# The Importance of Business Models

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Inspired by the success of microfinance, with more than $67 billion in assets, and mobile money pioneers like M-PESA, donor agencies are increasingly supporting inclusive business as a means to address poverty. However, the main fact about such private sector–led development is that business models matter often far more than the underlying product technologies—something most donor support models fail to take into account. Because of the exacting conditions of low-income markets—such as low purchasing power, and uncertain and variable cash flows—entrepreneurs cannot use the same models as those for middle markets. They need to develop new models, of which only a few will succeed. One of the key factors for success and impact is scale, but market entry models are much quicker to scale, while market creation takes much longer. Mature models scale faster than unproven models, where the ability to cover fixed costs and/or model validation costs is an impediment. As a result, most private sector firms tend to focus on easier-to-reach segments and markets, which require less business model adjustment and cost; even impact investors tend to support later stage, less risky enterprises. This suggests a substantial policy and donor agenda, but will require approaches and tools different from the ways that most of the problems are currently being addressed.

## WHAT IS THE ISSUE?

Many development actors now increasingly believe that one of the primary ways to achieve large-scale social impact is via commercially sustainable solutions.[1] Many are described as "inclusive business," which can be defined as a "profitable core business activity that also tangibly expands opportunities for the poor and disadvantaged." Private firms, social entrepreneurs, impact investors and donors have invested substantial time and effort in supporting new initiatives at the intersection of the private sector and development in the last decade. Although it is difficult to estimate the amount of donor money flowing into such efforts, or to quantify funding from multinational corporations (MNCs) or other large commercial enterprises, Global Impact Investing Network (GIIN) has estimated that impact investing has already capitalized $50 billion available to invest in such firms, and a 2010 J. P. Morgan report suggested that impact investing will be a $1 trillion asset class in the near future. All this new activity is premised on the assumption that scale, at least on the order achieved by microfinance, is achievable by using such private sector–led approaches.

Governments and donors promote private sector–led solutions, for reasons ranging from outcome and efficiency considerations to a desire to "crowd in" private investment and activity to provide social benefits. Some do so in recognition that in many countries the private sector is already providing a given good or service at large scale (for example, health in India), and to work with the system to improve what it can deliver affordably. This approach can also help fiscally strapped governments—whether in emerging markets or donor countries—to use their resources more efficiently and target their funds more to the poorest segments or most difficult situations.

A 2012 Monitor Group review for the Rockefeller Foundation suggests there are 13 donor programs providing grant or policy support focused exclusively on inclusive businesses, committing about $55 million per year (versus about $1.7 billion committed by GIIN-surveyed investors in for-return investment in 2012).[2] Another 16 donor programs promise substantial additional support, albeit only partially focused on inclusive businesses. Further new planned programs are rolling out quickly. And multiple other donor programs focus on private sector activity, but organize around a specific technology, like mobile-phone-based health technologies, clean cookstoves or developing improved seeds, in relatively limited ways.

However, recent research suggests that the single biggest factor that enables such private sector–led approaches to reach a meaningful scale in dealing with base of the pyramid (BOP) markets is *getting the business model right*. The business model—the specific combination of product, distribution, supply chain, financing, pricing, payment and sales—is often far more important in determining success than a given specific technology. In Kenya, M-PESA succeeds in part because of a compelling combination of mobile phone technology and billing platforms, but even more as a result of its detailed attention to building its network of tens of thousands of agents who service customers.

However, most donor funding approaches for inclusive business approaches miss the lens of the business model, focusing more often on a vertical sector or technology, and do not take into account the lessons from the businesses themselves. As a result, there is still too much of a "one size fits all" expectation around private sector support. Expectations are still framed by Silicon Valley venture capital or perceived MNC success stories like Unilever's Shakti program, rather than by the realities of engaging the poor with socially beneficial goods and services, or in supply chains. These assumptions raise the risk that such these investments will fail to lead to large-scale social change as intended, and they risk missing the opportunity of truly engaging private firms in the right way to address key development issues.

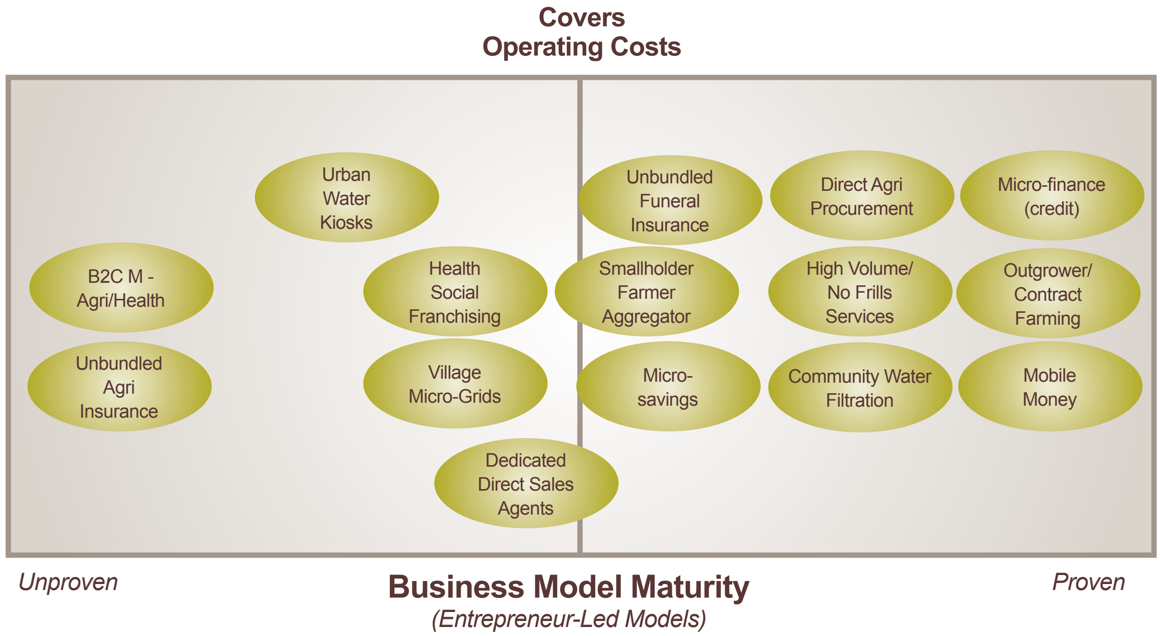
## WHAT NEEDS TO HAPPEN AND WHY?

### *The Importance of the Business Model*

The ability of a given business model to scale depends significantly on the maturity of the business model itself—that is, its ability to provide socially beneficial goods, services or livelihoods and recover its costs at scale. This in turn depends on a number of different factors: (1) whether it is promoting a pull product—for example, mobile phones and credit—or a push product—for example, contraception and solar lanterns; (2) how much of the surrounding ecosystem the business model also must manage and organize, especially but not only in models that involve supply chains; and (3) whether the task at hand requires *market entry* or *market creation.* The time to scale will depend on a combination of all three of these and additional factors, such as building out credible distribution and sales capabilities.

Some models can scale up quickly, but many require years, or decades, to get right before ever even being suitable for scaling up; thus, microfinance took more than 30 years, and contract farming more than 50 years. Many participants in inclusive business still tend to have unrealistic and overly optimistic expectations about

**FIGURE 1. MATURITY OF SELECTED BUSINESS MODELS, BY DEGREE OF OPERATING COSTS COVERED**




*Note: Business model maturity estimated based on (a) ability to cover costs, (b) multiple players deploying (c) large scale of buyers/suppliers etc engaged. *Dedicated direct sales refers to push products, e.g., health goods*

*Source: Monitor Analysis*

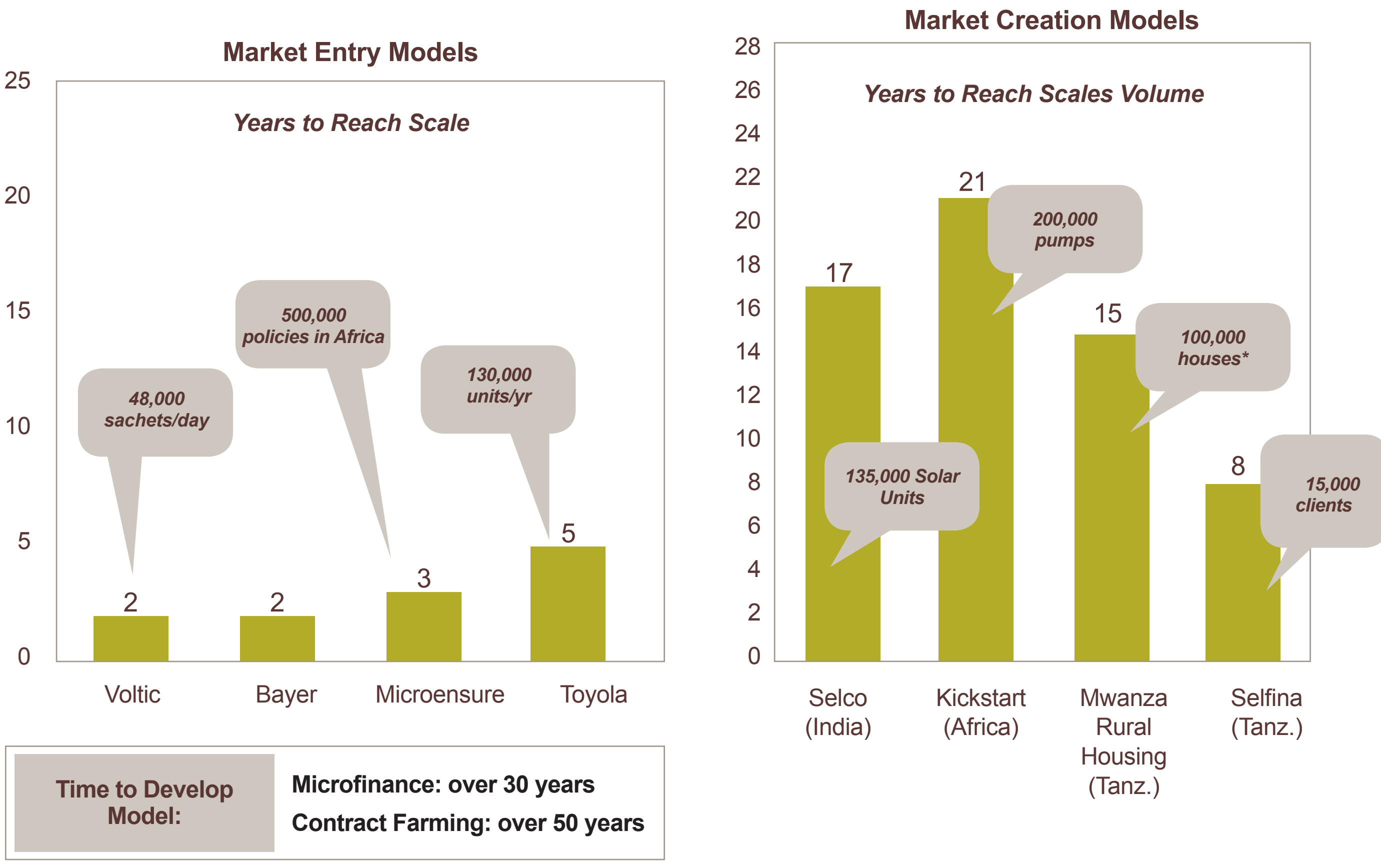
how quickly a given model can reach large numbers of customers or suppliers. This is especially true for expectations of small, inclusive commercial and social enterprises. There is, in fact, a broad diversity across business models, and each varies in its maturity, scale, reach and cost recovery. Figure 1 charts the maturity of different business models encountered, with a key break at the ability to cover costs.

### *Key Driver of Time to Scale: Market Entry versus Market Creation Models*

In addressing models for selling to BOP consumers, market entry business models typically—although not always—take less time to perfect and to scale up (see figure 2). These efforts target markets where the low-income consumer is already accustomed to paying for a good or service, albeit informally, expensively and sometimes for life-endangering quality. Examples include credit, where microfinance substitutes for informal money lenders; money transfers, where M-PESA substituted for expensive and insecure bus transfers of cash; cookstoves, where many consumers often already pay for both cookstoves and in many cases fuel; or budget private schools, where parents are already paying government (or private) school fees. In these cases, the presence of underlying demand can make it faster to achieve large-scale reach, because the demand creation task (and associated cost) is much lighter.

Market creation business models, conversely, often require much longer times to develop, perfect and scale up—typically a decade or more. Finding a business model that works in the first place requires experimentation, failure and trying again. Such models are often attempting to create markets among the BOP for socially beneficial goods and services that are not usually paid for by low-income households, require significant amount of trust, and often entail behavioral change and related communications. Often, investments in behavioral change—for instance, in contraception or irrigation—do not benefit the first mover but the whole category of private players. Such investment is a public good, but the cost can render a given business model unviable if left to one enterprise to cover.

## FIGURE 2. TIME TO SCALE UP FOR DIFFERENT MODELS




*Note: The different industries for the companies listed above include Voltic, drinking water in Ghana; Bayer, chemical crop protection in Kenya; Microensure, bundled credit life coverage via microfinance institutions; Toyola, clean cookstoves in Ghana; Selco, solar home systems in India; Kickstart, irrigation pumps in East Africa; Mwanza, rural housing Tanzania; and Selfina, microleasing in Tanzania.*

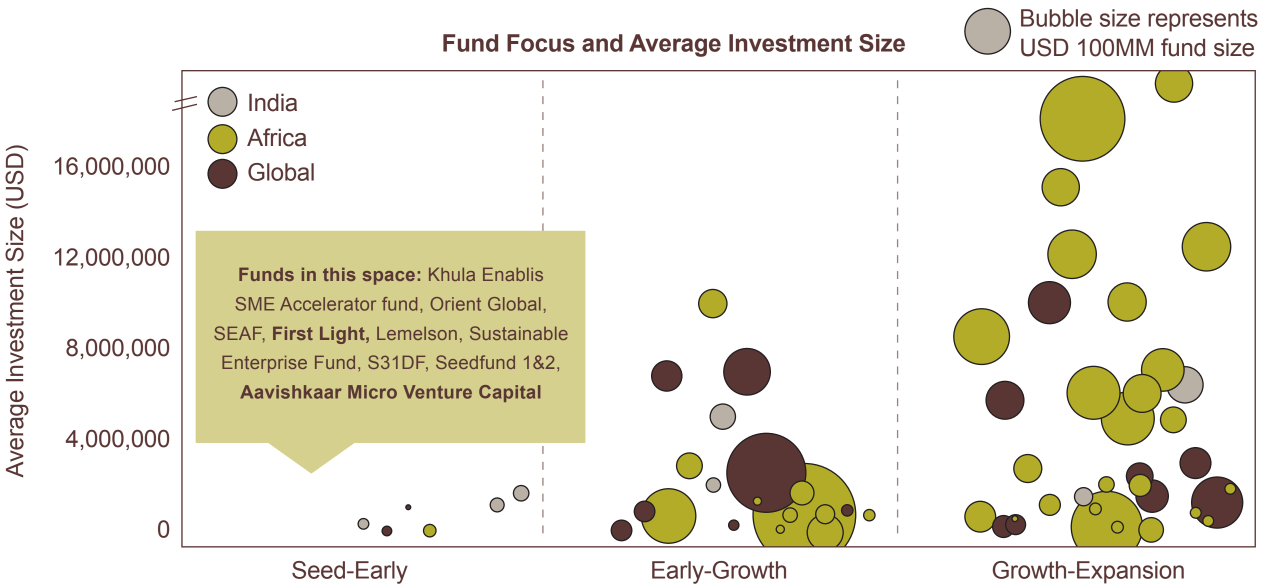
### *Private Sector Impact Investment: Still Skewed Toward Later Stage*

Although there has been a rush of private capital to support such inclusive enterprises, most private impact investment capital, as shown in figure 3, is structured to support later stage enterprises; relatively little capital supports very early stage business model development. Even impact investors, who explicitly seek positive impact and engagement of the BOP, find this stage of investing too speculative and risky, despite the fact that many of them are backed by donor funds. The early stage of testing an idea and proving the business model is inherently risky; in purely commercial investing in developed countries, venture capital firms can recoup this risk because markets are well developed and a few will pay off spectacularly, to cover the costs of the rest failing.

In inclusive business, this ultimate payoff equation is far less likely to be clear. The underlying customers targeted make up the segment of emerging markets with the lowest purchasing power, the least skill in operating commercial farms and the most variable cash flows. These enterprises do not offer compelling financial returns; a recent Monitor Group analysis suggests that for most such enterprises in agriculture, health, water and other sectors aiming to deliver a social impact, net margins are—optimistically—between 3 and 15 percent. Such margins suggest that none of these firms trading with the poor are doing so on exploitative terms. But, conversely, these margins offer insufficient returns

**FIGURE 3. FOCUS OF IMPACT INVESTMENT CAPITAL INDUSTRY (90 FUNDS), MID-2011**

*Most impact funders currently play primarily in the growth/expansion phases, but with some focus on early phases. There is little capital available at seed stage.*




| | | | |
|---|---|---|---|
| % Total Investors[1] | 13% | 22% | 65% |
| % Total Investment[1] | 19% | 29% | 52% |

Illustrative—Fund landscape not exhaustive

*Note: [1]11% of funds are present in the Early-Growth & Expansion Stages of Capital and these account for 37% of total investment*

*Source: Impact Investing Fund Landscape (collected through secondary research), Monitor Analysis*

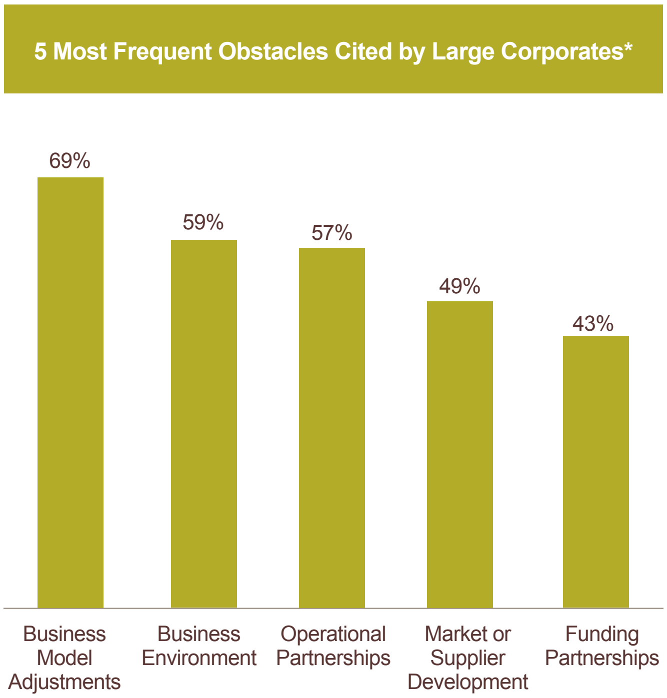
to entice commercial investment funds to take on the cost and risk of developing a new business model to serve these important segments. As a result, it is not surprising that most investors are focusing on less risky, later stage investments.

### *Firms Know It Is Expensive to Develop a New Business Model*

The conventional wisdom of how to scale up a private sector–led solution is often implicitly grounded in a Silicon Valley or large MNC paradigm of the continued investment in and growth of a single entrepreneurial entity or firm addressing a key market or challenge, inspired by Google, Danone, Coca Cola or Nokia. In certain cases, reaching scale due to the efforts of a single large firm or entity is the optimal answer. These are the firms, after all, with the resources, systems and scale to serve people in the millions. Conversely, social enterprises have encountered all manner of difficulties when developing their business models to address critical “route to market” and distribution issues.

This would seem to argue in favor of MNCs and large-scale organizations taking on the task of scaling up such solutions, at least from a public good perspective. However as figure 4 indicates, these firms are concerned about the high cost of reinventing a business model. They typically have higher return activities, technologies or markets to take on with their investment capital, and they are highly wary of striking operating or funding partnerships with donors or nongovernmental organizations (NGOs) to achieve

### FIGURE 4. TOP OBSTACLES IDENTIFIED BY 47 MNCS OPERATING IN AFRICA: WHAT KEEPS YOU FROM TAKING ON MORE BOP BUSINESS?




** One company can state more than one theme or have multiple corporate efforts.*

*Source: Monitor interviews with MNCs and national corporates with operations in Africa (n=47)*

these inclusive business solutions. Not surprisingly, many do not wish to target the poorest customers in the hardest-to-reach areas with the most volatile incomes but would rather reach lower-middle-income segments of emerging markets where there is more purchasing power, or engage with larger commercial farms as suppliers, and where less business model adjustment is required.

This suggests that it is perhaps inappropriate to hope that social impact at scale will be achieved primarily by either a large MNC becoming interested in providing social benefit or by an entrepreneurial firm taking the decade or longer required to create a market. This certainly needs to be one piece of the solution, but should not be the only solution.

## OBSERVATIONS AND NEXT STEPS

### *What Government and Donors Need to Address to Engage the Private Sector*

Although the potential of the private sector to have a transformational impact on “traditional” development issues is clear, what is less certain is how to unlock that potential. As commercial enterprises, private sector firms and investors will have a calculus of risk and return that is quite different from governments or the international donor community. There are four areas where this mismatch is particularly acute, although these are not the only ones:

- *Target population segment*. Firms and investors will find there is a lower risk, lower cost and higher return to trade with lower-middle-class segments than the $2-a-day BOP segments that donors traditionally target. Moreover, most inclusive businesses succeed when they trade with BOP *and* BOP-adjacent segments. Most donors want to target their support just to the poorest.
- *Stage of business supported.* As figure 3 indicates, most investors will prefer to support business at a later stage, which has more proven enterprises and business models, even if this leaves other innovative business models with potential social returns unsupported.
- *Alternative uses of capital.* Firms have other markets they can target besides socially beneficial products and services that trade with the BOP, which may earn returns more quickly with lower costs to address. Donors, conversely, always make implicit trade-offs (for example, invest in Africa versus South Asia, HIV/AIDS versus farmer productivity).
- *Focus on a technology versus a business model.* Multiple donor programs will support an isolated specific technology solution, like a new seed, health technology or mobile phone application without consideration of how it will be commercialized. Firms and investors, conversely, must always think about these technology and product development costs with an idea of the revenue model, distribution strategy, payment and pricing.

Left to their own devices, private businesses will pursue the more profitable, higher-income segments, such as the $8-a-day or $5-a-day segment, while the areas of greatest concern to donors are the very poor living on less than $2 a day. Firms will not think about such initiatives in isolation but will have a "hurdle rate," a certain rate of return that they could get by investing in other sectors or countries, which any potential investment will need to clear. Any investment in revamping or developing the required business model (see figure 4) will be weighed against other possibilities that do not require such heavy development.

As an illustration of these trade-offs, *The Economist*, describing large consumer goods firms' efforts in emerging markets, recently detailed Procter & Gamble's June 2012 announcement of "a much narrower strategy of focusing [only] on P&G's 10 biggest development markets as well as, worldwide, its 40 most profitable products and 20 biggest innovations." Naturally, there are some areas where private interests and donor objectives overlap, creating a "win–win." One such example is Natura's use of low-income women in urban areas in Brazil as sales agents for its cosmetics, or Unilever's announced plans to engage more than 500,000 small farmers in its supply chains, but these instances are still relatively rare.

How, then, can these differing interests be resolved, unlocking the vast creative potential, scale, distribution reach and deep pockets of the private sector to tackle some of the world's most pressing challenges? Investing in inclusive businesses and patiently nurturing business models that engage the poor requires a substantially different approach from policymakers and funders, and often takes them into territory that many are historically not accustomed to traversing.

Nonetheless, if the central task is to bring in private sector resources, scale and sustainability—ironically—few other actors besides multilateral and bilateral aid donors can mobilize the required capital and absorb the risk necessary to (1) develop and try new models, (2) make it cost neutral for larger firms to address these markets and opportunities, (3) invest not just in technologies but also in the whole business model that is required for commercial success, and (4) assist the successful enterprises in reaching the maximum number of people. To succeed at this, donors and policymakers will need new tools and means of doing so; many are ill suited to make direct investments in private firms for a range of reasons. They lack the expertise and knowledge of private firms and their operations; they have strict procurement and contracting requirements that value competition in making awards over making informed individual investments; they undergo significant scrutiny and risk of backlash over failed investments using public funds (think Solyndra); and their monitoring and evaluation frameworks are often far better attuned to public or NGO-led programs than to understanding the impact of investing in a given enterprise or set of firms.

As a result, a first, necessary condition for donors to begin to engage meaningfully with private firms, whether smaller impact enterprises or large MNCs, is the creation of independent, arm's-length intermediaries with the expertise, independence and investment outlook to be able to take on such tasks, and to do so at the scale required to address the problems at hand.

Beyond funding such enterprises, if donors are to take on the idea of supporting impact enterprises using a business model lens, they will also need to undertake a variety of other tasks, including:

- Fund research and activities to solve for issues that block business models from a range of sectors from being successful—for example, distribution, payment, aggregation, customer education and supplier training. These solutions can and should be crosscutting, and help make these elements cost neutral for any firm undertaking an impact-oriented business serving the poor.
- Develop data, staging framework, a point of view and rigorous standards on when a business model is mature and ready for the next stage, or when it is ready to be cut off from grant subsidy funds (either through commercial viability or failure to achieve stated goals).
- Generate data on additional business models to learn from—this policy brief has noted only a fraction of

the potential business models that exist that could successfully engage BOP populations.

- Issue “grand challenges” around specific business models or elements of them that need solving—for example, correspondent banking, social franchising and direct sales agent models.

There is, in other words, much to be done to organize the significant resources of the donor community if its members are to take enterprise solutions to poverty—and the business models that they employ—seriously.

## ENDNOTES

[1] This brief draws on analysis conducted over several years by Monitor Group’s inclusive markets practice, which has studied over 1,000 enterprises engaging with or serving low-income customers around the world. Relevant publications can be found at http://www.mim.monitor.com/. An extended elucidation of the same thesis, titled “Why Business Models Matter,” is available in the forthcoming volume *Getting to Scale: How to Transform the Lives of Millions of the World’s Poorest People*, published by Brookings Institution Press. The author thanks Drosten Fisher for his assistance in the research and drafting of this brief.

[2] These 13 programs do not include those that focus mainly on microfinance, of which there are many programs.