The Social Business Revolving Aid Fund: A Tool for Economic Empowerment in Lesser Developed Countries

Enabling a strategy for empowerment

Substantial recent research has been devoted to understanding the drivers of chronic poverty since the perceived failure of the "Washington Consensus". [Collier 2008, Easterly 2006, Green 2008, Moyo 2009] It is well understood that the developing world has large, typically agrarian rural populations of subsistence smallholders that do not have access to capital. They remain disenfranchised by globalization despite attempts at land redistribution, a flood of development aid, optimization of tariff barriers, and efforts to encourage government accountability and transparency. These policy actions can alleviate the effects of poverty in specific sectors of the economy in the short term, but have done little to empower large numbers of dispossessed people to economic self-sufficiency. These one billion chronic poor can be found throughout developing Asia and Latin America (hidden within rapidly improving aggregated income measures), but most persistently in Africa.

A key strategy for empowering rural farmers and their communities involves creating small and medium enterprises (SMEs) which 1) help the farmer enhance crop yield, 2) concentrate farmer production, 3) convert that production to intermediate or final goods having a higher contribution margin, 4) manage supply chain volatility, and 5) direct incremental value-added cash flow back to the farm community. [Coke 2012] The characteristics of such an SME include being:

- structured so profits accrue to the community
- sufficiently capitalized to become economically sustainable
- sophisticated enough to effectively manage both internal and external business processes
- representative of sufficient supply to control its own market access
- governed to withstand corruption

Most mid-echelon SMEs in a supply chain are capitalized by private investors who fund the startup for their own financial benefit. They design their businesses around customers, products, supply networks, legal jurisdictions, labor pools, and other resources that collectively offer a low-risk opportunity for value creation. Because they provide the startup and operating capital, they rightfully reserve a sizable portion of the retained earnings for themselves. But the incentive system in this structure pays farmers as little as possible, thus perpetuating their poverty.

The alternative is SMEs structured specifically for the benefit of farmer communities, whose for-profit motive is directing maximum retained earnings to community projects. Such companies are one type of "social business", functioning in some ways like a collective or cooperative but designed for maximum market and supply chain power.

Creation of these community SMEs requires capital far in excess of that available to the typical local community which is too small, unsophisticated, or resource poor. Private investment is not feasible since there is no financial return. The problem is more acute in countries perceived as being politically unstable and having weak financial and legal structures. Investors demand even higher levels of compensation for taking on the extra risk. This is one of the reasons that African countries as a whole have a much higher ratio of public to private capital than is typical in the west. Without private capital, it falls to the international donor community to create community SMEs.

Unfortunately, neither of the two relevant types of development aid is suitable for creating SMEs. First, individual smallholders can access micro-credit loans. But these do not scale to the community level because there is no collateral. Second, donors readily fund research projects focused on improving farming methods. But this agenda does little to enhance the farmer's position in the value chain. There is a gap between research and large scale implementation that is not met by current aid programs.

This paper proposes a new approach to donor support of community SME development. It advocates creation of government-sponsored revolving funds that hold ownership of the businesses in trust for the target communities. When adequately capitalized, community SMEs shift market power while also providing a healthy return to the fund, which can then sustainably support subsequent investments. The remainder of this paper elaborates this proposal in the context of social businesses generally.

Defining social business

The term social business was first articulated by Muhammad Yunus as part of pioneering the modern micro-credit movement over 30 years ago. He calls it a "non-loss, non-dividend business". Using his concepts as a starting point [Yunus 2009], this paper proposes an elaborated list of characteristics:

- Profit-making company that becomes financially self-sufficient in operation and growth.
- Operates at community rather than family scale.
- Company shares held in trust on behalf of the target population.
- Success maximizes social benefit, not shareholder wealth.
- Staffed primarily by those targeted for poverty reduction.
- Operates according to principles of economic, social, and environmental sustainability.
- Funding provided primarily by equity investment; not by debt, philanthropy, or government subsidy.
- Does not grant return to investors above their original investment, although it may be indexed to inflation.
- Profits feed organic business growth, or other community improvement.
- Operates where other profit-maximizing or state-sponsored companies don't see a viable market.
- Profitable market segments subsidize unprofitable ones for net sustainability.

A social business is in every way a normal operating company except that it directs the proceeds of its work to community improvement rather than investor wealth. As a result, it can have several advantages over other profit-making companies:

- More effectively secures the loyalty of employees who see the local benefit of their effort.
- The sense of empowerment encourages long-term sustainable behavior in families/communities/societies.
- Does not threaten entrenched government and commercial powers.
- Encourages collaboration rather than competition by sharing rather than sequestering resources.

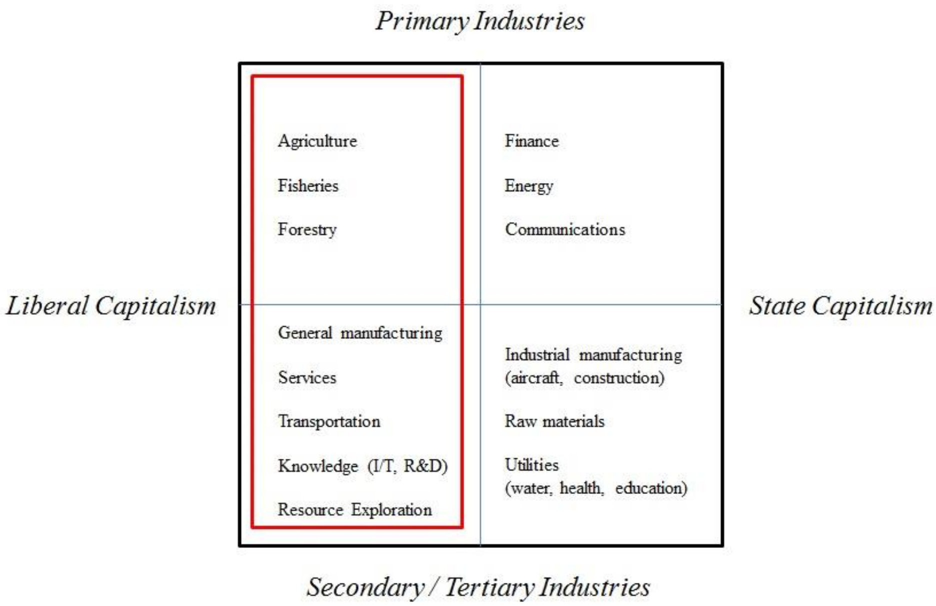
The "Fair Trade" and "Corporate Social Responsibility" (CSR) movements allocate more of a finite value chain to the poor by intentionally paying higher prices for farm production. Social businesses dedicated to shared value enlarge the whole pie by raising overall farm productivity. [Porter 2011]

Positioning the social business

Social businesses are a new phenomenon. The classic example is the Grameen Bank which is owned by and for the benefit of the poor women primarily in Bangladesh to whom it provides micro-loans. But whereas micro-credit has subsequently been adopted throughout the developing world, social businesses providing other products and services to the poor have not gained much traction. The poster child is Grameen Danone Foods, which fortifies yoghurt manufactured by Groupe Danone and distributes it as a nutritional supplement to poor families in Bangladesh. Simple packaging and minimal marketing keeps overall costs down, and sales to middle market customers in India subsidizes losses from low revenue sales to the poor.

The lack of traction may in part be due to the orientation of the business itself. Rather than being formed to provide rich world products to the poor, the business should be run by the poor themselves to supply products to wealthier segments of society. This is what micro-lending is meant to facilitate, but its focus on individual families does not allow the aggregation needed to penetrate middle market supply chains, achieve preferential raw material pricing, or ensure necessary product quality and consistency. The business concept being financed needs to be of sufficient scale to be competitive, but this requires more risk capital than is typically available to persons with no collateral, credit rating, or education.

Secondly, it is important to focus the business in areas that offer greatest competitive freedom and market transparency; far as possible from the oligarchies and crony capitalism that pervade many developing countries. The chart below lists various industry segments based both on whether they are primary industries, and whether those industries are typically heavily influenced by the state. The quadrants on the left suggest a number of possible social business positioning strategies.



Some of the most obvious social businesses are primary industry companies operating in the comparatively dull segments of agriculture, forestry and mari/aquaculture. Most of the world's poor focus their energies on finding food and water, so they are naturals at cultivation. With land, training, and proper infrastructure, many can become more productive. When their efforts are aggregated and product distributed through a cooperative, they obtain market power. [World Bank 2008]

History shows us that some of the most profitable businesses are those that supply front line companies in primary industries. For example, it was the Seattle-based retailers of picks and shovels that made the most money from the Klondike gold rush, and Howard Hughes built his fortune supplying tools to the oil wildcatters. Wherever a major industry exists, like mining in Mongolia or deep sea drilling off Brazil and Namibia, the operating companies doing the primary work need local supply of everything from housing to transportation to chemicals. One need only talk to the purchasing managers to identify numerous ways the poor (with some help) can earn a good income.

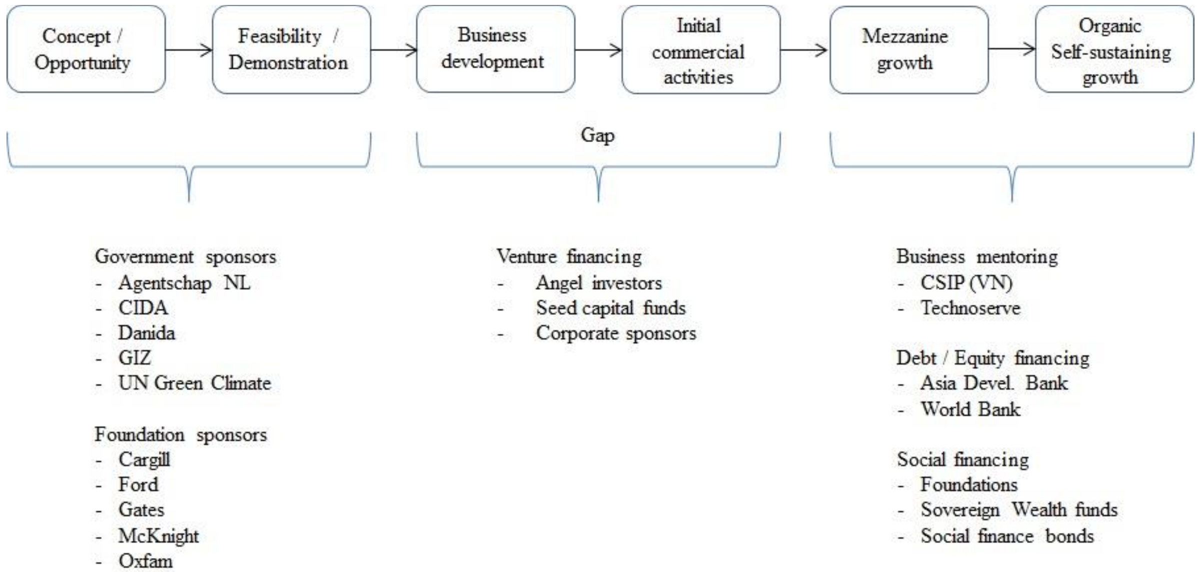
The lower left quadrant of the chart highlights other commercial segments. Many products and services found in advanced countries have not yet made their way to the developing world. It may be an issue of language or cultural norms that make localization difficult. It may be product design that is overly complex for a low-income society. It may be that the idea simply hasn't been validated by companies focused on the easiest markets first, or tariff barriers that make import uneconomic. In each case, local people know best what life challenges are most compelling, the features products need to have, and how they should be marketed. One just needs to walk the land and survey the people to find ideas.

The business funding gap

There are several stages through which a business concept evolves before becoming a self-sustaining, profitable business. Each stage requires different types of expertise, and is matched with appropriate sources of funding. The path is similar regardless of whether the venture is purely for the benefit of investors, or is created for the benefit of a low-income community in a developing country.

One source of ideas for a new social business are the research initiatives funded by a combination of government development aid and philanthropic gifts considered too risky and unproven to be financed by the private sector. The initiatives typically conduct a real-world demonstration and then document their findings in a written report. Often these projects generate real value, but after the research financing ends and the mentors leave, only the report remains. Financial sponsors in stage one do not specialize in transitioning the initiative into a self-sustaining business.

If a startup is successful and a business can operate for two years with demonstrated efficacy and financial return, it then becomes eligible for numerous sources of mezzanine financing using both debt and equity instruments. In the sustainability world there are a variety of government programs and foundations for growing a small business into a larger one.



The problem is the gap that exists between the two company maturities. Financing exists in this gap, but it is not optimal for community-oriented social businesses. When obtained from friends and family, institutional venture investors, or individual ‘angel’ investors the business usually surrenders control to the investors, and structures its activities to maximize early investor financial return. None of the traditional sources of capital typically found at this stage have as their mission creating businesses for social good.

Private venture capital identifies a potentially profitable opportunity led by competent management, and provides the funding necessary to reach a sustainable level of operation. But venture capital has high hurdle rates of return that are difficult to surmount in the developing world unless the state is an explicit partner. A business concept has to be large enough to so dominate its own value chain that market risk is minimal. Venture capital and State-sponsored national champions also tend to transfer as much value as possible up the value chain from local labor to their capital suppliers, a practice that does little to financially empower the local people.

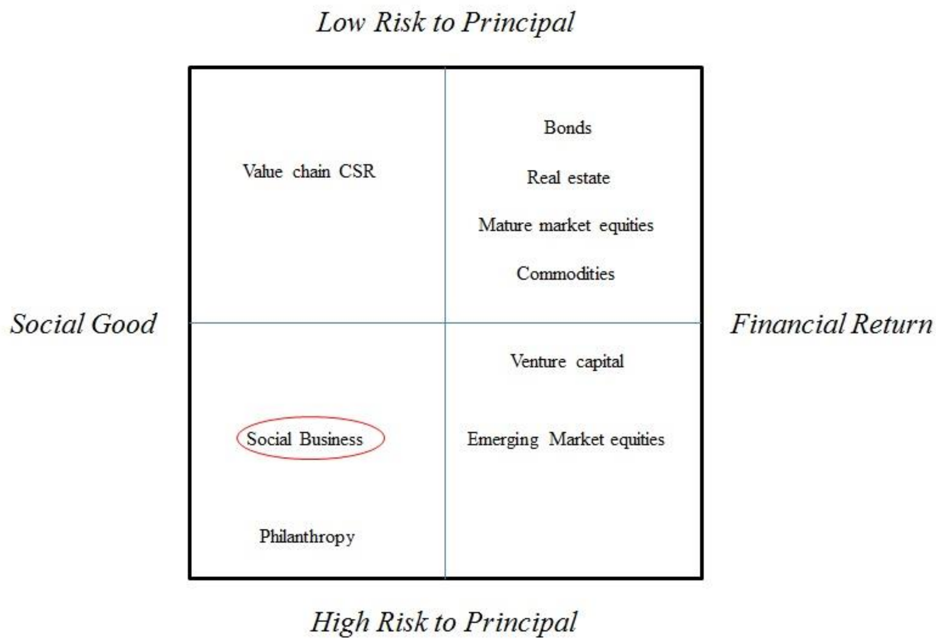
There is likewise little money in the institutional investment/banking community willing to accept relatively high levels of principal risk for relatively low levels of financial return. Wealthy investors in developing countries often will not invest that wealth in ventures local to themselves knowing how official corruption, discriminatory legislation, and unpredictable courts can destroy a business overnight. Many obtained their wealth using precisely those means and prefer to export their capital.

Social businesses in the gap are too big for micro-credit and too small for institutional money. Yet this is the very scale of investment critical to build competitive businesses that sustainably benefit a local community.

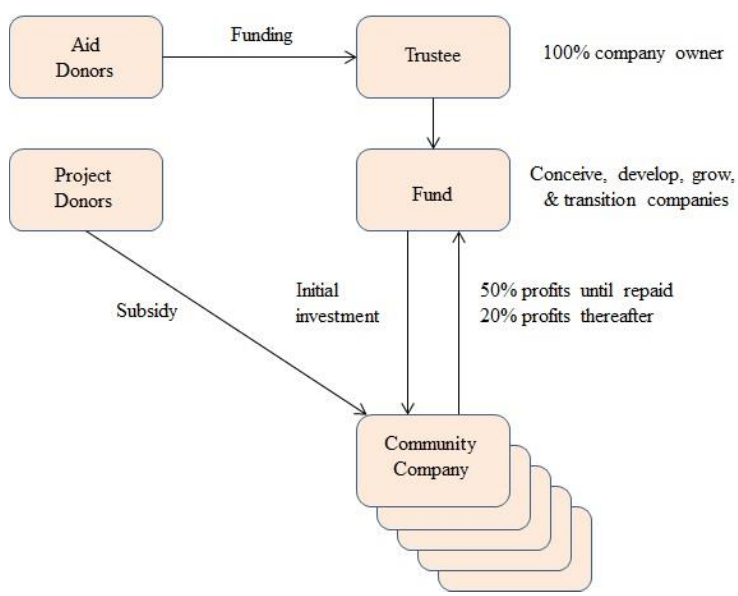
<u>Financing the social business</u>

The “rational capitalist” would never invest in a social business apart from personal philanthropic interest. This is the domain of government development aid, and positioned correctly, occupies an unexploited place in portfolio investment.

The chart below shows a variety of portfolio investments ranging from low to high risk, and categorized based on whether they primarily address financial return or social purpose. On the socially-oriented axis philanthropy by definition eliminates capital, while corporate social responsibility does not typically facilitate the creation of new business. Investments in a social business or a fund that incubates them would fall somewhere between depending on the characteristics of the underlying projects.



The proposed investment vehicle is a revolving fund that manages a portfolio of projects. The administration and compliance reporting would be for the fund in aggregate as a program, which is vastly more efficient than individually justifying to donors each project in the portfolio. A government-appointed trustee would hold shares of all project companies, with an on-going claim on their cash flow. Supplemental subsidy funding for project companies is solicited from third-party donors with specific interests, potentially including the recent phenomenon of internet-based "crowd-funding".



Funding does not take the form of conditional or "budget support" aid, nor is it passive investment as made by a sovereign wealth fund. Rather, foreign aid money is contributed to the fund with an oversight government entity serving as trustee. The capital is used to seed a portfolio of small & medium enterprise (SME) projects. As the new companies generate profits after tax they distribute a significant portion of the proceeds back to the fund. Once the fund is fully paid back, its share of company profits reverts to a lower percentage. The principal repayment plus residual cash flows are subsequently used to seed the next group of companies. In this way donor funds are solicited only once and do not represent a continuing obligation of taxpayers (unless the fund wants to service additional project companies while awaiting payback). Not all project companies will survive, but the portfolio overall is diversified and risk-weighted so the winners return more than the losers consume.

Conceiving the social business

Assessing a proposed business concept begins with effective screening criteria that separate ideas with promise from those that are non-starters. Here is one such list. It usually takes some study to apply the screening criteria, including preparation of pro-forma operating and financial projections. A social business fund must be even more sophisticated than institutional venture capital in assessing probability of success owing to the dependence on relatively unsophisticated stakeholder populations.

- Marketable commodity/service/product
- Minimal competition with State-sponsored companies or industries
- Economically, socially, and environmentally sustainable
- Applicable local academic infrastructure or expertise
- Innovative technologies accessible to local people
- Locally maintainable infrastructure
- Advantageous tax/subsidy regime
- Measurable success metrics
- 40% gross contribution margin

A realistic 5-year projection of financial performance should show the ability to reach a 40% gross operating margin before allocated overhead and taxes. This will provide sufficient cash flow to build retained earnings while repaying the original investment. The analyst must consider two offsetting issues; the opportunities to be a first mover in the developing world can generate outsized returns, but there are often infrastructure inefficiencies that will limit growth potential.

It bears repeating here that social business development aid should only go to communities that are not otherwise able to attract capital. The intent is not to compete with established businesses, or to create disincentives for use of private capital.

The entrepreneur must also consider entrenched interests that could be threatened by the new business and find ways to address or avoid them.

- Government corruption and conflicting ministerial incentives
- State dominance of strategic industries and value chains
- Exploitive or oligarchic capitalism
- Intellectual property dominance by academic institutions

The overall process of commercializing a social business idea requires multiple activities as shown below, with special attention to the first four. These resemble methods used by non-governmental organizations (NGOs) doing capacity building.

- Identify at-risk communities with self-sufficiency potential
- Document community needs and resources by meeting with the various stakeholder groups
- Conceptualize a value proposition, design the value chain, document a business plan
- Engage stakeholder network to ensure robust community support
- Negotiate land use, taxes, subsidies, etc. with relevant civil authorities
- Identify and recruit influencers, leaders, and enthusiastic collaborators
- Begin with a pilot project to identify challenges and adjust business model
- Commercialize to sustainable economies of scale

Project developers start with an inventory of needs and resources that resembles a SWOT analysis. It considers both the macro and micro environment in which the company will operate and the numerous external forces that can impact company success. One quickly discovers that the stakeholder group is larger than first apparent and that each needs to be represented at some level in discussions to avoid surprises and ensure political support. The value proposition must ensure that incentives are well aligned throughout the value chain, and that the target community cannot easily be dis-intermediated. Finally, it is advisable to conduct a small scale pilot before making commercial scale investments in order to elevate the inevitable issues.

Managing the social business

Corruption is always a problem, and to a degree, corporate governance must rely on peer pressure by the group to keep participants honest and productive. Courts are frequently too unpredictable to be an agent of accountability. Funded companies are subject to regular financial and operational audits to ensure that success and accountability metrics are being accurately collected and presented.

It is advisable not to place shares of the social business in the hands of individuals since there is always the problem of corruption. They should be held by a trust held on behalf of the target community, which can then adopt its own rules for using retained earnings for business growth, community health/education/sanitation projects, or distribution of a dividend. Only when the group elects to terminate the company or it becomes unsustainable should the company assets be liquidated by the trust. Proceeds would typically remain in the company shell as a resource for on-going community development.

Staffing a new business that is created for the underprivileged of the developing world adds immature management and a short-term 'poverty mentality' to the mix that can consume capital rapidly and unproductively. So capacity building and knowledge transfer need to be a key part of any such project. This is normally the domain of NGOs, which can be contracted as an integral service provided by the social business fund. Fortunately, there is some international donor support for this type of capacity building, and several organizations specialize in doing the required education and mentoring.

Progress measurement is different in a social business, which exists to maximize social benefit, but must still operate profitably. Business decisions must frequently consider tradeoffs between conflicting objectives, which raises the importance of collecting, measuring, and reporting appropriate metrics.

Finally, it should be pointed out that in the western world business decisions are made by owners and managers using data-based logic. In the developing world decisions require a group consensus process that is more experiential, involves many more stakeholders, and takes a much longer time. We are sometimes asking people to change long-held behaviors that in some cases impact cultural norms. They need to see strong advocacy and a clear and safe path to empowerment before risking such change.

Toward a new vision of empowerment

This paper offers a new model for creating economic opportunity among the world's poorest communities. It proposes using social business structures coupled with revolving fund development aid. Empowering disadvantaged people requires applying virtuous capital at the point where research initiatives are ready to transition into businesses. Structured well, the investment principal can be recycled as communities become economically sustainable.

References

Poverty reduction

- Collier, Paul. *The Bottom Billion*. Oxford University Press, 2008
- Easterly, William. *The White Man's Burden*. Penguin Books, 2006
- Green, Duncan. *From Poverty to Power*. Oxfam Intl., 2008
- Moyo, Dambisa. *Dead Aid*. Douglas & McIntyre, 2009
- Coke, James. *Economic Empowerment in the Agricultural Supply Chains of Lesser Developed Countries*. 2012

Social business model

- Yunus, Muhammad. *Creating a world without poverty*. PublicAffairs, 2009
- Porter, Michael & Kramer, Mark. *Creating Shared Value*. Harvard Business Review, Jan-Feb 2011, pp. 62-77

Business and competitive concepts

- World Development Report 2008. *Agriculture for Development*; World Bank, 2008
- Porter, Michael. *The Competitive Advantage of Nations*. Free Press, 1990