanding what makes an early-stage social business investable and where the biggest gap between entrepreneurs and investors lies is the primary goal of this research paper. To understand this gap and which are critical areas that can bring both sides closer, this paper draws on Dasra’s 7 years of experience running the Dasra-Social Impact accelerator program. In particular it draws on Dasra’s experiences administering the Village Capital peer-funding model for each of the Dasra Social-Impact cohorts. Village Capital presents a unique opportunity to gain some insight into how entrepreneurs make investment decisions. Social entrepreneurs are given the freedom to make allocate investment to one or more of their peers, much like microfinance. The underlying principle is that entrepreneurs will apply an evaluative framework to their peers that will enable them to allocate funding to the most profitable and investable organization, as would an investor. However, our interactions with various institutional investors have shown that an entrepreneur’s and investor’s perspective on what makes a business ready to absorb capital are not aligned. Through our research, we found four key areas that are prospective avenues for further work to build the social enterprise and impact investing ecosystems:

1. Risk/return profiles make early stage social impact investments rarely attractive to investors within a relatively mature market due to long due-diligence and post-investment needs.
2. Entrepreneurs are aware of the broad investment criteria, but lack clear understanding of investor needs and capacity to address them. Specific challenges depend on entrepreneurs’ background, but there are trends.
3. The disconnect between entrepreneurs and investors occurs in their divergent understandings of five major areas: types of funding available vs. required; the degree of social impact; exit options; business models; human resources and governance.

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\(^3\) Beyond Profit Social Enterprise Magazine, 2010
4. If intermediaries can effectively build the capacity of entrepreneurs to become investment-ready, then the large potential pool of funds that are available for impact investments can be realized.

Methodology
Dasra spent four months leveraging its experience in working closely with early stage social enterprises as well as investors to map and synthesize the different perspectives of both these groups on what makes a social enterprise attractive to investors. Our approach consisted of a literature scan of seminal works on impact investing globally and in Asia, and interviews with early stage social entrepreneurs and investors.

- **Secondary Research:** In recent years, several key reports by Monitor Institute\(^5\), J.P. Morgan and Rockefeller Foundation\(^6\), Avantage Ventures\(^7\), etc. have provided valuable insights into the need for investment in social enterprise, estimated market sizes and potential returns on investment, and provided clarity on how investors can approach social impact investing. Our research scan found a disproportionate amount of literature on impact investing globally as opposed to the reality of social entrepreneurs looking to tap into global flows of capital directed towards impact investing.

- **Primary Research:** To understand this issue, we sought out first-hand perspectives from entrepreneurs and from investors, as well as from intermediaries operating in the social impact space. By leveraging Dasra’s network of investors who have invested in social businesses in India, we studied the criteria for a business to be considered investable, the key challenges in identifying those businesses, as well as some signs of increasing support provided by investors in helping companies achieve “investment-readiness”. On the other side, to better understand the challenges facing entrepreneurs in the fundraising process, we leveraged the network of alumni from Dasra Social Impact, an executive education program that provides successful non-profit and social business leaders with skills necessary to scale their organizations.

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\(^5\) *Impact Investing for Social & Environmental Impact*, Monitor Institute, January 2009  
\(^6\) *Impact Investments: An Emerging Asset Class*, J.P. Morgan, November 2010  
\(^7\) *Beyond the Margin: Redirecting Asia’s Capitalism*, Avantage Ventures, 2011
Dasra conducted interviews with
- Over 15 impact investors
- 4 Village Capital winners
- Over 30 social entrepreneurs participating in the Dasra Social Impact program designed to provide training and mentorship support to social enterprises

An online survey of 60 social entrepreneurs on challenges faced in growing their organisations and raising capital. The survey disseminated via the internet. Dasra crafted a set of five questions to understand what were key challenges to scaling, how these were ranked and what are critical success factors that would enable an organization to grow and scale.

**Data Analysis:** Bringing together data from investor interviews, and entrepreneur interviews and surveys enabled Dasra to compare different perspectives on investment readiness. By contrasting growth constraining areas identified by social businesses with challenges faced by investors when considering organizations for investment, we were able to identify underlying philosophical divergences within each stakeholder group and clarify the key areas on which both groups are mismatched. The case studies provide insights into what can be done to overcome these mismatches.

**Articulating Investors’ Perspectives**

Our research found that investors could broadly be divided into two categories- impact-first or financial-first investors. Impact-first investors put a significant amount of importance on the impact of the organization pre-investment and keep track of impact for the duration of the investment, whereas financial-first investors use impact as a lens during the pre-investment phase and then trust that the organization continues to make an impact once invested in. The most important criteria for both types of investors are the long-term success of the organization and the exit potential. Investors who participated in this research unanimously agreed that sound business models that will succeed and scale in the context of the market are imperative. Other critical factors are financing requirements, understanding of competition and customers, characteristics of promoter, team and governance structure. To ensure that all these critical factors are met, investors indicated that the due diligence process is often long and
resource-heavy. This proves to be a significant barrier considering small, early-stage investments. In addition, early stage investments require considerably greater post-investment support further increasing the cost for investors.

**Articulating Entrepreneurs’ Perspectives**

Our research found that entrepreneurs fall in two categories based on their background:

1. **Entrepreneurs from the Bottom of the Pyramid**, who have a good understanding of the challenges on the ground and can execute their models effectively, but have challenges with presenting plans to funders, business strategy and planning. These entrepreneurs tend to be closely related to their own market, clearly understand the true needs and behavior of that market and can better relate to their customers. They have credibility within the community and can drive day-to-day execution at the ground level. On the other hand, they tend to lack the professional experience needed for strategic planning and scaling of the business. This group in particular also faces the challenges of communicating on the same level as investors, and may struggle to articulate their deep knowledge of the market in a way that is convincing to the investor. In this case, both investors and entrepreneurs need to be sensitized to each other’s needs to differentiate when an answer is not available versus when it is not articulated in the same language.

2. **Entrepreneurs from private sector backgrounds**, who are have strong business skills but face challenges executing their models in the field. This group tends to be the opposite of the group described above and as a result, they may have promising technology and business skills but lack deep knowledge of the target market and presence on the ground.

Both types of entrepreneurs are often cash- and resource-strapped and as a result, short-term challenges take over long-term planning. Another critical challenge that entrepreneurs face is raising seed funding, as investors don’t want to invest in them until they have tested their model. Most often the seed funding comes from friend and family or the social business starts out as a non-profit and then transitions to a for-profit once the model has proven to be effective. The transition from non-profit to for-profit has its distinct kind of challenges, the most pressing ones being the change in governance structures, the mindset change of the organization’s team and maintaining the trust of their main funders.
Clarifying disconnects between entrepreneurs and investors

Bridging the gap in understanding between investor and social entrepreneur starts with understanding what makes an attractive social business for investors and what the challenges are that early stage entrepreneurs face. While details vary across investors and entrepreneurs, patterns emerge across five key areas where there is a mismatch between entrepreneurs and investors:

1. Types of capital available vs. required
2. The degree of social impact
3. Exit Options
4. Business Models
5. Human Resources

1. Types of capital available vs. required

In the Beyond the Margin report, Avantage Ventures identified the range of potential investments, which placed social impact investing between purely philanthropic donations and purely commercial investments\(^8\). As depicted in the spectrum below, socially responsible investments aim to avoid harm, whereas impact investments aim to actively achieve social and environmental goals. Yet even within impact investing, there is a large range of expected returns. Whereas some investors are on one end of this spectrum with a clear profit-first objective, expecting market-beating returns and defining social impact by

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\(^8\) *Beyond the Margin: Redirecting Asia’s Capitalism*, Avantage Ventures, 2011
investing in areas facilitating economic development, others focus on impact-first and aim
to recycle any return on the investment into further social investments. In many ways, the
orientation of the investor is often determined by the source of the funds and their
alternative use – investing in traditional commercial businesses or donating to non-profits.
To that extent, the post by Aleem Walji titled The “Missing Middle” and the Growth of Social
Enterprises roughly divides the capital available into three camps – impact-first, profit-first,
philanthropical capital.9 The orientation of the investors also determines their return
expectations, and the time horizon for the return expectation.
Social entrepreneurs express facing difficulty in accessing start-up capital with a
combination of grants, debt and equity. In our survey of over 60 social entrepreneurs, 70%
cited availability of the appropriate type of funding as a key challenge to scaling their
organizations10. In the last few years, social venture capital firms have been instrumental in
providing risk capital and support to early-stage small business ventures. However, there is a
growing need for more risk-taking, longer-term capital, grants to fund proof-of-concept and
cheaper uncollateralized loans for working capital. Since many businesses are constrained by
regulatory restrictions in accessing grant funding (which non-profits can easily access), there
is a growing prevalence of hybrid models, where a non-profit and for-profit entity work
towards a common social mission. This enables social businesses to leverage risk taking
philanthropic capital to create markets, supply chains and behavior change amongst
beneficiaries. However it also creates significant complications from a governance
perspective where venture funders are not keen to fund non-profits and grant funders are
wary of subsidizing a business11.

2. The degree of social impact

In terms of assessing social impact, the prevailing sentiment across impact investors in India
is that social impact is a “by-product of scale and the enterprise”12. In fact, almost regardless
of the position on the spectrum of primary objectives, we found that most investors define
it as being ingrained in the business model and linked to key operating parameters (sales, #

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9 The "Missing Middle” and the Growth of Social Enterprises, Aleem Walji, July 2011
10 Dasra Analysis
11 Dasra Interviews
12 Dasra Interviews
of suppliers, etc.). While J.P. Morgan reported increasing usage of early industry standards in measuring social and environmental performance\textsuperscript{13}, we found that in India, investors are aware of the efforts, but any of these standards are yet to gain traction. Investors cited the length and comprehensiveness of the assessment as the key reason for not using them, not to overwhelm the already resource-strained entrepreneurs. Instead, investors across the board focus on the main drivers of impact as linked to the numbers already tracked and reported by the investees. For example, if the social benefit comes from providing sustainable jobs, impact could be linked to the number of people employed and the salaries being paid out. If the benefit is in cost-savings due to an innovative product (e.g. solar-powered lamps or remote-control irrigation system), impact can be linked to the number of devices sold and the cost-savings per device.

3. Exit Options

The investors’ focus on the exit from the investment drives a large share of misunderstanding between investors and entrepreneurs. As one of the investors we interviewed pointed out, many social impact funds have a dedicated pool of capital that has a limited lifetime in which it can be invested and recovered. In addition, the success of impact investments is measured by the ability to recover and recycle the initial investment. On the other hand, many of the investors also expressed a sentiment that the capital required to truly scale up a social business is simply not available in the impact investing space. While “patient” impact funding is available to fund the early-stage scaling and development of social businesses, eventually an organization needs to be able to achieve market returns to attract commercial capital\textsuperscript{14}. While there is still disagreement among investors as to how “patient” this early capital would be before the market returns are achieved, most investors look ahead to the exit when evaluating social businesses for investment consideration. Typically social early stage social businesses face severe challenges in attracting the type of patient capital they require. While for most investors patient capital has a timeline of 3 to 5 years, for most entrepreneurs patient capital that will allow them to scale their operations must have a 7 to 10 year horizon.

\textsuperscript{13}Impact Investments: An Emerging Asset Class, J.P. Morgan, November 2010
\textsuperscript{14}Dasra Analysis
4. **Business Models**

Assuming that a social business clearly generates impact through the core activities and we move beyond the “first hurdle”, the focus on eventual exit determines the key things that an investor is looking for in a business beyond social impact. First of these things is a solid business model in the context of the market, which is based on clear articulation of three critical components:

- **Product’s or service’s value proposition to the customer.** As one of the investors pointed out, “When we make an investment, we have a hypothesis - that there is a real need for their services, and they are satisfying this need.” Being able to articulate that need and value proposition becomes a key factor in making the business attractive to the investor.

- **Understanding of customers’ alternatives and the company’s comparative differentiation.**

- **Company vision in the context of the market size, growth and major trends in the sector.** An attractive business should be able to articulate how large its potential market is, what position and market share the business aims to achieve within that market, and what makes them believe that the market share is achievable.

In other words, an attractive business knows its target customers, understands how and why they choose to buy a particular product, and knows the market size and potential competition. These factors may not seem crucial when the company is at the early stages of development, but these factors become increasingly important when looking at the growth potential anywhere between three to seven years from now, which in turn determines the exit option at that point. One of the investors shared that in their experience social entrepreneurs tend to care too much about satisfying the immediate social need and may lose sight of the economic sustainability and longer-term vision of the business. In fact, these parameters are so important that for many of the interviewed investors, the essential part of the due diligence process involves spending time with current or potential customers on the ground and understanding their needs and alternatives.

5. **Human Resources and Governance**

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15 Dasra Interview
For investors, a key criterion that defines an attractive business is the ability of the founder and her/his to execute on the plan. Our interviews with investors revealed that the key characteristics that make an entrepreneur attractive are:

- Ability to execute vision
- Willingness to get feedback and/or change direction
- Transparency and openness to share information
- Understanding of her/his own shortcomings

In contrast, our survey of social entrepreneurs, many had correctly identified credibility of the entrepreneur and the team as key criteria for investment, but majority had attributed that credibility to factors external to the business on hand, such as education, media and prior track record. Interestingly, while the investors valued these factors (and prior track record in particular), they placed significantly more emphasis on what we can call credibility internal to the business: ensuring that the team is balanced and has a clear execution plan that distils how the organization is planning to go from their current state to achieving their vision. Multiple investors relate that when it comes to evaluating entrepreneur’s ability to execute, the critical evaluation factor is the founder’s ability to recognize his or her own weaknesses and to form a team that addresses these gaps\textsuperscript{16}. Investors are also looking for the founder’s ability to attract good individuals for their team in the process of building a strong second line of command that will eventually be running the business\textsuperscript{17}. Overall, however, when it comes to evaluating teams, the typical strengths and weaknesses of the founders tend to correlate with the nature of their background.

To that extent, forming a solid team presents its own challenges to the entrepreneur and the investor alike. This issue exists for social businesses across the world, but is particularly pronounced in the social impact sector in India, due to cultural and socio-economic factors (i.e. highly capable individuals familiar with the BoP market are more likely to join a larger corporate organization that would provide a safety net for their family)\textsuperscript{18}. It is not surprising then that social businesses themselves easily identify this issue in our survey as being one of the key obstacles to becoming investment-ready.

\textsuperscript{16} Dasra Interviews
\textsuperscript{17} Dasra Interviews
\textsuperscript{18} Dasra Analysis
Our survey respondents from all sectors emphasized the challenge of attracting talent with strong execution and management experience, especially at senior management levels. The constraints on funding and weak reporting structures further limit the ability to attract experienced people. Furthermore, there are critical skills shortages within each sector such as teachers in education, doctors in healthcare and maintenance workers in energy, which many innovators stated as an underlying challenge to scaling their impact.

In our survey, many social businesses mentioned the need for skilled mentors to assist with industry-specific expertise and business planning and management capacity building support as challenges. This type of mentoring and capacity building support often improves the attractiveness of an entrepreneur to funders.

While most social businesses report attracting a good team to be one of their most significant challenges to becoming investment ready, few are focused on the governance structure – a significant point of concern for investors, who see it as a critical hurdle to being able to scale the organization in a transparent and accountable manner. On the flipside at an early stage attracting the level of talent investors typically look for in COO and CFO roles are extremely cost-intensive and nearly out of reach for most enterprises. The issue of governance structures gains even more importance in the cases when a social business originated from a non-profit, or maintains a hybrid structure, where both entities share human resources.

Understanding the potential of the Village Capital Model to bridge the gap

We reached out to over 30 participants in the Dasra Social-Impact program who had participated in the Village Capital Peer funding exercise. Built on the same philosophy as microfinance, Village Capital places the responsibility for allocating funding within a peer group. The assumption is that the peer group will think like an investor and allocate funding to the most investable enterprise. Local entrepreneurs go through peer support programs where they get extensive feedback from one another on their enterprises, build a network to accelerate their success, and connect with investors who provide for specific investment education.

**Village Capital Winners**
The winning social entrepreneur receives an investment of $75,000 into his or her business and moves into the Dasra Social Business Portfolio.

**Village Capital Peer Groups**
Organizations divide into small working groups to share business plans, take peer feedback and decide on selection criteria for assessing the strongest business plan.

**Mock Presentations and Final Voting**
Each group finalizes business plans over the 6 month period and refines through feedback and mock presentations. During the final workshop, peer voting takes place and winners are selected for investment.

**Dasra Social-Impact**
3 week program over 6 months – intense training, brainstorming, networking to create and deliver a business plan for growth and skill to start on the journey to deliver the plan.
Dasra Social-Impact piloted the Village Capital model for the first time in 2009, which resulted in two $75,000 investments in businesses working in rural India – Sabras and UTMT. The Village Capital funding competition is explained in the diagram on the right. Social entrepreneurs spend six months going through a program of hands-on assistance to create the winning business plan. During the program, social businesses receive inputs from mentors and peers:

- Creating a theory of change to understand and demonstrate social impact
- Understanding scaling capacity
- Articulating business model to investors
- Creating an investor-focused financial and HR model to deliver model at scale
- Building and developing a network

According to Village Capital, the final ranking should be transparent and should evaluate the enterprise according to the following criteria:

- Entrepreneur/team
- Profitability of the venture
- Sustainability of the venture (cash flow/burn rate/how long will it last)
- Investability of the venture (what are exit opportunities for the investor)
- Social impact

However, our conversations revealed that all entrepreneurs who participated in these funding decisions almost unanimously reported to allocating funds to the highest impact enterprise, as opposed to the most investable enterprise. The criteria for selection of winners are listed below in order of importance:

- Highest Impact
- Inspiring
- Good Communication
- Friend
- Excellent Model
- Active Group Member
- Most Investable
Well performing enterprises have tangible, easily visible, and direct impact, suggesting Village Capital peer groups tend towards a collectively riskier investment approach. Winners are consistently some of the most actively engaged group members, successfully building and managing relationships with peers, and shaping voting criteria.

As can be further explored in the case studies attached to this paper, the four Village Capital winners report:

- Ability to leverage Village Capital award through visibility and credibility with other funders and investors
- Improved understanding of, and ability to successfully communicate with, investors
- Feedback resulting in refined business models and plans for scale
- Peer support and partnerships

The process of having to think and choose like a funder “triggers something” in all participants: “you want to improve your own organization.” One of the non-winning participants from the 2010 class established five partnerships with peers and others met through Dasra Social-Impact Village Capital. All entrepreneurs agreed that the “healthy competitive spirit” and “cohesion among groups” resulted in successfully delivering constructive criticism, building confidence, and creating connections, making organizations more attractive to investors after the village capital process.

**Bridging the gap: promising approaches**

An increasing number of investors are interested in investing in businesses that not only yield a financial return, but also make a social impact. Impact investing is entering the mainstream and is emerging as an alternative asset class that channels large-scale private capital into addressing the world’s most pressing social challenges. However, the reality is that this potential capital for social businesses is currently not being realized, as there seems to be a disconnect between the supply of impact investment capital from the investors and the demand for capital from social businesses. As explored in the preceding pages, this gap between investors and early stage social enterprises occurs due to the lack of information about potential investment

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19 Dasra Interview
20 Dasra Interview
21 Dasra Interviews
22 *Impact Investments: An Emerging Asset Class*, J.P. Morgan, November 2010
opportunities, high due diligence cost, high perceived risk, limited range of exit options, lack of standardized impact measurement and reporting, as well as a mismatch between investors’ and social businesses’ expectations. There is an asymmetry in resources that are available for investors compared to social entrepreneurs. Whereas there are many platforms for investors to share resources and knowledge, there are few networking opportunities for social entrepreneurs. Additionally, entrepreneurs often lack adequate representation in regards to financial and legal agreements, once considered for investment. This causes delays in fund-raising and sometimes results in entrepreneurs accepting “inappropriate” investments. Funders also require entrepreneurs to have a strong team in place before investment, but the entrepreneur often needs the investment to make the investment in talent.

Literature has alluded to the need for an efficient capital market with investors who understand the need and potential as well as the risk and complexity of social enterprises can facilitate innovation and development. The Village Capital program has shown that despite the key criterion for winning organizations applied by entrepreneurs being different from investors’ criteria, peer funding has effectively enabled early stage enterprises to grow their enterprises and leverage additional funding (slides 3, 6, 9, 12 in attached case studies). This indicates the need for and effectiveness of intermediaries in bridging the gap between social entrepreneurs and investors. If intermediaries can effectively build the capacity of entrepreneurs to become investment-ready, then the large potential pool of funds that are available for impact investments can be realized.

In sum, based on experiences with Village Capital and the Dasra Social Impact accelerator program, Dasra’s five recommendations for strengthening early stage social businesses to make them more investment ready are:

1. Recognizing capital needs of early stage entrepreneurs as distinct and providing access to risk and blended capital
2. Supporting intermediaries such as incubation and accelerator programs to build the capacity of entrepreneurs to pitch their models effectively to investors

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23 Impact Investors in Asia: Characteristics and Preferences for Investing in Social Enterprises in Asia Pacific, Impact Investment Shujog Limited, September 2011
24 Dasra Interviews
25 Dasra Interviews
3. Sharing COO and CFO roles amongst enterprises at an early stage to mitigate high costs associated with human resources
4. Standardizing impact measurement through third party audits
5. Creating regulation specific to taxation and access to capital for social enterprise under Section 25 of the Companies Act to avoid confusing governance structures