

From Philanthropy to Business: When Transformation Is The Only Way to Stay True to Your Mission

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Abstract

The sustainable development of micro, small and medium-sized enterprises (MSMEs) in Latin America is FUNDES' mission and reason for being. The work of FUNDES involves targeted learning among its customers that can be translated into potential supply chain efficiencies in both manufacturing and services companies. The article describes the transformation of FUNDES from a philanthropic foundation to a limited company. Further, it explains how FUNDES – by working with local MSME suppliers and distributors – helps large firms to get embedded and to contribute to sustainable development. The article highlights how the new business model of FUNDES – despite a protracted economic crisis – benefitted MSMEs in Latin America by becoming part of the supply and distribution systems of large firms and having procurement arrangements with them.

1. Introduction

Micro, small and medium-sized enterprises (MSMEs) play an important economic role in most countries and are critical for the sustainability of supply networks. The World Trade Report 2016 emphasizes this and stresses that especially in developing countries small firms can be “critical vehicles of social inclusion, for instance, by providing opportunities for women to participate in economic activities” (WTO, 2016, p. 14). Also, the United Nations' Sustainable Development Goals (UN SDGs) highlight the “poverty-reduction dimension associated with micro firms and SMEs” (WTO, 2016, p. 14). In all countries, the share of micro firms among the total population of firms is always the highest between 78 and 87 percent (WTO, 2016, Table A.1). However, the share of MSMEs that are formal – meaning that they are officially registered and pay taxes – amounts to just 26 percent as

reported by the International Labour Organization (ILO, 2015, Figure 2.3).

The World Bank Enterprise Surveys dataset reveals that electricity and access to finance are the two most frequently cited obstacles for businesses in developing countries, and that access to finance affects small businesses much more than it does medium and large businesses (Kushnir et al. 2010). Further, formal firms face competition from the practices of informal companies (i.e. informal payments) and corruption among government officials poses significant challenges for formal firms (Kushnir et al. 2010).

In Latin America small and medium-sized firms provide more than 80 percent of employment (OECD 2016, p. 206) but contribute only 30 percent to GDP (OECD/ECLAC 2012). This has to do with the fact that large enterprises are more productive and innovate as they benefit from economies of scale and invest more in machinery and skilled workers and they are also more likely to develop new products (ILO 2015). The productivity gap in Latin America persists as MSMEs specialize in low value-added products and are active in low-productivity sectors such as agriculture, commerce and services (OECD/ECLAC 2012).

FUNDES works at the interface of MSMEs and large companies such as multinational enterprises (MNE) and strives to create win-win situations for firms of all sizes and obviously for itself. Only where profits accrue can businesses be financially sustainable for the long term. From the perspective of large firms the key to success is having access to local suppliers or distributors to efficiently handle complex supply chains that support the firms' product range. Accordingly, local suppliers or distributors are central to large firms' sustainability strategies. For some firms like SABMiller¹ which buys from or sells directly to approximately 1.5 million small businesses

worldwide, the latter are critical to the company's whole value chain (SABMiller 2016). In Latin America small retailers account for 40 percent of their sales. The company's business directly relies on the "ability of suppliers, farmers, distributors, and retailers to survive, grow, and prosper" with SABMiller (SABMiller 2016). Local procurement or distribution is typically recognized to generate local employment, enhance growth and other positive externalities such as improved livelihoods.

In many less developed countries like Costa Rica, the exigency is that MSMEs must first meet the required standards or become export ready before they could supply large firms. This is no simple matter. Research suggests that measures helping MSMEs to become "fit" to be included in the supply or distribution systems of large firms need to be devised carefully and the different characteristics of MSMEs need to be taken into consideration (Pedersen, 2009). Simply transferring sustainability practices to MSMEs that had been developed by large firms has been found inappropriate (Pedersen, 2009). Instead, interventions should enhance MSMEs' capabilities, know-how and expertise and provide financial help.

FUNDES realized how being integrated through procurement and distribution and becoming part of the supply systems of large firms can dramatically help micro and small businesses. By assisting MSME enterprises to become linked to large firms as suppliers or distributors, FUNDES is playing an instrumental role in enabling the transfer of knowledge and technologies. In other words, FUNDES is facilitating the technological embeddedness² of large partner companies in Latin America.

From its origins as a social company, a core activity of FUNDES is the empowerment of local communities. This in turn allows FUNDES to engage in tackling social and environmental concerns in partnership with its large companies. Again, FUNDES helps these firms to embed locally and create positive sustainability effects for communities such as better access to clean water, a functioning recycling system, vocational training, entrepreneurship development, better personal security and so on. Essentially, the work of FUNDES gives the impulse for large companies and MSMEs to introduce far-reaching

organizational and systems changes which can create shared value for all parties involved.

2. Historical background

Since its creation in 1984, FUNDES³ has modified its business model many times to keep up with a changing political and economic environment and to ensure its continued impact in resolving the most pressing issues that hinder a more durable development of MSMEs in Latin America. Throughout the first decade (1984–1994), "access to capital" was the driving theme. At that time, FUNDES worked towards the formation and development of a micro-finance industry by offering guarantees to creditors and often by giving out loans itself. The underlying assumption was that a lack of access to financial services was hampering the growth of MSMEs, above all during the early stage of their respective development, which has been confirmed by World Bank Enterprise Surveys data.

By the mid-1990s FUNDES had helped to create a micro-credit industry in most countries in the region. At the same time, it became increasingly apparent that "access to knowledge" was equally important for MSMEs. In fact, if a hierarchy had to be established for the importance of capital vs. knowledge, should the latter not come first? Based on these modified premises, FUNDES began to organize group sessions and offer lectures covering a broad range of topics in which MSMEs were lacking both knowledge and complementary skills.

In 2004, FUNDES started to move away from the dissemination of knowledge towards offering consulting services as the group adopted a more fundamental approach to training and implementing best practices. With the generous support of philanthropic organizations such as AVINA Foundation⁴ and international development agencies such as the Multilateral Investment Fund (MIF)⁵, FUNDES' new value proposition to the MSME sector was one of high-quality – yet subsidized – retail consulting. Since most MSMEs would not be able to pay the full cost of such services, subsidies remained crucial at that stage.

In 2008, two significant events had far-reaching effects on FUNDES and its operations. First, a financial and economic crisis that had originated in the United States would turn global. In Latin

America, the economy experienced a downturn due to falling demand at home and abroad. Against a backdrop of fundamental uncertainties, both donors and beneficiaries (MSMEs) started to reduce their investments in all those goods and services that were not considered to be vital. It goes without saying that consulting services were among the first victims of such adjustments.

At about the same time, the governing body of FUNDES (VIVA Trust⁶) decided to diversify its investment portfolio and communicated that some of its recipients, FUNDES among them, would “soon” have to look for alternative sources of funding. It was decided that a five-year transition period would be adequate to identify and secure such new sources.

All of a sudden, FUNDES had its back up against the wall – and needed to reinvent itself once again. The underlying parameters, however, were fundamentally changed. Faced with the prospect of running out of money shortly, management had to come up with a financially self-sustaining model. Confronted with a tedious economic crisis, FUNDES needed to increase the positive impact on MSMEs in the region. Instead of supporting some 3,000 MSMEs every year, the new objective was to reach out to about 25,000 businesses.

2.1 The new model

As is often the case in critical situations of this kind, stepping back and bringing the broader context into full view turned out to be a helpful exercise. In the process, management came to realize what might sound trivial with hindsight: MSMEs are not islands in the business world, but strongly depend on the ecosystem surrounding them. Building on this fundamental insight, FUNDES started to analyze the MSME world in a much more systematic and comprehensive manner. At the same time, it became apparent that finding partners and customers with the requisite financial resources to pay for FUNDES’ new value proposition was going to be crucial.

One of the weaker elements in FUNDES’ previous structure, i.e., the sheer diversity of its offerings across different countries, turned out to be decisive in developing the new model. For many years, FUNDES had accumulated experience as well as expertise in MSME support activities in ten Latin-American countries. This impressive stock of

knowledge would now make it possible to study a wide array of solutions in light of the new challenges related to self-sufficiency. In Bolivia, for example, the FUNDES approach to helping MSMEs had led to the creation of large groups of micro and small businesses facing similar challenges, and to providing these clusters with access to their three most urgent needs: capital, knowledge and markets. Access to markets was achieved by connecting the clusters to their main buyers either domestically or abroad. While the weak element in the Bolivian model was its dependency on donors, the business opportunity was in the provision of access to the buyers, i.e. the one element in the value chain with the necessary resources to finance the scheme. From the very beginning, there was a clear understanding that those big players in the value chain (anchor companies) would not go along and invest unless FUNDES was capable of creating incremental value for them.

The new model was thus based on the assumption that FUNDES would be able to create sufficient value for the anchor company (as a customer) through training of suppliers or distributors. Only in this manner would investments in support of MSMEs’ (beneficiaries) value chain integration turn into smart business decisions. Opportunities were expected to be both in upstream (supply) and downstream (distribution) sectors.

The new model also put forward a different incentive structure with MSMEs having to pay a small fee for the services they receive. This raised MSME motivation and made them much more receptive compared to when receiving training for free. The agreements with the anchor companies, on the other hand, included strict financial targets that had to be met such as increased sales turnover, improved margins or more efficient procurement. If they could not be achieved, the anchor company would have the option to cancel the contract with FUNDES.

In a nutshell, FUNDES’ new model consisted in the provision of business development services (BDS). As articulated in a case study on FUNDES,

"BDS aims to increase MSME market access, reduce productivity gaps between these organizations and large firms, formalize MSME businesses, establish adequate working conditions, and create more

Cerrejón is an integrated mining and transport infrastructure complex in La Guajira. It is Latin America's largest thermal coal open-pit mine producing more than 32 million tons a year. A 150-kilometer railway track connects the mining site with the seaport of Puerto Bolivar from where the coal is shipped worldwide. In parallel runs a motorway for operational support which can be freely accessed. The independently operated mine is owned in equal shares by a joint venture partnership between Anglo American, BHP Billiton, and Glencore. Cerrejón employs more than 12'000 people - half directly and the other half as contractors. More than 99 percent are Colombian nationals. The company is one of the largest private exporters and taxpayers in Colombia. The annual royalty payments amount to US\$ 233 million (2014) and US\$ 197 million (2014) in corporate taxes. Cerrejón makes considerable environmental (US\$ 56 million, 2014) and social investments (US\$ 10 million, 2014).

dynamic business environments” (Bucher et al. 2016).

Even in the early stages of the process, FUNDES realized that government agencies and international development organizations would buy into this new approach as well. And these customers, too, would not get involved unless they were convinced of FUNDES’ value proposition, regardless of how they might interpret the meaning of “value” in their respective context.

2.2 The early stages – proof of concept

Since FUNDES had been operating as a philanthropic organization for some 25 years, the biggest challenges under the new business model were waiting in the prospecting and commercial activities and the new competition from other BDS providers⁷. So far, the most important common denominator in the profiles of FUNDES’ 200-plus employees had been a strong focus on social skills and environmental awareness. Commercial skills, on the other hand, had never been an important part of FUNDES’ job profiles, neither in the management team nor with the organization’s trainers and consultants.

At the same time, early successes were deemed crucial to generating a list of convincing sales arguments for potential partners under the new model.

A Brazilian steel producer (Gerdau), with thousands of scrap metal collectors in its supply system, was one of the early adopters of the new “FUNDES Way of Doing Business” by commissioning the service of training and organizing scrap metal suppliers. While Gerdau benefited from the initiative by ensuring a constant and well-organized supply of raw material, the 200 beneficiaries (i.e., the scrap metal collectors)

were able to generate growing business volumes with a reliable partner and thus to increase their personal income. The most successful beneficiary in this project runs a company with dozens of primary scrap metal collectors under contract. With annual revenues of approximately US\$ 400,000, this has been one of FUNDES’ showcase beneficiaries to date. FUNDES provided coaching and guidance in six subject areas and created a manual for scrap metal collectors and provided technical assistance as well. Among other things, the project improved the adequate classification of scrap metals, reduced the risk of accidents and illnesses from managing residues, and improved the health, living and working conditions of the recyclers and their families.

Similar project formats were introduced in other countries with hardware stores as beneficiaries in the downstream value chain of a cement producer (customer), or in the upstream supply chain of a supermarket and a hotel group (customers) with their vegetable and fruit suppliers (beneficiaries). All of these initiatives are part of the answer to strategic challenges for clients. At the same time, they allow for the strengthening of MSMEs in their respective value chains – which is, of course, the mission of FUNDES.

2.3 The need to scale up – the creation of shared value

While early success facilitated expanding the scope at the national level, some failures helped to improve the model. Three years into its implementation (2012), the number of customers and beneficiaries was still small. Regional expansion of at least one of the locally successful projects was imperative to come close to the target of 30,000 beneficiaries by year five.

At that point (January 2011) Michael Porter and Mark Kramer published their groundbreaking concept of “The Creation of Shared Value” (CSV) (Porter & Kramer 2011). The underlying message is that if a company wants to stay in business, it must not only create economic value for itself and its stakeholders but simultaneously create value for the society in which it is embedded.

This, in turn, is necessary not just to meet its social and environmental obligations but primarily to become more competitive. This message fit like a glove on FUNDES’ hand. What is more, Porter and Kramer started to support FUNDES in getting the message out to potential customers mainly in the private sector. Large-scale events were organized to create and foster awareness among potential clients.

A little later, a leading international company in the beverage industry commissioned FUNDES to strengthen its traditional channel of mum and pop stores as a strategic complement to the rapid globalization process in the food retail business. Implementation started in one country, then gradually expanded to the region. In the case of the collaboration with SABMiller, FUNDES consultants improved the business skills of over 26,000 shopkeepers and empowered them. The methodology that FUNDES had developed addressed not only the financial sustainability of the microenterprises but also helped to improve the quality of life of their families and the development in their communities. It resulted in increased sales for shopkeepers and SABMiller of 11 percent in Colombia, 9.3 percent in Ecuador, 9.6 percent in El Salvador, 22.7 percent in Honduras, 11 percent in Panama and 11 percent in Peru (FUNDES 2017). The marketing margin improved for SABMiller on average by 2 percent. Also, brand reputation and customer loyalty could be enhanced as well.

By 2014, other customers (in realms such as consumer products, hardware stores and the credit card business) also started to take their initiative with FUNDES to a regional dimension. With an impressive number of success stories in its portfolio, FUNDES found the arguments it needed for the successful prospecting of new clients and for further strengthening its commercial activities. Solid foundations were now in place to take the new

model to scale and create an organizational structure that allowed for a fast track expansion strategy.

2.4 Structure follows strategy

The organizational and legal structure of FUNDES was historically built to allow for an efficient and effective implementation of the philanthropic business model with foundations in both the headquarters (general policies and controlling) and the country offices (implementation). Foundations are arguably among the most rigid legal structures as they are designed to implement initiatives funded by generous donations. In most instances, the central office has the fundamental responsibility to support all branches of the organization financially. In such a framework, transferring resources from one country branch to another is virtually impossible. Structures of this kind are, therefore, genuinely incompatible with the needs of an internationally active, financially self-sufficient organization where the head office is predominantly a cost center that needs to be financed through the repatriation of funds from its subsidiaries.

The implication is that some things will have to be turned upside down. The country branches are gradually being dismantled and replaced by a legal structure of limited companies (Ltd) so as to give the new business model the legal framework that is required. Service level contracts between the subsidiaries and the head office ensure financial flows to support activities of the corporate HQ team.

The change of the legal structure of any organization does not per se imply a change of its mission. In fact, FUNDES has no intention of altering its original purpose; it does, however, aim to reach out to more beneficiaries by improving its business model. The highest organizational body still is the original foundation based in Panama.

2.4 The human factor

Every FUNDES executive will confirm that the biggest challenge during the transformation from a philanthropic organization to an economically sustainable one has been on the people side. Of the more than 200 staff in the former charitable FUNDES organization, approximately 150 had to be dismissed to make room for 60 new employees with the right profile for the new approach. 150 dedicated

employees came (or had to) realize that they did not possess the necessary skill set for the new “FUNDES way” of supporting the same type of MSMEs they had supported over the previous 25 years. The fact that these employees had been competent professionals in the context of a philanthropically oriented institution did not make this part of the game plan any easier.

In light of numerous, eminently personal consequences involved in this section of the change process, it will come as no surprise that the most frequent complaint about the transformation has been about the time it took to change and adjust the teams.

3. The outlook

The market potential of the niche that FUNDES has identified and begun to penetrate thanks to the new model is vast. FUNDES is unique as it helps large companies to embed locally by empowering their local MSME suppliers or distributors. As FUNDES knows the needs of its customers, it is able to design and implement solutions on the ground to strengthen MSMEs throughout Latin America. This is very different from large consulting companies focusing on strategy development. With its specialized training methodology and consultancy work, FUNDES induces higher efficiencies, profitability and innovation throughout the entire value chain. Its focus on embeddedness yields not only positive impacts for MSMEs and large companies, but also for local communities and the environment. FUNDES is a positive impact company and is already aligned with the sustainable development goals (SDGs) that are aspiring to create prosperity for everyone without harming the environment or jeopardizing freedom on the planet.

However, the current business model centering on face-to-face training generates high personnel expenses. This is a major challenge for FUNDES to stay competitive. Even though FUNDES after five years of transformation has benefitted over 50,000 MSMEs, with 80 satisfied customers (large companies) and generated total revenues of US\$ 10–15 million each year, it is clear that FUNDES once more needs to reinvent itself in view of the challenges ahead.

Meeting the aggressive 2020 target of becoming one of Latin America’s largest high quality consulting companies, of improving the performance of some 25,000 MSMEs every year, and of generating annual revenues of US\$ 50 million requires further changes in FUNDES’ business model. The question is how FUNDES can contain costs while making more attractive offers to large companies and scale up its operations to reach out to ever more MSMEs?

In the past, FUNDES has enabled change through innovation, for example, in training methodologies or financial instruments. As information technology is now accessible to a large extent in Latin America, new innovations pertaining to digitization in training and consulting could yield an interesting avenue for FUNDES. Yet understanding and respecting the local context and dynamics in the different markets of operation will remain key to delivering quality services and being successful. Of course, it will also be necessary to make adaptations to the organizational structure to include implementing strategic business units with regional responsibilities and authority as well as strengthening management teams. Even though limited resources naturally slow down the change process, they allow for constant adaptation and fine-tuning even before scaling up.

The new phase of transformation ahead of FUNDES will enable the company once more to stay true to its mission of enhancing the performance of an ever-larger number of micro, small and medium-sized companies over the next years. This will be very helpful to MSMEs in Latin America who need to continue to improve productivity in order to become more competitive and stay in business. FUNDES will therefore keep making significant contributions towards the SDGs and more sustainable growth trajectories in Latin American economies.

Acknowledgements: I am very grateful to *Constantine Bartel* providing comments on the draft version of this paper.

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Endnotes

1 In October 2016 the British multinational brewing and beverage company SABMiller Plc was acquired by Anheuser-Busch InBev for US\$ 107 billion. This unites the

world's two biggest beer makers. SABMiller, which had grown from its South African base (founded in 1895) into a global company, ceased to exist as a brand and is now a business division of the Brazilian-Belgian corporation Anheuser-Busch InBev SA/NV, which is headquartered in Leuven, Belgium (from Wikipedia: <https://en.wikipedia.org/wiki/SABMiller>).

2 Embeddedness of a company refers to the ties it has with local stakeholders and how it engages with local communities and includes local suppliers or distributors in its value chain and so on. Technological embeddedness encompasses the collaboration between a large firm and local public and private actors, to trigger innovations, develop local technologies and facilitate knowledge transfer to address local solutions (Andersson et al. 2007).

3 FUNDES was established in 1984 by the Swiss industrial tycoon Stephan Schmidheiny with the aim of supporting the development of MSMEs (MIPYME in Spanish) in Latin American countries.

4 In 1994 Stephan Schmidheiny established the AVINA Foundation, which contributes to sustainable development in Latin America by encouraging productive alliances among social and business leaders.

5 The MIF is an independent fund administered by the Inter-American Development Bank (IDB). It was created in 1993 in order to support private sector development in Latin America and the Caribbean.

6 The VIVA Trust was established in 2003 by Stephan Schmidheiny with the objective of ensuring the long-term sustainability of philanthropic organizations in Latin America.

7 In some instances BDS providers are sponsored by (foreign) governmental or non-governmental organizations.

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Ueli Frei lives in Switzerland and Costa Rica. Over the course of twenty years of living and working in Latin America, he has developed an intimate understanding of the critical issues in the region. And he is determined to use his for-profit experience to unleash the full power of business and wealth generation in the service of human dignity.

