

Stanford SOCIAL INNOVATION Review

Informing and inspiring leaders of social change

Impact Investing

Social Entrepreneurship Needs a New Funding Model

Impact investors pass on enterprises with potential because the deals are too small to justify the effort. A new model works through intermediaries to get entrepreneurs the capital they need.

By **Ben Powell** | Fall 2020



(Illustration by Marina Muun)

EOS International is a small, promising social enterprise that is undertaking a test that could have great implications for philanthropists. The nonprofit works with more than 1,200 rural communities to help local entrepreneurs provide safe drinking water to more than half a million people across Central America. Its cofounder, former Peace Corps volunteer Wesley Meier, believed that with a small investment he

could purchase dechlorination kits in bulk and sell them to dozens of communities, giving an additional 39,000 people access to clean water. Even though he works in extremely underresourced communities, Meier's business model enables EOS to be repaid for its services. This gave him hope that he could access a new source of growth capital aside from grants: impact investment, or private investment for public good.

Meier's challenge—how to secure a modest investment of \$50,000—is common among social entrepreneurs. Also common is extreme frustration at the cost of finding that kind of financing. The impact investing field has not yet organized itself to make such investments in its own future pipeline efficiently—and time is running out. Even before the COVID-19 pandemic put small

businesses in a vise, impact investors struggled to find ways to fund deals between \$50,000 and \$1 million. This gap is so well known, it has a name: the “missing middle,” which refers to companies too big for microfinance and too small for banks—i.e., the vast majority of social entrepreneurs. The transaction costs to invest in these small deals—finding, supporting, investing, and managing companies—are simply too high relative to their deal size to interest investors, no matter how attractive the social returns. Investors are left waiting for companies to reach milestones that never come because the support needed to meet those milestones is never offered.

The frustration long felt by those who advocate for more efficient strategies to drive investment to entrepreneurs is now boiling over into existential dread. The economic downturn threatens to wipe out thousands of social enterprises and to shatter the fragile, emerging global ecosystem of incubators, accelerators, and entrepreneur support organizations (ESOs) that have arisen in recent years to serve them and, in the process, model a new kind of stakeholder capitalism.

While Meier pondered how to raise funds, Sarah Agha Ashby, CEO of World Impact Foundation, grappled with a problem of her own. Leading a foundation focused on using innovative finance to help companies provide basic services to poor communities, she was looking to find enterprises in need of catalytic capital. Given her impact-first investment criteria, she was willing to invest in the form of a grant, so long as it supported real accountability around impact and operational strengthening. Agha Ashby hoped to develop the capacity of companies to treat recoverable grant funding as a traditional investment in terms of capital usage and reporting, as well as to support a pipeline for future investment.

My team at Agora Partnerships—an ESO that focuses on delivering consulting, training, and investment programs to entrepreneurs and trainers—wanted to drive capital into social enterprises from our acceleration programs in Latin America. Together with World Impact, we cocreated a grant model we’ve named Delta, the fourth letter of the Greek alphabet, which in the language of mathematics signifies change. It is precisely the sort of new funding model that social enterprises—and the sector itself—needs at this moment.

Aligning Interests

In 2016, EOS participated in Agora's Impact Acceleration Program, which is designed to strengthen social enterprises and set them up to raise investment and grow their impact. EOS is the first organization to receive a Delta investment.

Here's how the funding model works: First, a funder makes a tax-deductible grant to an ESO. The ESO, in turn, invests the grant in the form of a zero percent loan (technically, a recoverable grant) to a company that has successfully completed the ESO's vetting process and that fits the investors' impact criteria. Invested companies then have 12 to 24 months to repay the loan. If the company fails to repay, there is no legal recourse or collateral to compensate the ESO—the ESO has taken a calculated risk in support of its mission and lost. On the other hand, if the company repays, the investor can follow up with additional investment, and the ESO is rewarded by being able to keep those funds for its own purposes *as an unrestricted grant*—the most important kind of capital for any nonprofit organization.

This approach is promising because it promotes and aligns the interests of the three core stakeholders that matter in impact investing: entrepreneurs, funders, and ESOs.

Entrepreneurs | The vast majority of early-stage entrepreneurs in emerging markets, especially those addressing the **United Nations Sustainable Development Goals** (SDGs), need capital that is accessible and does not demand the large risk-adjusted returns that the VC business model requires. When Agora asked 23 small companies in our network that sold products to low-income consumers if they would be interested in this type of capital, 20 responded yes within 48 hours.

A zero percent loan does several important things for entrepreneurs. It reminds them that the investor and ESO want them to manage for impact—indeed, training on how to measure impact may be a requirement of the investment. It communicates to them that funders and those with resources hear them, respect their work, and support them. It builds a different kind of relationship than most entrepreneurs have with investors. Social entrepreneurs on the front lines should be afforded respect and capital that acknowledge the personal risk they are taking, the vision they are building toward, and the leadership they are modeling.

Funders | Most grant funders in the impact investing field are interested in supporting a specific industry, region, business model, or demographic group. But many funders increasingly wonder

how to invest to support systemic change itself—change that shifts patterns of funding to create a new equilibrium where much more capital is available to deserving entrepreneurs. It is simply impossible to create this kind of permanent change in the way capital is invested without first strengthening local institutions that champion entrepreneurs. In countries with underdeveloped entrepreneurship markets, access to these kinds of organizations is often the only way to give young people the agency to start their own venture.

The Delta model helps funders to invest directly in companies and indirectly into the ecosystem in a way that is transparent, aligns incentives, and pays for performance. The model is especially relevant for donor-advised funds (DAFs) and foundations that want to invest directly in social enterprises but are not yet ready to create full-fledged investment funds. Delta investments make it easy for these kinds of funders to join the field, partner, and learn. Working with an ESO and with Delta grants around a specific theme (e.g., food security, basic services, or underrepresented entrepreneurs) can help foundations like World Impact to seed the pipeline they need in the future while fostering productive relationships with ESOs and building their own brands among entrepreneurs.

ESOs | ESOs benefit because Delta grants help to make them more competitive as they seek to recruit companies into their programs (selectivity of companies and quality of staff being two key attributes of high-performing accelerators). By providing material incentives and not just well wishes, they can help grow the market and reinforce an impact culture that must take root for the field to grow.

Another benefit is sustainability. Less than 5 percent of accelerators worldwide are commercially sustainable; the rest are engaged in constant battles to fundraise. With Delta funds, the dependent variable for economic success is moved down the value chain, closer to where real value is actually created—where the ESO intersects with entrepreneurs. The best ESOs want to be rewarded for innovation and performance—not grant writing, compliance, or chasing donor dollars. They want a rational relationship between the success (or failure) they see in supporting entrepreneurs and their own team's success—just like in the private sector.

Absent a system that rewards high-performing ESOs (for outcomes, not outputs), the impact field will lose its frontline talent. But if the field can create and deliver funding models that reward

performance and that value catalytic, small investments, it will attract and retain highly skilled talent, who will, in turn, build the entrepreneurial finance markets that the sector needs. Small- and medium-size businesses account for two thirds of global employment and half of global GDP—the stakes are not small.

Supporting the Whole Ecosystem

At the heart of the challenge is what economists call friction costs: information inefficiencies that grind down communication and make it costlier to close small deals, the kinds that offer the first and sometimes only investment-access point for younger and less powerful groups of entrepreneurs. This friction is the consequence of an underdeveloped philanthropic market that has very few standardized products and funding models that don't link pay to performance, create high barriers to entry with complex applications and long sales cycles, do little to support local institutional or ecosystem strengthening, and make no distinction between for-profit and nonprofit partners. Most important, they come from insufficient awareness and appreciation of the fragility of the impact entrepreneurship ecosystem itself and its ability to generate a future pipeline.

When funders use a Delta grant, by contrast, they drive catalytic capital at excellent terms into the hands of mission-driven entrepreneurs more efficiently than any other method. And they do this in a way that supports the sustainability of the whole ecosystem. The model holds the promise of more productive and efficient relationships among entrepreneurs, ESOs, impact investors, and funders to work in concert, each aware of how the other contributes to the success of the whole.

Ben Powell is founder and CEO of Agora Partnerships, a nonprofit focused on helping entrepreneurs in Latin America to access knowledge and investment, and grow their business to achieve the UN Sustainable Development Goals. Agora is one of the oldest and largest communities of impact entrepreneurs in the Americas, with more than 1,000 alumni across 21 countries creating thousands of jobs and improving more than six million lives. Powell is a Draper Richards Kaplan Fellow, an Ashoka Fellow, and a recipient of Columbia Business School's social innovation award.

If you like this article enough to print it, be sure to subscribe to SSIR!

Copyright © 2020 Stanford University. Designed by Arsenal, developed by Hop Studios