UNIT 4 SOCIAL VENTURE CAPITAL

Structure

4.1 INTRODUCTION

Venture capital is financing that is invested in start ups and small businesses that are usually high risk, but also have the potential for exponential growth. Social enterprises are entrepreneurial organizations that innovate to solve societal problems. Governmental organizations, non-governmental organizations, and charities used to be the major players in the battle against some of the biggest social and environmental issues. However, due to the interconnected nature of our modern societies, together with the improved technology, entrepreneurs are also looking to solve social issues. Socially responsible investing and entrepreneurship have led to the emergence of social investment funds and businesses. The lack of funding opportunities is one of the major disadvantages social enterprises face. Social enterprises are not profitable enough to access traditional financial markets, resulting in a *financial-social return gap.* However, having a sustainable funding model is important to realize social impact on a meaningful scale.

Venture Capital has emerged as a new financial method of financing during the 21st century. Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects. There is a common perception that venture capital is a means of financing high technology projects. However, venture capital is investment of long-term finance made in:

1. Ventures promoted by technically or professionally qualified but unproven entrepreneurs, or
2. Ventures seeking to harness commercially unproven technology, or
3. High risk ventures

The term 'venture capital' represents financial investment in a highly risky project with the objective of earning a high rate of return. While the concept of venture capital is very old, the liberalization policy of the government in the 90s appears to have given a fillip to the venture capital movement in India. In the real sense, venture capital financing is one of the most recent entrants in the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked. These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. In this unit you will read about social venture capital, its types and models.

After reading this unit you will be able to

- Explain the meaning of social venture capital
- Differentiate between traditional venture capital and social venture capital
- Describe various types of social venture capital investors
- Discuss how the social venture capital works

4.2 WHAT IS SOCIAL VENTURE CAPITAL (SVC)?

Social venture capital is an investment funding funded by social venture capitalists to provide seed funding investment in a social enterprise with the aim of achieving financial gains while delivering social impact through their enterprises. The venture capitalists (VCs) are the only class of professional investors whose sole occupation is to study, finance and support start ups. Among potential financing sources for new start ups, venture capital (VC) occupies a unique position. Social venture capitalist aims at investing in a socially responsible manner in companies, which are looking to provide real social change. Social venture capitalist often focuses on companies that want to solve environmental and social issues, such as alleviating poverty. The firms can aim to solve these issues either directly through their product or service, or by implementing special programmes in this area.

A growing number of social entrepreneurs and investors realize that social enterprises of all sorts can generate financial returns that will make them attractive to the right investors.

Bugg-Levine et al., 2012, HBR

It is a highly philanthropic form of investing, as the focus is on finding companies with a strong social conscience. Despite the pivot being on socially responsible companies, social venture capital investing still emphasizes on returns. It isn't simply a form of charity work or provision of donations; social venture capitalists select investment opportunities with a healthy return on investment in mind.

Box 4.1: Government launches Rs 500 crore social venture capital fund in 2014

The National Innovation Council, in partnership with the Ministry of Micro, Small and Medium Enterprises (MSME), launched the India Inclusive Innovation Fund (IIIF), an impact investment fund that will invest in ventures catering to the country's poor. The Rs 500-crore fund to be registered under market regulator SEBI's Alternative Investment Fund regulations as a Category –I venture capital fund, to provide financial support to social ventures operating in areas such as healthcare, food, nutrition, agriculture, education and skill development, energy, financial inclusion, water, sanitation and employment generation.

4.3 DIFFERENCE BETWEEN TRADITIONAL VENTURE CAPITAL AND SOCIAL VENTURE CAPITAL

All investors want to put their money toward businesses that are going to succeed, usually in the financial sense and provides good return on the investment. However, the social venture capitalists do not measure the success of their investment in mere financial terms. Instead, social venture capitalists are interested in funding projects that are designed to solve social problems. There has been an increased effort in recent years by social entrepreneurs to overcome the challenges of the traditional donation based philanthropy model through social investment opportunities.

While both social venture capital and traditional venture capital focus on attracting a healthy return on the investment, the two investing methods still differ in terms of their broader goals.

Box 4.2: DFID is investing up to GBP 35 million in the Samridhi Fund

DFID is addressing this unmet need for capital through its Poorest States Inclusive Growth Programme (PSIG). Under the programme, GBP 35 million is being invested in the Samridhi Fund, a venture capital fund managed by SIDBI Venture Capital Limited (SVCL). The fund is investing returnable capital in socially-orientated enterprises across the eight lowest-income states, based on the premise that investment of 'patient' capital in high risk, promising social businesses can help secure benefits for the poor and ultimately, crowd in more investments. According to this 'impact investing' model, once successful, businesses should be able to attract more regular private capital, continue to grow and provide direct and indirect benefits for the local populations.

Traditional venture capital sets the maximization of the financial risk-return relation as the most important goal to achieve. On the other hand, social venture capital has a broader objective. Not only does a social venture capitalist wish to maximize the financial return, they are also interested in maximizing the social or ecological return. The focal point is on making profit while also improving the social and environmental conditions the company is focusing on.

It would be wrong to assume that the social capital doesn't look at financial returns at all. Besides, the persistent myth around social venture capital is that it "doesn't generate attractive returns". But recent years have shown that social venture capital can, in fact, even provide healthier returns than traditional venture capital.

4.4 TYPES OF SOCIAL VENTURE CAPITAL INVESTORS

Social venture capital is provided by specialist social venture capital firms, funds, and impact investors. Many major venture capital firms tend to have special social venture capital funds operating alongside traditional funds. Furthermore, both, international and local development banks, can be a source of social venture capital. It should be noted that social venture capital investors often have different ways to define 'socially responsible'. For example, certain investors focus on ensuring that the funds they invest in avoid certain industries deemed harmful for the common good, such as arms trade, gambling, tobacco, or alcohol, for example. On the other hand, others focus on a more in depth view of the company's business model. These individual investors might focus on finding companies that target a specific social goal or which operate under a fairer business model, such as improved minimum wage. The focus of social venture capital firms is often on the developing world. The investments are directed to developing countries and companies operating in these countries. Nonetheless, social investments are on the rise in the developed world as well and attract significant amounts of funding.

If we look at the types of social venture capital investors, we can see the different approach investors take on this investment method. The types of social venture capital investors include:

1. **Social venture accelerators** - These are similar to seed accelerators. The focus is on providing seed funding to start ups with the potential to scale. Like traditional seed accelerators, social venture accelerators often focus on tech-based companies.
2. **Social incubators and funds** - Social incubators and funds are another form of social venture investing. The focus of incubators is to provide start ups and entrepreneurs with facilities and funding. Besides, there are special social incubator funds, which focus on social investment intermediaries that generally carry a higher financial risk.
3. **Non profit oriented funding** - Certain investors tend to focus more on non profit investing. Social venture capital is often the perfect match for a non profit looking to deliver social impact while maintaining a social enterprise pattern.
4. **Business Angels** - Finally, there are business angels, investing in start ups and private companies. Business angels are wealthy individuals, who invest their money in business ideas. The influx of capital can help an idea develop into a viable company and provide the base to begin producing the product or service proposed.

Activity 1

Visit any Social Enterprise in your vicinity and discuss with the management and write about the source of funding of the enterprise. Also write about the social impact intended by the enterprise.

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Social venture capital's success in providing healthy returns for investors have accelerated the setting up of different funds and firms. Some of the more famous social venture capital firms include:

- **Acumen Fund** - A new approach to social impact investing, which acts as an intermediary between philanthropic organizations and social enterprises.
- **Grassroots Business Fund** - A non-profit based in Washington, DC, aimed to build and support high-impact enterprises that provide sustainable economic opportunities to thousands of people at the bottom of pyramid.
- **Triodos Bank** - One of the world's leading sustainable banks, which aims at making money work for positive social, environmental and cultural change.
- **Omidyar Network** - Aims to create a more equitable economy, promote responsible technology that improves lives, and discover the emergent issues that will shape our future.

Check Your Progress - 1

Notes: a) Write your answers in about 50 words.

b) Check your answer with possible answers given at the end of the unit.

1. What is Social Venture Capital?

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2. Who are Business Angels?

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4.5 HOW DOES SOCIAL VENTURE CAPITAL WORK?

The basic premise of social venture capital is similar to traditional venture capital. Contrary to popular perception, venture capital plays only minor role in funding a start-up. Essentially, the investor invests capital in a company and later receives a return. Like traditional venture capital, social venture capital aims at finding the entrepreneurs and start-ups with products and services that offer growth potential with social agenda as the core value. Once these start-ups are identified, capital is provided to help the company fulfill its potential.

Whilst the most important metric for venture capitalists is profit and financial return, social venture capitalists focus on other metrics during the investment period as well. To social venture capitalists the metrics that matter include:

- Financial profitability
- Business development (scalability)
- The social mission/ecological impact of the business

Therefore, the objective isn't only about the financial return and social venture capital typically cashes out only once the social enterprise realizes a return on all of the above metrics. This means that once the enterprise has achieved the desired social or ecological goal, together with a financial return, the return is distributed back to the investor.

The access of capital is crucial for growth of social enterprises. Investors differ in their approaches on issues related to social return, financial return and risk. Similarly, social entrepreneurs differ in how they balance and align social and financial factors. There are 4 guiding principles for social entrepreneurs when trying to get access to capital.

1. Trade-offs do not exist! Alignment between financial and social objectives is key
2. Build and present a well balanced management team. An investor will never believe that you make it on your own
3. Measure your impact! Your contribution becomes visible if measured
4. Avoid mission drift at all times

Investors look for organizations in which both aspects come together in an integrated way. Besides, investors give importance of a team that shows its commitment to the social enterprise, rather than a single person. The visibility of making an impact as an investor and social entrepreneur help in attracting more investment.

The venture capital industry has four main players: entrepreneurs who need funding; investors who want high returns; investment bankers who need companies to sell; and the venture capitalists who make money for themselves by making a market for the other three.

Social ventures can utilize a range of funding options. Most forms of social venture funding include:

- Debt capital **-** Debt capital is the capital that a business raises by taking out a loan.
- Mezzanine capital **-** Mezzanine financing is a hybrid of debt and equity financing that gives the lender the right to convert to an equity interest in the company in case of default, generally, after venture capital companies and other senior lenders are paid.
- Equity investment **-** Social venture capital firms also use equity investment through preferred shares.

Furthermore, in many instances, social ventures combine the use of debt capital with mezzanine capital. By understanding how venture capital actually works, the entrepreneurs can mitigate their risks and increase their potential rewards.

Venture capitalists evaluate deals through a complex process in selecting the ventures for financing. The venture capital deal evaluation process is normally a three-legged stool in which the legs are the market, the technology and the team. There is perpetual argument about which leg is the most important for a venture capitalist to evaluate the financing deal. The Rachleff's Law of start up success states that *"The #1 company killer is lack of market"*. Venture Capitalists invest more time with the potential avenues for financing as they move in their investigatory work known as *due diligence*.

4.5.1 Profile of the Ideal Venture Capitalist

From a venture capitalist's perspective, the ideal entrepreneur:

- is qualified in a 'hot' area of interest,
- delivers sales or technical advances such as FDA approval with reasonable probability,
- tells a compelling story and is presentable to outside investors,
- recognizes the need for speed to an IPO for liquidity,
- has a good reputation and can provide references that show competence and skill,
- understands the need for a team with a variety of skills and therefore sees why equity has to be allocated to other people,
- works diligently toward a goal but maintains flexibility,
- gets along with the investor group,
- understands the cost of capital and typical deal structures and is not offended by them,
- is sought after by many venture capitalists,
- has realistic expectations about process and outcome.

Venture capitalists make money on management fee and on carried interest. Management fees are generally a percentage of the amount of capital that they have under management. Management fees for the venture capitalist are typically around 2%. The other side of making money is the carried interest. To understand this concept, carried interest is basically a percentage of the profits. This is normally anywhere between 20% and 25%. Venture capitalists would like to have a clear involvement in a venture in order to stay close to their investment and to have a say in major decisions that could impact their returns in the long run. Venture capitalists normally buy in equity between 15% to 45% of a venture. They request board involvement in return for the investment that they are making in the form of board of director or board observer.

4.5.2 Guiding Principles for Social Investment (*Source: PwC, 2014*)

i) Trade-offs do not exist! Alignment between financial and social objectives is key

According to popular belief it is impossible to 'do good' and make a profit at the same time. As a representative of a financial institution puts it: 'We expect that the social enterprise shows a convincing (social) mission, but also a convincing business case.' When integrated, the two aspects strengthen each other, making an attractive financial return to expand your impact. There are already many well-known examples. Taxi-Electric, a price competitive taxi service that runs its cars on electricity and employs the long term jobless is increasing its impact by selling as many taxi rides as possible. Tony Chocolonely and Specialisterren are also well known examples of social entrepreneurs, who increase their positive impact as they grow their sales and revenue. Increasing the effect of your social mission can increase financial gain and vice versa. Investors look for organizations in which both aspects come together in an integrated way.

ii) Build and present a well-balanced management team

An investor will never believe that you make it on your own. Investors stress the importance of a team that shows its commitment to the social enterprise, rather than a single person. Having a group of people willing to invest time and effort in the social enterprise is regarded as an indicator of future success. Investors look for a social enterprise with a strong (management) team that shows a balance of complementary skills. Financial institutions, investment funds and venture capital firms specifically mention that they look for these signs when considering an investment. Yet, this does not mean it is impossible to get funding on your own.

iii) Measure your impact! Your contribution becomes visible if measured

To prevent early dissolution, start with something small, easy to measure, preferably already available in your daily business. An example would be to measure the number of people you employ or the amount of positive feedback you receive. Every method has its limitations and there is no perfect system, but it allows you to see the progress you make and it brings focus to your work. Taking the question 'why' you want to measure your impact as a starting point will contribute to your alignment of financial and social objectives.

iv) Avoid mission drift at all times

Mission drift occurs when an enterprise moves away from its initial mission. This usually takes place after a couple of years, for example with new employees, leaders, owners or when a new investor is interested. Investors see mission drift as an issue when the focus of the social enterprise shifts from a balanced view towards financial gain, at the expense of the social mission. If mission drift occurs to the extent that the pursuit of financial gain no longer contributes to the pursuit of social gain, the mission may no longer be in line with what was initially discussed with the investor. Investors are therefore hesitant to commit themselves to long term investments.

4.5.3 Examples of Successful Ventures

i) UBER

Uber was founded with a killer app concept that an individual could hail a car ride not with a wave of the hand, but with a smartphone. The concept caught on with the Silicon Valley venture capital crowd; by summer 2015, its total funding reached $10 billion.

There is an almost insatiable appetite to buy into Uber and its leadership in the car hailing business. For example, in August 2015, Google

Ventures plunged over $250 million into Uber, and the company's biggest investors also include blue-chip Silicon Valley venture capital firm Kleiner Perkins Caufield & Byers, Fidelity Investments, Jeff Bezos of Amazon, Goldman Sachs, Blackrock, Lone Pine Capital, and dozens of other venture capital firms, hedge funds and private billionaires. Traditional Wall Street hasn't been left at the curb either.

The thinking among Uber financial supporters is that a tidal wave of cash will drown any rival and allow realization of the ultimate goal, a monstrously successful initial public offering (IPO) valued at $70 billion or more.

ii) INSTAGRAM

This online mobile photo sharing and video sharing site was developed in San Francisco by Kevin Systrom and Mike Krieger. In a little under a year and a half, it garnered over 100 million users, and quickly attracted the eye of many venture capitalists. Instagram raised $7 million in Series A funding from several different investors, including Benchmark Capital, Jack Dorsey, Capital fund, and Adam D'Angelo, which put the company at a value of $25 million. In a subsequent round of funding, they raised $500 million from venture capitalists, putting the company value around $25 million. Social media giant Facebook ended up purchasing the company for an impressive $1 billion dollars.

iii) KHAN ACADEMY

Khan Academy is an American non profit educational organization created in 2008 by Salman Khan, with the goal of creating a set of online tools that help educate students. The organization produces short lessons in the form of videos. Its website also includes supplementary practice exercises and materials for educators. All resources are available for free to users of the website and app. The website and its content are provided mainly in English, but is also available in other languages. Khan Academy is a non profit organization, mostly funded by donations coming from philanthropic organizations. In 2010, Google donated $2 million for creating new courses and translating content into other languages, as part of their Project 10 program. In 2013, Carlos Slim from the Carlos Slim Foundation in Mexico, made a donation for creating Spanish versions of videos. In 2015, AT&T contributed $2.25 million to Khan Academy for mobile versions of the content accessible through apps. The Bill & Malinda Gates Foundation has donated $1.5 million to Khan Academy.

4.6 RESPONSIBLE VENTURE CAPITAL

What is responsible investment? A definition of responsible investment could cover various approaches. For example, sustainability, socially responsible investing, ESG (Environmental, Social and Governance) integration, applying a human rights lens, impact investing and gender-smart investing, among others. The objectives of responsible investment can include:

1. Managing risks – Risk management provides downside protection to funds and portfolio companies. This could include, for example,

protecting a start-up from a damaging social media backlash or future proofing a disruptive business model against regulatory change.

2. Adding operational value – Proactive ESG management can improve the performance of companies in all sectors. For instance, good practice in human resources can help attract and retain the best talent.

3. Identifying strategic opportunities – Adopting a responsible lens can help investors to spot new trends and areas of potential growth. For instance, by designing products for underserved female markets, creating technology that empowers workers or addressing demand for renewable energy through off grid solar.

4.6.1 Environmental, Social and Governance (ESG) Integration at VC Funds

VC fund managers are advised to integrate ESG into their investment processes to enable effective management of risks and opportunities across their portfolio. Given the small teams and time constraints of most VC fund managers, the approach needs to be streamlined and tailored to the specific fund strategy. The core elements of an effective ESG management system include:

1. ESG policy – Each fund manager should develop an ESG policy, outlining a core set of responsible investment principles and summarizing the fund manager's approach for integrating ESG into its investment processes.

2. ESG requirements – Fund managers should identify a set of ESG requirements or standards, which should include adherence to all applicable ESG laws and regulations as a minimum. Depending on the fund's LPs (Limited Partners), a list of excluded activities (such as gambling, pornography or arms) may also be a formal requirement.

3. Roles and responsibilities – There should be a clear allocation of responsibility for ESG at the fund manager, including adequate resources and expertise for day-to-day implementation (matching the fund's risk exposure). While many firms manage ESG through their investment teams, other options include having an in house ESG specialist (more common for funds focusing on higher-risk sectors) or engaging external advisors. For higher-risk investments, a dedicated advisor may be most appropriate. For lower risk investments, it may be possible to expand the scope of other advisors to cover ESG. For example, a legal advisor may be able to cover compliance with local labour laws.

4. Managing failure – Many VC backed companies will ultimately fail, and VC fund managers can play an important role in helping to ensure that these companies are wound up responsibly. This could include supporting entrepreneurs to ensure transparent communications to employees, providing advice on welfare support, and developing a common retrenchment framework aligned with international standards.

5. ESG reporting and disclosures – An annual ESG summary may be required by some LPs. Even if not a mandatory requirement, VC fund

managers should consider preparing a short annual ESG summary for LPs and/or for public disclosure. Some LPs may also require material ESG incidents to be reported at the time they occur.

Activity 2

Review some relevant literature and make a brief writeup on any one successful venture which could integrate ESG into their investment process.

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Check Your Progress - 2

Notes: a) Write your answers in about 50 words.

b) Check your answer with possible answers given at the end of the unit.

1) What do you understand by mezzanine funding?

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2) Write five characteristics of an ideal entrepreneur from a venture capitalist's perspective.

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4.7 LET US SUM UP

Venture capital (VC) is a new asset class in many emerging markets and has the potential to achieve development at scale. Successful VC-backed companies often provide significant jobs, skills and a route into formal employment in countries with growing populations and high youth unemployment. In this unit you have read about the meaning of social venture capital. You also read about the difference between social venture capital and traditional venture capital. Social venture capitalists are investors who typically back for-profit businesses that target consumers at the bottom half of the pyramid for larger benefits of the society. With emergence of social entrepreneurship, the funding of social enterprises has increased in the country like India. Social venture capitalists do not only provide long term funding, however, also participate in managing the social ventures. How the social venture capital works has been discussed along with various types of social venture capital.

4.8 KEYWORDS

Venture Capitalists (VCs) - is a private equity investor that provides capital to companies exhibiting high growth potential in exchange for an equity stake.

Acumen Fund - new approaches to social impact investing, which acts as an intermediary between philanthropic organizations and social enterprises. Acumen seeks a close partnership with the philanthropists often referred to as "donors" and the beneficiaries of that philanthropy, emphasizing the active role that all parties take in their projects.

Grassroots Business Fund - a non-profit based in Washington, DC, aimed to build and support high-impact enterprises that provide sustainable economic opportunities to thousands of people at the bottom of pyramid.

Debt capital - Debt capital is the capital that a business raises by taking out a loan.

Mezzanine capital - Mezzanine financing is a hybrid of debt and equity financing that gives the lender the right to convert to an equity interest in the company in case of default, generally, after venture capital companies and other senior lenders are paid.

Equity investment – Social venture capital firms also use equity investment through preferred shares.

4.9 BIBLIOGRAPHY AND SELECTED READINGS

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4.10 CHECK YOUR PROGRESS – POSSIBLE ANSWERS

Check Your Progress - 1

Answer 1: Social venture capital is an investment funding funded by social venture capitalists to provide seed funding investment in a social enterprise with the aim of achieving financial gains while delivering social impact through their enterprises.

Answer 2: Business angels are investors who invest in start-ups and private companies. Business angels are wealthy individuals, who invest their money in business ideas. The influx of capital can help an idea develop into a viable company and provide the base to begin producing the product or service proposed.

Check Your Progress - 2

Answer 1: Mezzanine financing is a hybrid of debt and equity financing that gives the lender the right to convert to an equity interest in the company in case of default, generally, after venture capital companies and other senior lenders are paid.

Answer 2: From a venture capitalist’s perspective, the ideal entrepreneur:

- is qualified in a “hot” area of interest,
- delivers sales or technical advances such as FDA approval with reasonable probability,
- tells a compelling story and is presentable to outside investors,
- recognizes the need for speed to an IPO for liquidity,
- has a good reputation and can provide references that show competence and skill.