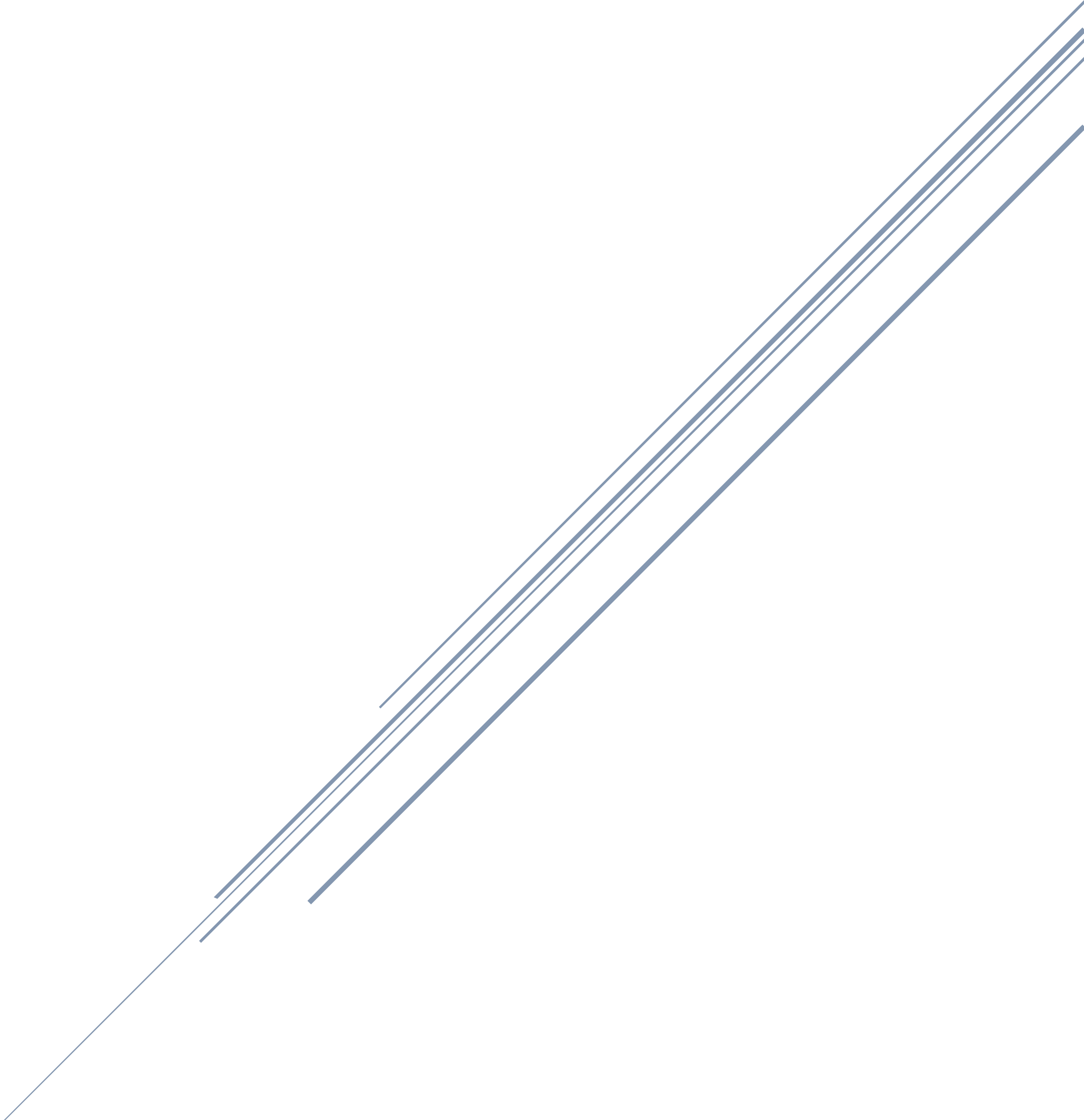
SCALING PURPOSE-DRIVEN COMPANIES

White Paper



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Scaling Purpose-Driven Companies

Purpose-driven companies balance their operations to serve a variety of stakeholders including customers, investors, suppliers, and the communities where they operate. They intentionally allocate available resources to more than shareholder return, and thus are sometimes called 'social business'. In order to protect their purpose, they may separate representation in corporate governance from claims on distributable earnings. Investors understand that their investment rate of return will likely be sub-optimized. Because such companies require patient, purpose-driven investment, their growth must largely be financed internally.

The growth challenge is particularly acute for small businesses. Their connection to consumer markets is often held hostage by much larger organizations possessing supply chain leverage, and their small volumes consign them to being price-takers with a minimal slice of overall value chain profits. They are exposed to local market risk with no ability to shift production or distribution away from depreciating currencies or corrupt regulatory bodies. Larger competitors with adaptive supply chains can better respond to changing consumer demands, and enjoy economies of scale that allow them to undercut higher-cost suppliers. Small businesses operating on market fringes have always struggled to maintain financial sustainability. Like it or not, profits convey influence and voice, and social impact is a function of both.

This paper suggests several strategies to position purposeful companies for greater commercial resilience, with the understanding that each must be locally adapted:

1. Smaller companies should become part of larger value chains that vertically integrate as much supply and distribution as possible to gain market control and maximize margin capture. Each participating organization leverages its comparative advantage to help maximize the performance of the whole.

2. Achieving value chain scale requires collaboration among participants that must rest first on a foundation of trust and mutual interest.

3. Greater scale demands more sophisticated planning and execution business practices. These capabilities can be supplied by a shared service when expertise does not exist within the value chain.

4. Investing in value chains requires that capital transition from loans and donations to strategic social business private equity placements. Separating ownership and governance mitigates asset abuse while giving a broader stakeholder group an enhanced missional voice in value chain operating and financial decisions.

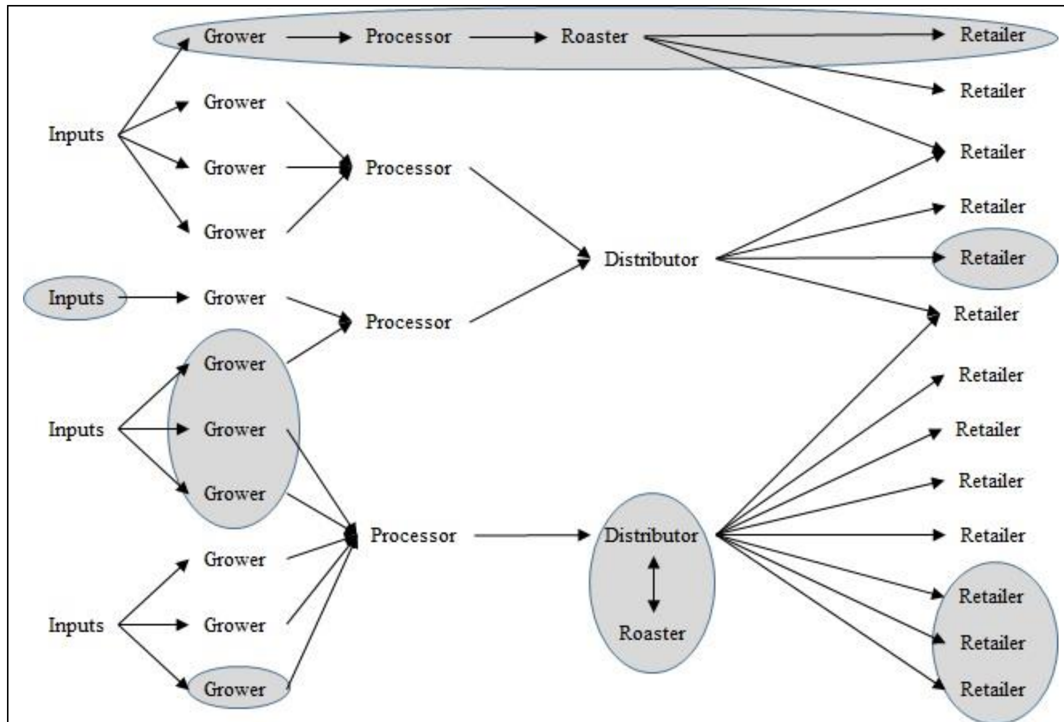
<u>Transition from Companies to Value Chains</u>

A value chain is simply a connected group of value-adding suppliers looked at from the perspective of the total value delivered to the end customer. Value chain designers consider how to best include each supplier so it can add the greatest possible value appropriate for their position(s) in the network. They also reconfigure the supply network over time based on actual performance. The total income to the value chain net of its aggregated costs is the collective profit. Profit is allocated as part of value chain governance to various purposes such as reinvestment for growth, profit distribution to investors, and financing of missional activities.

Company owners, managers and investors should regularly look for strategic expansion/acquisition opportunities evaluated through the lens of a classic Strength-Weakness-Opportunity-Thread (SWOT) analysis. Solid business plans that sustainably provide for a triple bottom line impact should be seriously considered for funding by the emerging ESG and faith-based investment communities.

In some industries, numerous organizations/projects are part of fragmented eco-systems. The diagram below illustrates a fictional coffee industry network with individual company operations circled and shadowed. There is only one integrated end-to-end supply network shown. More typically, companies work with a few growers or

operate standalone retail shops. There are numerous gaps in which the companies depend on others controlling product movement, pricing, inventory, and margins. The objective in scaling a company is to re-organize this network and fill in the gaps to take back the value chain margins and maximize purposeful community impact.



The art of value chain design lies in applying core principles in ways that work for all participants in a group win.[1]

- *Aggregate everything*. Volume allows access to larger distribution channels, leverages economies of scale, allows broad dissemination of best agricultural practice, and provides more options for supply/demand balancing.

- *Vertically integrate as much of the value chain's operations as possible*. When demand exceeds supply, processors and roasters have pricing power over distributors. When supply exceeds demand, distributors have the pricing power. Controlling both allows the value chain to best match supply and demand for optimal profits and customer satisfaction.

- *Optimize intermediary processing to balance transportation cost, harvest scheduling, and storage requirements.* This is often accomplished by distributing processing closer to the source of supply and turning inventory more quickly in smaller batches. Inventory storage is used at various positions in the network to synchronize supply with consumer demand patterns.

- *Differentiate products.* Branding of commodity products is used to convey unique value to the consumer, such as premium coffee from indigenous peoples or sponsorship of local sustainability projects (eg., sanitation, health, education). Alternatively, the formulation of specialized food and industrial products from commodity crops captures value added pricing from smaller markets. The key is matching agricultural potential to non-traditional market opportunities (eg., fermentation of saccharified starch to industrial intermediate chemicals rather than food-grade paste).

[1] Coke, James. "Economic Empowerment in the Agricultural Supply Chains of Lesser Developed Countries", 2012.

- *Pursue missional opportunities by owning or interacting closely with growers and retailers*. Evangelists functioning as crop buyers are uniquely positioned to meet with farmers, cooperatives, village leaders, and community influencers. They can also teach farmers best practices that bring blessing to their land and household.

- *Govern the supply network as one virtual organization*. Negotiating buy-sell (transfer) pricing between entities is difficult and can lead to contests over who should capture the margins. This is avoided by a) recognizing system-wide revenue at the point of final product delivery, 2) paying every entity's reasonable costs (allocated fixed plus variable) from those revenues (or a working capital pool if cash flow timing is an issue), and 3) distributing profits as a group wherever needed most. The governance system must reflect the reality that not all of a company's activity may be a part of the value chain.

A facilitator brings all the potential supply network participants to the table. Ideally, this is an entrepreneur or investor from within the industry trusted by all the parties. A value chain map like that diagrammed above is used to model various scenarios for collaborating and networking the various operations. The group identifies what activities are needed to build out the most effective supply network, identifies what part each company can play, and targets missing parts for acquisition or new company development. Some configuration of existing company operations may be required. The goal is to design flexible, end-to-end supply networks that can sell into additional markets and increase the financial and spiritual impact potential for everybody.

There may also be opportunities for horizontal expansion in which the vertically integrated value chain takes over supply of its own key inputs. Examples include:

- Raw material production (minerals mining, seed propagation)
- Resource management (energy, water, waste remediation)
- Logistics (transportation, customers clearing and brokering, warehousing)
- Packaging (box production, printing and labeling)
- Equipment support (maintenance, repair, replacement parts fabrication)

Operating these businesses allows the value chain to impact the participants in supply chains serving other, unrelated industries. For example, the ability to fabricate basic replacement parts might lead to creation of an outsource contract manufacturing company that specializes in 3D printing or working exotic metals. The opportunities are endless to the extent there is a market within reach and retained value chain investment capital available to deploy.

Operate as a Community

Purpose-driven companies typically serve an affinity group organized around a common purpose or need. The group may be a cause, a local community of people, or even a weak provincial government. Most such groups are not sovereign in that they are subject to the laws of the nations in which they operate, but they are otherwise autonomous and self-governing voluntary associations based on trusted relationships. Similarly, social businesses are simply legal associations of people doing business together. A social business value chain is also a voluntary, self-governing association of like-minded or otherwise cooperating companies.

Communities can always find a way to do business together; just as they eat, worship, and raise children together as part of community life. But a lone business or entrepreneur rarely collaborates successfully with others absent the community ethos. This becomes readily apparent when negotiations around value chain integration start. Entrepreneurs, investors, and others gathered around the value chain map need to be humble in this understanding to allow group wisdom in decisions. They need to be in trusted relationship with one another as a pre-requisite for doing business together. If the folks around the value chain table are protecting turf, they will never be able to decide how to align everyone's incentives and how to allocate collective earnings.

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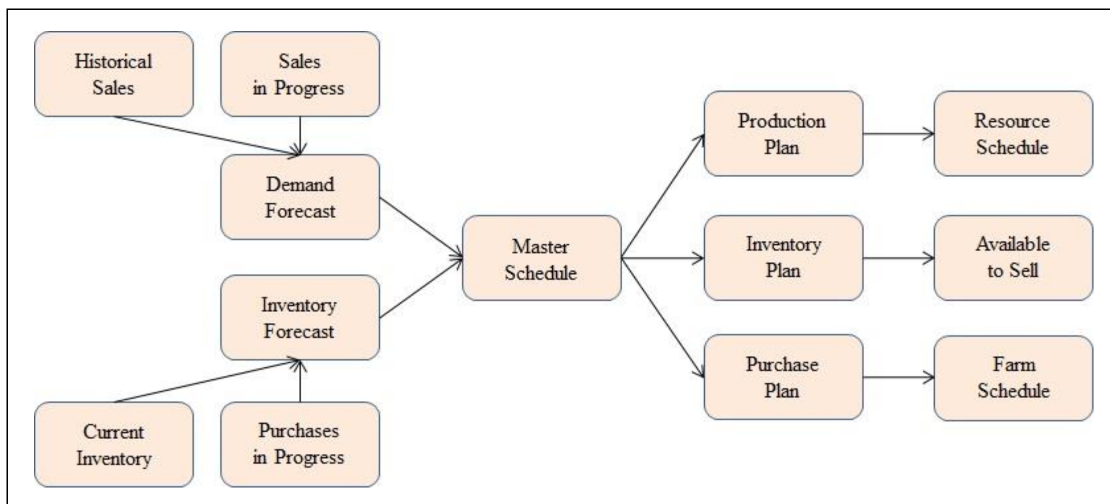
Proactively Manage the Supply Network

Managing an end-to-end supply network involves plenty of daily execution activities that need to be coordinated among parties. Those found in the food /cold chain include:

- Planting, cultivating, and harvesting crops
- Converting plant material into food and other products
- Moving material among all the cultivation, processing, warehouse, and retail locations
- Complying with government requirements for traceability, export/import, and food safety testing
- Contracting and paying participants, collecting from customers, and publishing accounts

Good planning is required to ensure that daily execution runs smoothly. The diagram below illustrates some of the planning tasks that balance demand and supply throughout the value chain. They ensure that farmers do not harvest all at once, producers do not exceed capacity, sufficient transportation is available, and inventory is never too high or too low to provide cost-effective demand satisfaction. It takes some analysis to know when to allow customer demand to set reorder levels and when to push forecasted needs to distribution warehouses. Long lead times for transport, customs clearance, product drying, and so on are factored into the schedules alongside the customer's own order fulfillment lead time. Too much inventory stuffed into the pipeline ties up valuable working capital and leads to product spoilage. Working capital dictates trade finance requirements.



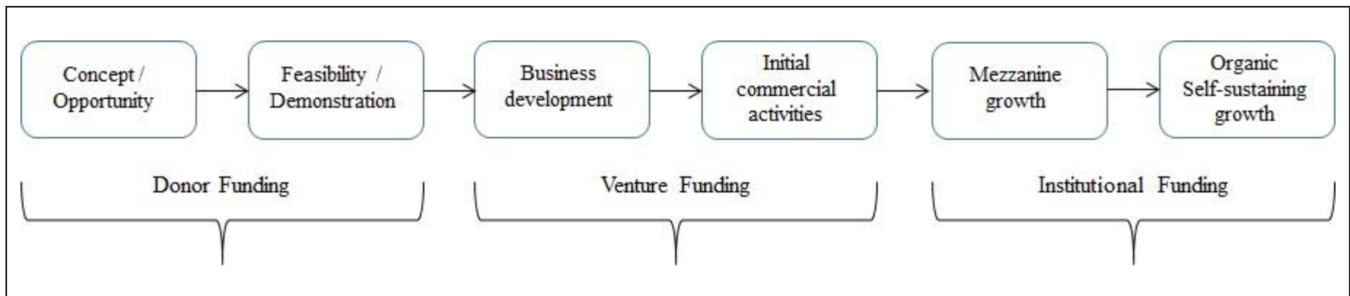
Unless the full supply network is simple, regional, and involves minimal product differentiation/postponement, computerized support is required to do all the planning, tracking, and reporting required. Additionally, technologies like RFID for product identification and monitoring linked with GPS movement tracking can be helpful in quickly identifying deviations from the plan that are going to unbalance supply and demand. Laboratory sampling of raw, intermediate, and final product is essential for quality assurance that minimizes potential legal liability. Blockchain-based traceability guarantees customers get what they expect.

All of this takes sophistication that most SME companies possess only in part. For that reason, it may be helpful to offer a shared service to value chains that provides the required capabilities so they can focus on their daily operations. This would centralize the expertise and analytic infrastructure to gain further economies of scale.

Scale Investment

Purpose-driven companies without access to public equity markets are dependent on specialized investment capital. Startups can sometimes rely on incubation programs and related donor funding, including commercializing research that has been publicly funded. Private investment then fills a critical gap between

proofs of concept and mezzanine growth, especially for faith-based initiatives screened out by secular funding sources. Much of this investment takes the form of loans, whether micro or venture, that are intended to be repaid out of business earnings. Many of the recipients have no collateral, but loss rates to investors are low since entrepreneurs typically turn to family and friends to help meet the required payoffs if the business fails.



Many companies start with some mix of donor and debt financing. They grow to a point where larger amounts of working capital are required and find themselves in the market for venture money. Entrepreneurs must choose between plateauing and accepting expensive/constraining investment. In too many cases when anticipated market growth does not appear, these arrangements result in the company's assets being liquidated to provide the investors with their agreed return.

We cannot consolidate value chains and grow purposeful companies to an impactful size in this way without compromising their missional autonomy. If we want them to scale for impact, then we need to scale their capitalization. Additionally, providing finance to a virtual value chain instead of its member businesses requires a different approach to structuring the legal entities and their governance. Here are some thoughts on moving such finance to the next level:

- *Use private equity rather than debt*. This forces investors to be more rigorous in their investment screening, more active in company governance, and more patient seeing a cash return on their capital. The benefit is more robust stakeholder alignment, improved access to additional wraparound support when needed, and less risk of a forced liquidation. Private equity is an investment in the full sponsoring community, and partnership with its mission. Importantly, it allows entrepreneurs to avoid Jewish and Islamic prohibitions on use of debt that indentures families and tribes. One approach to distributing investor return is to provide dividends as a pre-agreed share of the profits being allocated until the principal is returned, after which dividend share follows a declining scale.

- *Investors also need to collaborate to reduce risk*. Investments in the millions rather than hundreds of thousands of dollars will be required to consolidate and grow some worthy value chains. Few ESG and social sustainability funds can manage this exposure, so the investment community needs to develop a protocol for more aggressively working together to mobilize the necessary capital. From the perspective of the entrepreneur, it is often more efficient to pitch a consortium with rapid follow-on due diligence.

- *Leverage a holding company when investing in the value chain itself*. It is sometimes appropriate to invest at the value chain rather than individual company level, which allows the network to add and delete collaborating organizations and services as needed without changing the capital structure. A (typically foreign) holding company provides working capital wherever it is needed in the value chain in exchange for a claim on specific assets that cannot be sold by the companies that may be using them. It may passively direct the investments and hold the assets, or actively manage network wide activities by receiving the end customer revenues and directly paying the various company costs.

- *Separate ownership and governance*. We have made the case that community is a pre-requisite for doing business together, and this requires making a place for broader than normal stakeholder engagement in

governance decisions. The community needs its own incentives and buy-in. But it is equally true that corruption can arise anywhere and we have seen many instances of local entrepreneurs liquidating donor-funded assets for their personal benefit. For this reason, investors might retain legal ownership of capitalized assets while the broader community makes decisions regarding the most productive use of those assets. Keeping asset ownership in a foreign holding company also discourages local government expropriation.

- *Sell investors appropriate Key Performance Indicators*. Investment funds sell participation in their portfolios based on some promise of return to investors. The sales pitch must shift to one in which success is measured by multi-dimensional impact. Explicitly Christian funds should report metrics on social/spiritual impact alongside portfolio company operating and financial performance. Tremendous business growth and missional impact can be happening without current financial return when stakeholders have decided to reinvest earnings in growth. These profit allocation decisions must be transparent to the fund's investors, and celebrated when expectations have been properly set.

It is notable that ESG and social sustainability investment funds have found it difficult to sell multi-dimensional impact to investors during the past 40 years. But a new generation is now receiving family wealth transfers that appears more amenable to socially redeeming investment. Anecdotal evidence even suggests that ESG-oriented capital is presently having difficulty identifying enough worthy projects. The funds lack the resources needed to properly evaluate the deal flow in the context of their investment criteria.

Implications

The foregoing is theory until proven in the marketplace. We know the commercial best practices around value chain management hold throughout the business world. We are looking for purpose-driven commercial collaboration, funding, and governance applied at a scale that achieves industry value chain impact. We cast a vision via real world experience.

The ideal value chain for applying these principles is one with the following characteristics:
- The industry is simple to understand, with limited product families and basic supply network structure.
- A defined end customer market is stable with reasonable pricing margins.
- Local companies are already concentrated in a geographic area with substantial aggregate production.
- Strong local community involvement in the industry is supportive of the entrepreneurs and companies.
- Investors are already engaged with the companies and supportive of scaling the value chain.

Agricultural 'farm-to-fork' value chains offering differentiated branding are always good candidates. So too are contract manufacturing and business process outsourcing companies that use emerging market resources to serve first world customers having higher cost structures. This is particularly true when a manufacturing process is geographically close to ores, fiber, and other required bulk raw materials.

Managing a well-structured portfolio of impact investments requires managing to a broader set of metrics than do most active investment managers. Sustainability requires holding a few companies that generate lots of cash to allow the fund to subsidize the overall fund mission. It requires much more active engagement in governance and local due diligence. The portfolio manager is as much a part of the entrepreneurial value chain as any other stakeholder.

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