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Capitalizing on Convergence

By James E. Austin, Roberto Gutierrez, Enrique Ogliastri, & Ezequiel Reficco

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apitalizing on **convergence**

*Nonprofits and businesses
are converging – in the value
they create, the stakeholders
they manage, the organizations
they form, and the
financial instruments they use.*

*The era of convergence is
upon us. Do you know how
to take advantage of it?*

IN THE 1960S, BUSINESSES AND NONPROFITS TRUNDLED along on separate tracks, having little to do with each other. IBM's overwhelmingly male workforce, for example, may have donated to Goodwill during the holidays, or volunteered with the Boy Scouts on the weekend. But come Monday morning, employees were back in their blue suits and red ties, ready to widen their company's profit margin. For their part, Goodwill and the Boy Scouts were pleased to receive donations and volunteers. But they didn't expect much else from IBM, or, for that matter, from any other business.

Over the past three decades, however, that has all changed. The paths of businesses and nonprofits have not just crossed; they have converged. In the 1970s, corporations started listening – albeit reluctantly – to nonprofits, as environmentalists clamored for more Earth-friendly practices. Then the 1980s ushered in Margaret Thatcher, Ronald Reagan, privatization, and the slashing of government social services. Charged with serving the world on a shorter shoestring, nonprofits had to become more entrepreneurial,

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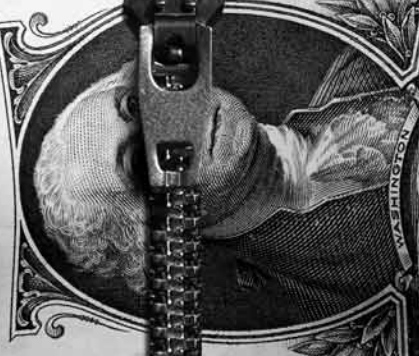
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Now it's 2007, and the business and nonprofit sectors have so much in common that it's sometimes hard to tell them apart.

efficient, and professional, and so looked to business for management models. Meanwhile, corporations began increasing their social contributions and even started delivering social services commercially, such as healthcare, childcare, eldercare, education, and prison management.

Next came the telecommunications revolution of the 1990s, which not only shone a spotlight on environmental and labor transgressions around the world, but also helped consumers organize against offending corporations and governments. With the 2000s came a slew of scandals in both sectors, which left donors and shareholders alike demanding that nonprofits and businesses more clearly account for their activities.

Now it's 2007, and the business and nonprofit sectors have so much in common that it's sometimes hard to tell them apart. IBM partners with the nonprofit Women in Technology to co-host an engineering camp for middle-school girls and has become a national champion for excellence in public education. And though Goodwill Industries still accepts donations, it's as much a booming business as it is a charity: Goodwill's \$2.21 billion in revenue from nearly 2,000 stores made it one of the top 15 discount retailers in the United States in 2003.

IBM and Goodwill are not alone. In our research, we find that nonprofits and businesses are converging much more quickly, broadly, and deeply than most people suspect. Through our studies in the United States and Europe, as well as our recent work with the Social Enterprise Knowledge Network (SEKN) in Latin America and Spain¹ (see sidebar on p. 27), we see many areas of convergence between the two sectors. In this article we explore four of the most important areas: value creation, stakeholder management, organizational structure, and capital mobilization. This multifaceted melding of the sectors creates opportunities to improve not only nonprofits and busi-

nesses, but also society as a whole. Seizing these opportunities, however, requires a new managerial mind-set.

Creating Value

Back in the 1960s, everyone knew that nonprofits created social value, whereas corporations created economic value. But this dichotomy no longer holds. As the nonprofit sector grows faster than does its funding, nonprofits keep pioneering ways to fill their coffers, often by creating income-generating operations. For example, the biggest charitable organization in Mexico, Nacional Monte de Piedad, I.A.P., stocks its kitty by running pawnshops. And in the United States, the YMCA network reports that it earned the bulk of its \$5.06 billion revenues in 2005 from its health and fitness, childcare, and camping services. Indeed, some critics, including Burton Weisbrod of Northwestern University, believe that nonprofits are unfairly encroaching on business's terrain.

Globally, nonprofits earn 57 percent of their income from selling services and goods, but only 13 percent from private donations, according to Lester Salamon and colleagues' book *Global Civil Society: An Overview*. Some nonprofits even outpace their for-profit and public sector counterparts, such as Associação dos Pequenos Agricultores do Estado da Bahia (the Association of Small-scale Farmers of the State of Bahia, or APAEB), a Brazilian nonprofit that aims to improve the living standards of the sisal growers of Bahia. For-profit companies were not creating business opportunities in this impoverished, drought-stricken region of Brazil, so APAEB decided to create those opportunities itself. The organization first coordinated production among hundreds of independent sisal growers, then expanded into transporting and processing the fiber, and ultimately began manufacturing sisal cords, rugs, and carpets. In two decades, APAEB created 3,900 jobs in a city of 20,000 people, and the region's per capita income tripled. At the same time, APAEB's own assets went from \$4,000 to \$9 million. APAEB now injects more funds into the local economy than does the local government.

Meanwhile, corporations assume more and more social responsibility, viewing it as good for business. Starbucks, for instance, figures that it saved about \$36 million – about 20 percent of its net income in 2001 – because the company's socially responsible projects helped keep employees loyal and therefore reduced turnover costs.² And the outdoor apparel company Timberland believes that giving employees paid time off to perform community service attracts, develops, motivates, and retains superior personnel.

National and global data reflect corporations' growing commitment to social responsibility. Almost all *Fortune* 500 companies now make charitable donations, and 25 percent of them include community service and social betterment in their mission or

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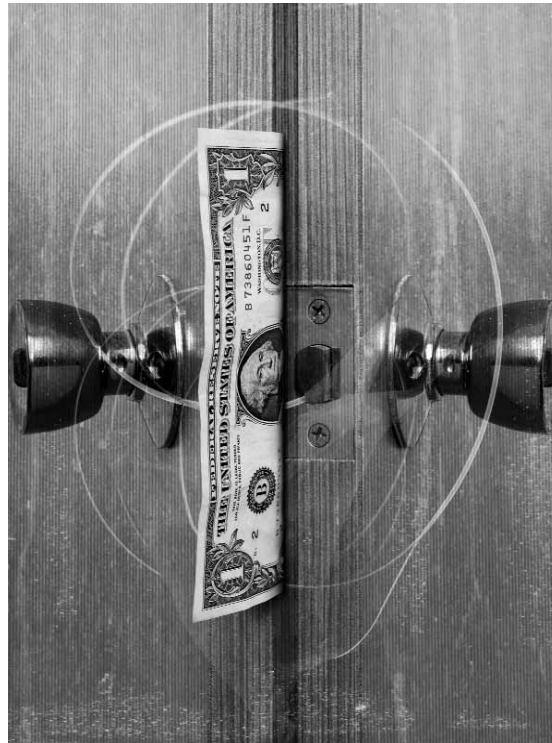
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value statements. In 2005, U.S. corporations donated more than \$12 billion to nonprofits and invested \$1.6 billion in cause-related marketing programs with nonprofits – up 33 percent from 2000, according to the *IEG Sponsorship Report*. Worldwide, about 475 corporations now use the most popular corporate social responsibility (CSR) reporting instrument, the Global Reporting Initiative (GRI), and many others use more than 300 other instruments to report on CSR.

One corporation that has integrated social action into its business strategy is the Mexican multinational cement company Cemex. Through a credit-savings program called *Patrimonio Hoy*, Cemex helps low-income families construct their own concrete homes – at two-thirds the usual cost and in one-third the usual time. In so doing, *Patrimonio Hoy* not only tackles Mexico’s overcrowding problem, but also connects Cemex with a stable and largely untapped market.

As nonprofits and businesses create both social and economic value, they face the same challenge: balancing these sometimes competing goals. At *Intermón Oxfam*, the Spanish chapter of the humanitarian aid group Oxfam, the income-generating side of the organization often fails to see eye to eye with the society-serving side. Whereas the income-generating side must court corporations for cause-marketing partnerships, the society-serving side must monitor and even denounce corporations for their poor social performance. The resulting tension between the two sides is “exhausting,” says Xavier Masllorens, manager of communications and marketing.



In the for-profit world, the Spanish apparel conglomerate Inditex has also learned that integrating social and economic imperatives is easier said than done. In the space of a little more than a decade in the 1980s, Inditex expanded to 45 countries on five continents, outsourcing much of its production to low-cost nations. To address labor and environmental issues in its supply chain, Inditex created a CSR department, adopted GRI guidelines, and partnered with local nonprofits. Despite Inditex’s best intentions, however, its CSR personnel are often at odds with its purchasing staff, who are always pushing for lower

prices and shorter turnover times.

To reconcile the two faces of value creation, nonprofits and businesses still have a lot to learn from each other. Nonprofits must learn from their for-profit counterparts how to build financially sustainable organizations with more professional processes. The nonprofit *Asociación Chilena de Seguridad* (Chilean Safety Association, or ACHS), for example, has borrowed extensively from the for-profit sector. “The only thing that sets us apart from a business is that we don’t have to distribute benefits to shareholders,” says Mario Bravo, ACHS’s chief financial officer. “But we are constantly seeking to improve our efficiency.” With a mission of improving workplace safety in Chile, ACHS uses a balanced scorecard and regularly holds strategic planning retreats. These practices allow ACHS to earn surplus revenue, which it then reinvests in training, technology, and infrastructure. According to CEO Eduardo Undurraga, strategic planning techniques led ACHS to diversify into other lines of

The Social Enterprise Knowledge Network

This article relies heavily on the findings of the Social Enterprise Knowledge Network (SEKN). From 2003 to 2005, SEKN analyzed the management practices of 40 successful social enterprises in Spain and Latin America, 20 of which were operated by companies, and 20 of which were operated by nonprofits. Researchers interviewed hundreds of people, and also reviewed company documents and secondary sources. Previously (2001 to

2003), SEKN had analyzed 24 strategic collaborations between businesses and nonprofits in Latin America.

SEKN was established in 2001 by leading Latin American business schools, the Harvard University Graduate School of Business Administration, and the Avina Foundation. Its research focuses on high-priority areas in the field of social enterprise. Members select a single research topic, design a set of common research questions and

methods, and then conduct field-based research.

Researchers in each participating country examine in depth at least four cases of social enterprise in the chosen topic area. The findings from each country allow researchers to make comparisons across countries. Harvard University Press has published SEKN’s books, and Harvard Business School Publishing distributes SEKN case studies. –J.A., R.G., E.O., & E.R.

A Nonprofit Microfinancier Changes Its Stripes

Bolivia's top-ranked financial institution, Banco Solidario S.A., or BancoSol, started out as a nonprofit microfinance institution but has evolved into a for-profit commercial bank. Through its transitions, the bank has been able to continue serving the poor while integrating management practices from both sectors.

In 1986, a group of nonprofits and socially minded investors created BancoSol's forerunner, a nongovernmental organization (NGO) named Prodem. Its mission was to give microloans to groups of low-income entrepreneurs in Bolivia – a nation where more than half of the population did not use a bank. To meet the demand for Prodem's services, the organization needed more funding than it could legally secure as an NGO. And so in 1992, Prodem became BancoSol, a private bank offering a full line of financial services. As a full-fledged bank, BancoSol was able to grow more quickly by investing clients' savings and securing loans from other financial institutions. Conscious that they were "mixing oil and water," the bank's leadership carefully integrated the nonprofit and for-profit cultures and managerial practices.

The institution achieved excellent results and became an international reference point in the microcredit arena. In 1999, however, BancoSol's fortunes changed. Increased competition, a stagnant economy, and political turmoil in Bolivia led to decreasing profits. BancoSol's return on equity fell by more than half to about 4 percent.

BancoSol's CEO and management team considered three strategies to improve the company's performance: return to the original nonprofit formula, shift toward larger clients and more commercial banking, or keep the original microenterprise segment but innovate and change. They chose the third option, and set out to develop new products and services, improve the bank's portfolio of investments, standardize operations, and achieve cost efficiencies – soliciting advice from both their nonprofit and for-profit stakeholders. BancoSol also developed a new social scorecard, which integrated its social and economic performance metrics. By 2004, BancoSol had fully recovered from the crisis and ranked as Bolivia's best financial institution. –*J.A., R.G., E.O., & E.R.*

Reference: Ogliastri, Enrique, Karina Caballero, and Mauricio Melgarejo. 2005. "Banco Solidario S.A. The Strategy of Recovery 2000-2004," Case 27692. Alajuela, Costa Rica: INCAE.

business, stabilizing its cash flow and helping it survive the severe economic recession of 1982.

Corporations, in turn, must learn from nonprofits how to create and measure social value. Half of the corporations that we interviewed lacked an explicit mission statement for their social enterprise activities. Among those that did, many failed to specify their beneficiaries or the specific problems to be tackled. Without a well-defined mission statement, organizations often fail to effect – let alone measure – social change.

Inditex is one company that has not only a clear mission statement, but also a code of conduct that applies to all of its manufacturing, distribution, and sales operations. Inditex also uses a complex scorecard, which the corporation calls its "Corporate DNA," to grade its 1,900 suppliers on social and environmental dimensions, not just on price. Purchasing managers are

asked to factor in social and environmental criteria before awarding supply contracts. The scorecard and code of conduct are shaping a unified culture that integrates the company's economic and social goals.

Managing Stakeholders

Another vestigial belief, still afoot in some quarters, is that businesses are beholden only to the individuals and institutions that provide their capital, whereas nonprofits are beholden only to their beneficiaries. Yet as nonprofits and businesses share goals, they must also commingle stakeholders.

For nonprofits, good intentions are no longer good enough. Donors – individual and institutional – are thinking more like investors and expecting higher returns on their social investments.³ And because many governments now outsource much of their social service delivery to nonprofit organizations, these organizations are now directly accountable to, and more carefully scrutinized by, public agencies. International agencies such as the World Bank are also turning to nonprofit organizations to help with development projects.⁴ Nonprofits that fail to meet their stakeholders' expectations feel their wrath, as did the American Red Cross following its 9/11 and Katrina relief efforts.

At the same time, businesses are broadening their definition of stakeholders to reflect their expanded aims. As Orin Smith, then president and CEO of Starbucks, put it, "[Our stakeholders] include our partners (employees), customers, coffee growers, and the larger community." Some

corporations even include representatives of nonprofits, workers, and grassroots associations in their governance bodies, or create ad hoc bodies for them, such as advisory boards or social councils.

When enterprises identify who affects or is affected by their actions, and then work with these stakeholders, they fare far better than those that do not. That's what the oil company Hocol discovered in southern Colombia. Residents blamed the company for a severe drought in 1991, and workers organized a strike. Realizing that local stakeholders had a poor opinion of Hocol, the company stopped subcontracting its social initiatives and began enlisting community and government input on every one of its social programs, including community development, income generation, and environmental education. Hocol also began employing local people and purchasing local goods as

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much as possible. Over the years, this approach has given Hocol such a strong social license to operate in conflict-ridden Colombia that it is now one of the most profitable of the country's largest 100 companies.

Restructuring Organizations

As businesses undertake social missions and nonprofits make money, their forms and boundaries must change. To succeed, many social enterprises have had to operate in ways that would have been unthinkable decades ago.

Many nonprofits have created for-profit subsidiaries, while many for-profits have established nonprofit subsidiaries. For example, the poverty reduction nonprofit Share Our Strength formed a for-profit subsidiary, Community Wealth Ventures, to advise nonprofits on how to earn income. Meanwhile, the for-profit consulting companies Monitor Group, Bain Consulting, and McKinsey & Company created the nonprofit Monitor Institute, Bridgespan Group, and McKinsey Nonprofit Practice to deploy their expertise in the social arena.

The number of U.S. corporate nonprofit foundations has, in turn, risen from 1,295 in 1987 to 2,549 in 2003.⁵ These trends are also very much in play in Latin America, where the world's largest producer of hard candy (the Argentine company Arcor), the world's leading producer of iron pellets (the Brazilian business Samarco), and Central America's largest producer of sugar (the Guatemalan agribusiness Pantaleón) have all created corporate foundations. Google has taken a new approach to corporate foundations, establishing a for-profit foundation with a seed endowment of \$1 billion to focus on poverty alleviation, health, and the environment. It decided to organize the foundation as a for-profit entity so that it would have more flexibility in deploying its social capital as investments in companies or for lobbying policymakers.

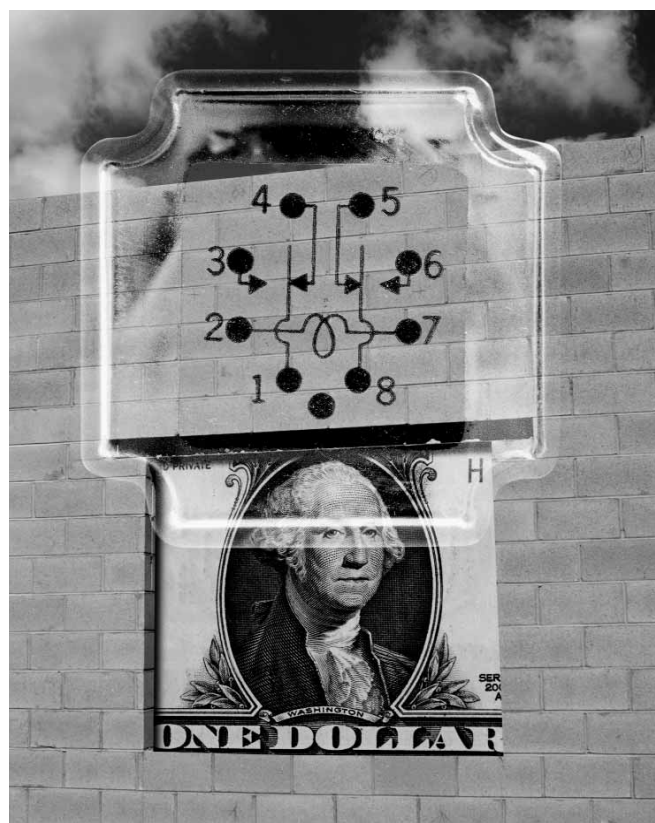
In some cases, convergence between sectors is giving rise to new organizational forms. Hybrids such as Newman's Own and Pura Vida Coffee are for-profit corporations, but with a core mission to generate social value. And then there are major global businesses owned by nonprofit foundations, including Tata Enterprises, the giant Indian conglomerate; Ikea, the world's largest home-furnishing retailer; and Grupo Nueva, a Latin American manufacturing conglomerate. To complicate matters all the more, some organizations, such as Bolivia's BancoSol, start out as nonprofits but turn into for-profits midstream (see sidebar on p. 28).

Yet another new organizational form is cross-sector joint ventures,⁶ such as the 17-year-old partnership between Timberland and the community service nonprofit City Year. Home Depot has a strategic alliance with KaBoom! to build playgrounds in inner-city communities, which fuses the company's building supplies and employee knowledge with the nonprofit's expertise

in developing community playgrounds. Even former adversaries are becoming allies as nonprofits and businesses converge. The timber products company Georgia-Pacific works with the Nature Conservancy to manage environmentally sensitive forestland. This alliance takes advantage of Georgia-Pacific's expertise in forestry management and the Nature Conservancy's expertise in environmental science.

One of the more novel cross-sector alliances is Posada Amazonas, an eco-lodge in the Peruvian Amazon that is jointly owned by a native community, the Ese'ejá, and a small Peruvian company, Rainforest Expeditions.⁷ The Ese'ejás granted Rainforest Expeditions exclusive rights to build an eco-lodge and lead tours on their reservation. In return, Rainforest Expeditions agreed to manage all operations, as well as to hire and train community members seeking work. The joint venture is run by the company and the community, with each holding 50 percent of the voting shares, and the Ese'ejás participate in decision making on all strategic issues through the management committee. Profits are shared by both partners: 60 percent goes to the community and 40 percent to the company. Because of Posada Amazonas' unique structure and brand, it is able to charge tourists premium prices.

For all of their benefits, cross-sector alliances make demands that partners may not be equipped to meet. When the Texas-



Financing Social Missions

Here is a sampling of innovative financial products that organizations are using to raise money for social causes:

Microfinance institutions: Historically, would-be entrepreneurs in the world's most impoverished regions had no access to start-up capital, even though the amounts they needed were little more than pocket change to the average American. But now, around 3,000 nonprofit and for-profit microfinance institutions (MFIs) make very small loans (microloans) to millions of small businesses (microenterprises) around the world, usually with the underlying goal of improving the health and welfare of the businessperson's society as a whole. Over the past 30 years MFIs have grown into a \$9 billion industry. MFIs in Mexico, Peru, and India have successfully issued commercial bonds both as private placements and public offerings. Several international MFI investment funds have been created to lend or provide loan guarantees to MFIs around the world. BlueOrchard Financial Securities raised \$87 million, and the Global Commercial Microfinance Consortium, led by Deutsche Bank, closed in 2005 with 26 institutional partners committing \$75 million.

Calvert Community Investment

Notes: In 1995 the Calvert Group partnered with the Ford, MacArthur, and Mott foundations to create both the Calvert Foundation and a new way to

lend to nonprofits. Social investors buy notes in \$1,000 denominations, choosing the length of the loan, from one to 10 years, as well as the earned interest rate, from 0 to 3 percent. Calvert then lends this money to nonprofits in the United States and abroad. As of 2006, Calvert has raised \$95 million from 2,400 investors, which it has lent to almost 200 nonprofits. While other loan funds invest in nonprofits, Calvert has incorporated its notes in the Depository Trust Company system, through which most U.S. securities transactions are electronically processed. This means that brokerage firms can now handle the notes just like any other security. As a result, major investment firms have now begun to trade them – another important convergence between the social and commercial capital markets.

Social venture philanthropy: Social venture philanthropists (SVP) treat their grants as investments, and so they systematically measure the social return on those investments. The Rockefeller Foundation's Program Venture Experiment has invested \$13 million as a complement to its philanthropic grantmaking. The Acumen Fund was created in 2001 with \$8.5 million in seed funding. Other successful firms include Social Venture Partners and Venture Philanthropy Partners. Several funds have a

specific focus, for example, NewSchools Venture Fund focuses on educational innovations, Investors' Circle on environmental sustainability, and Aavishkaar India Micro Venture Capital Fund on innovative rural enterprises.

Donor-advised funds: Such funds (DAFs) were traditionally a community foundation tool, by which individuals would place their philanthropic capital with a foundation that would help them decide which nonprofits to support. DAFs then migrated to the business sector. Pioneered by Fidelity's nonprofit Charitable Gift Fund, DAFs managed by commercial companies allow those companies' financial service clients to make charitable donations as part of their portfolios. About 36,000 of Fidelity's commercial clients have signed up for this tax-advantaged donation vehicle, which to date has raised \$5.5 billion in donations, making it one the largest new philanthropic capital sources. Most of the other major financial services companies now also offer DAFs. –J.A., R.G., E.O., & E.R.

For fuller elaboration, see Emerson, Jed and Josh Spitzer. March 2006. "Blended Value Investing: Capital Opportunities for Social and Environmental Impact." Geneva: World Economic Forum.

based supermarket H.E. Butt Grocery Co. (HEB) entered northern Mexico, for example, it brought with it not only its products, but also its social vision: a world-class food bank that could serve northern Mexico's hungry for the next 20 years. HEB chose the Monterrey Food Bank to be its local partner for this charitable undertaking.

Yet HEB's ambitious goal did not jibe with the food bank's traditional culture of austerity. In the words of Blanca Castillo, the food bank's executive director: "We couldn't have a new truck because we were a social aid institution. We were not supposed to have last-generation computers because that's only for private corporations."

To realize its vision, HEB had to donate substantial amounts of technology, equipment, and management training to the

food bank. In exchange, the food bank taught HEB how to work with local organizations and how to reach its target beneficiaries. In the end, the partners capitalized on each other's resources, but only after they invested heavily in each other.

Mobilizing Capital

The final area in which businesses and nonprofits are converging is how they raise money. Thirty years ago, businesses raised money in the capital markets, using sophisticated instruments that appealed solely to investors' material goals. Nonprofits, on the other hand, sought donations and grants in the highly fragmented philanthropic marketplace, largely appealing to donors' emotions.

Not anymore. Both nonprofits and companies are exploring the other sector's ways of mobilizing capital, because many of their investors are the same individuals or institutions that invest their capital in both the commercial and social arenas. This convergence of financial mechanisms broadens the sources of funding for both businesses and nonprofits. It also gives investors more choice and makes for better matches between those with capital and those who need it.

Social investors and nonprofits are taking advantage of several sophisticated instruments to fund their missions, including microlending, social investment notes, social venture capital, and donor-advised funds (see sidebar on p. 30). Some of these products offer donors both financial and social returns.

At the same time, corporations are appealing to the social sensibilities of investors, rather than just to their wallets. Among the investors that corporations are attracting to their social enterprise projects are foundations and international development agencies. A growing number of commercial mutual funds use environmental and social criteria to select companies. Some new venture capital funds, including Investors' Circle, Generation Investment Management, and Medley Partners, are also using social and environmental criteria, not simply to attract socially oriented investors, but also to identify more sustainable businesses that will prosper over the long haul.

By using the commercial financial markets, these funds permit scaling and reduce transaction costs for people interested in social investing. They also reduce the cost of capital for social enterprises. In the last eight years, assets in socially responsible funds have grown 400 percent, and the number of funds has gone from 65 to 200,⁸ amounting to about \$2 trillion under management. Although researchers do not fully agree on whether social responsibility improves financial performance, socially responsible funds do seem to have performed well.⁹ For example, the Amana Income Fund, which is managed by a U.S. firm in accordance with the principles of Islamic finance, was one of the top-ranked funds in terms of its one-year return.

Despite their early promise, these new ways of raising capital are not yet tried and true. Moreover, they are mostly limited to the wealthier parts of the world, which already support flourishing commercial and philanthropic markets. One possible exception is the microfinance industry, which is mainly a developing-country phenomenon. Once largely donor-financed, microfinance now taps into the commercial capital markets. As of 2006, the Microcredit Summit Campaign reported that more than 3,000 microcredit institutions were serving 92 million low-income people, 84 percent of whom were women.

Converging Into a New World

Although nonprofits and for-profits are more allied than ever, they still have many differences of degree and kind. This is good.

Nonprofits should continue to serve as watchdogs, making sure that businesses and governments do as little harm as possible. And businesses should continue to perform their core economic functions efficiently, because they are the engines of a healthy economy.

Yet the leaders of nonprofits and businesses would be wise to shift their current mind-set from one of "us and them" to one of "we." This new mind-set thinks in terms of systems and focuses on interdependence, partners, and strategic allies. It embraces new organizational forms and views organizational boundaries as elastic and permeable. It takes advantage of the migration of talent across sectors and deepens its relationships with the full range of its stakeholders.

This new mind-set recognizes that it must not only produce both economic and social value, but also capture the synergies between the two. It seizes new instruments to integrate the financial and philanthropic capital markets. And it insists upon transparency and accountability, understanding that this will ultimately attract more talent, trust, and funding.

In the galaxy of social enterprise, the planets are realigning. Their trajectory suggests disruptive change, major challenges, and significant opportunities. Although much uncertainty looms, what is certain is that we will be in it together. □

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