Social | Capital
PARTNERS

# The Five Critical Factors of Social Enterprise Profitability

*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.*

## The Model

The decisions that employment-based social enterprises make with respect to the five factors will determine where they will be located on the web in Figure 1 below.

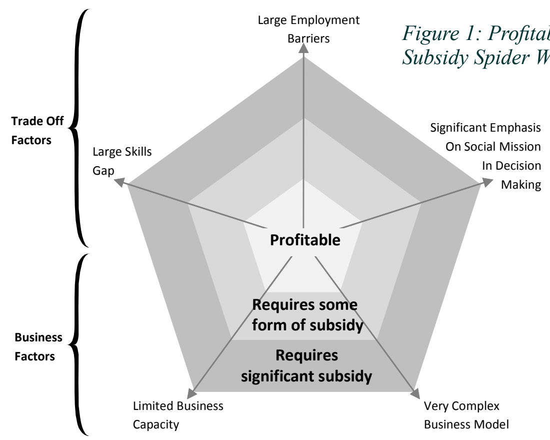


*Figure 1: Profitability / Subsidy Spider Web*

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. Examples include training businesses that hire people with significant employment barriers and large skills gaps. The objective of these businesses usually is not to make money – it is 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 so there is a bias to the social goals in 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.

## The Five Factors

### The inherent business capacity of the social enterprise

Inherent business capacity is divided into the *operating capacity* - management that possesses all the requisite skills to successfully run the business - and *financial capacity* - 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.

### The complexity of the business

Complexity of the business model essentially means the degree of difficulty involved in operating the business successfully. This factor is strongly correlated to inherent business capacity: the more complex the business model, the more essential it will be to invest in external resources with specialized industry knowledge and expertise.

### The size and nature of the employment barriers of the people being hired

The choices made around 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. The job-readiness factor within a given target employee group is also a very important factor in the likely financial success of the business.

### 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

This refers to the inherent difficulty of the job for which the target employees 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.

### The degree of emphasis on the social mission in the day to day decision making process

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). This 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).

# LESSONS: BUSINESS FACTORS

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.

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.

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.

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. Ironically by optimizing the business forces more time and effort gets devoted to the social mission.

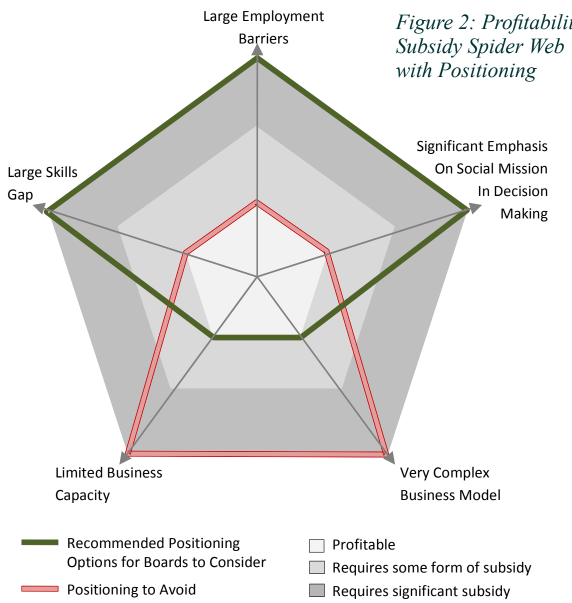


*Figure 2: Profitability / Subsidy Spider Web with Positioning*

# LESSONS: 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. 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.

Boards can and should make conscious choices about these trade-offs and understand the likely consequences. The choices 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.

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 on the left. The green area 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 red area. 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.

## SUMMARY

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. 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. Ultimately we believe we will all be better investors and operators of social enterprises if we make conscious choices with respect to these tradeoffs.

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The complete version of this article is available online:
**http://socialcapitalpartners.ca/ideas-learning**

We appreciate your comments and feedback on our work. Please direct all correspondence to **info@socialcapitalpartners.ca.**



Social Capital Partners (SCP) is a national, non-profit, social finance organization established in 2001. We believe that market forces can be utilized more effectively to solve structural social challenges in Canada.

In support of this belief, SCP arranges for growth financing and provides advisory services to businesses that integrate a social mission into their HR model and expand career opportunities for disadvantaged populations.

SCP has financed and helped grow successful social enterprises across the country which currently employ over 400 people with employment barriers:

- Atira Property Management, Vancouver
- Inner City Renovation, Winnipeg
- Renaissance/Fripe Prix, Montreal
- TurnAround Couriers, Toronto