

# **RECONCILING FINANCIAL AND SOCIAL PERFORMANCE THROUGH HETEROGENEOUS BUSINESS MODELS: AN EMPIRICAL STUDY OF IMPACT-ORIENTED INVESTORS**

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## **ABSTRACT**

Although past research has improved our knowledge of whether firms can profit from socially-oriented strategies, scholars have called for more investigation on the mechanisms in which this link can occur. Building on the literature on business models in strategic management, we discuss how heterogeneous bundles of complementary, self-reinforcing choices can attenuate the tensions arising from the joint pursuit of financial and social goals. We benefit from the emergence of so-called “impact investors,” who have actively pursued enterprises combining these goals, to gather qualitative data and inductively propose four key dimensions varying across models: the marketability of the social activity, investor motivation, contractual incentives, and impact measurement. Distinct combinations of these dimensions then lead to three alternative models: selection of marketable socially-oriented activities, attraction of investors with tamed profit-based motivation, and impact internalization through outcome-based contractual incentives. We contribute to the literature by explicitly incorporating business model heterogeneity as a mediating factor linking social orientation and profitability, and expand the analysis of business models in the context of socially-oriented businesses. In addition, we provide a more refined characterization of investors as key stakeholders, whose adoption of distinct models can help support, instead of derail, the social orientation of enterprises.

## **Key words**

Social enterprises, business models, impact investing, social performance, shared value

## INTRODUCTION

A central question pursued by scholars examining socially-oriented strategies is whether firms can support profitable operations while addressing social and environmental goals (Barnett and Salomon, 2006; Margolis and Walsh, 2003; Slawinski and Bansal, 2015). Some emphasize that short-term pressure from financial markets can lead enterprises to underinvest in social practices and even neglect disadvantaged beneficiaries (Battilana and Dorado, 2010; Dean and McMullen, 2007; Ebrahim et al., 2014). Yet others stress that the sheer pursuit of profitability can encourage firms to grow by developing sustainable stakeholder relations or catering to poorly served customer segments (Aguilera et al., 2007; London and Hart, 2004; Prahalad and Hammond, 2002). Porter and Kramer (2011: 16) go as far as to argue that the pursuit of shared value is “integral to profit maximization.”

These distinct views suggest not only that firms face particular tensions in their attempt to reconcile financial performance (FP) and socio-environmental performance (SP), but also that the “business case” for their reconciliation is highly heterogeneous across firms (e.g. Barnett, 2007). While some strategies involve creating socially-oriented activities that naturally lead to superior economic value, others require organizational and financial mechanisms capable of attenuating short-term market pressure or internalizing part of the social gains that firms generate. To make sense of this potential heterogeneity, we draw from the literature on *business models* (BM) in strategic management (Baden-Fuller and Morgan, 2010; Zott and Amit, 2010) to propose that the link between social orientation and profitability is mediated by distinct bundles of complementary, self-reinforcing choices influencing the intensity and nature of the tension between social and financial goals.

We use grounded theory to identify these dimensions and propose alternative BMs allowing for the reconciliation of FP and SP. In particular, we benefit from the recent emergence of so-called *impact investors* and study the various models that they use to support

social entrepreneurs. Impact investors are typically family offices, private equity firms and other institutional funds actively seeking enterprises that to various degrees try to combine FP and SP (Brest and Born, 2013; Morino, 2011). The field gained substantial traction after the publication of an influential report by J. P. Morgan (2010), claiming that impact investments represent a new “asset class” with a potential to reach \$400 billion to \$1 trillion dollars in total assets (J.P.Morgan, 2010, p. 6). Instead of simply screening certain types of firms to be included in a financial portfolio (e.g. socially responsible investing) or donating resources without any expected financial return (e.g. philanthropy), impact investors influence the adoption of BMs more actively supporting profitable enterprises that pursue and even measure socio-environmental outcomes.

Our study contributes to the literature in several important ways. We describe how alternative BMs link firm-level social orientation and profitability, thus acting as a key mechanism through which firms solve inherent tensions when having to reconcile social and financial goals (Ven der Byl and Slawinski, 2015). Although a few studies have examined alternative models for social enterprises (Boons and Lüdeke-Freund, 2013; Santos et al., 2015), we adopt the theoretically-grounded conceptualization of BMs as bundles of self-reinforcing dimensions and propose in an inductive fashion alternative models based on the coding and analysis of 65 interviews with impact investors and entrepreneurs. We also contribute to the literature on BMs in strategic management by extending its reach beyond the usual emphasis on economic value (e.g. Teece, 2010) and proposing how alternative models support the creation of “blended value” mixing social and financial dimensions (e.g. Nicholls, 2009; Zahra and Wright, 2016). In addition, by centering our analysis on impact investors as key stakeholders, our study also reveals the mechanisms in which financial markets help support, instead of derail, the social orientation of the firm. In our discussion, investors are neither profit-maximizing actors neglecting social performance nor passive actors simply

avoiding firms with negative impact. They are instead active actors influencing the adoption of heterogeneous BMs combining profitability and social impact.

## **THEORETICAL BACKGROUND AND CONTEXT**

### **Social Orientation, Social Performance, and Financial Performance**

Over recent decades we have witnessed a vibrant debate on whether firms can capture economic value while at the same time addressing social and environmental needs (Barnett and Salomon, 2006; Barnett, 2007; Margolis et al., 2007; Margolis and Walsh, 2003). A research strand has attempted to unveil mechanisms through which these two objectives can converge, thereby leading to a reconciliation of FP and SP. Scholars focusing on the bottom of the pyramid, for instance, contend that firms can leverage their distinct competencies to create better products for high-growth low-income markets that are poorly serviced by existing players (Prahalad and Hammond, 2002; Seelos and Mair, 2007). Proponents of the shared value perspective, in turn, argue that firms can build sustainable competitive advantage when socio-environmental issues affect firm-level operations, thereby creating an opportunity to meet societal demands as a way to sustain profits in the long run (Porter and Kramer, 2006). As organizational goals are influenced by a complex web of stakeholders with myriad interests (Donaldson and Preston, 1995; Freeman, 1984), firms can develop corporate strategies to build their reputation and benefit from positive stakeholder relations (Aguilera et al., 2007).

In parallel, a large literature on social enterprises has emerged to explain the dilemmas involved in socially-oriented enterprises that also need to financially support their operations. These enterprises have to simultaneously cope with social and financial demands and create organizational mechanisms to avoid mission drift (Battilana and Dorado, 2010; Ebrahim et al., 2014; Pache and Santos, 2010). The duality faced by social enterprises can create formidable challenges to funding, sustaining, and leveraging their activities. Not only can

economic returns be constrained when entrepreneurs prioritize their social mission, such conflicting interests can also affect the ability of entrepreneurs to deliver financial returns in the short or medium term (Doherty et al., 2014). Given these constraints, research has shown that social enterprises often prioritize one dominant logic and only a few proactively manage to combine distinct logics (Mair et al., 2015).

Although these perspectives indicate that tensions involving potentially opposing financial and socio-environmental needs will vary across firms, research on the mechanisms through which tensions are managed has been relatively scant (Hahn et al., 2015). While some firms juxtapose multiple demands, others adopt a more polarized view leading to a disproportionate emphasis on a single dimension, either financial or social. Thus, there is opportunity to move beyond the issue of whether FP and SP can be reconciled to the analysis of the mechanisms through which firms can resolve organizational tensions (Ven der Byl and Slawinski, 2015; Slawinski and Bansal 2015). Echoing Barnett (2007: 795), we need to understand the “business case” for the reconciliation of FP and SP, which will probably be firm-specific rather than universal across firms and industries. From this perspective, below we draw from the BM literature on strategic management as a theoretical lens to explain heterogeneity in strategies combining FP and SP.

### **Business Models: Dealing with Tensions between Social and Financial Goals**

The use of tools to design and implement BMs is widespread among practitioners (Osterwalder and Pigneur, 2010), but the conceptual analysis of what those models mean and represent has also gained increased scholarly attention. Management research has a long tradition of proposing taxonomies and configurations that could conceptually represent organizations and organizing principles (Fiss, 2007; Miller, 1986). In a similar vein, Baden-Fuller and Morgan (2010) argue that BMs can be understood as ideal types reflecting mental conceptualizations of actual phenomena (much in line with Weber, 1978), organic systems of

interrelated dimensions, or “recipes” to achieve a combination of objectives. Indeed, strategy research has also emphasized how firms face systems of complementary dimensions whereby each particular choice—such as market positions, pricing tactics, or organizational attributes—increases the benefits of adopting other elements in the system (Milgrom and Roberts, 1995; Porter, 1996). Following this perspective, recent literature has conceptualized BMs as systems of complementary self-reinforcing choices affecting firm-level outcomes (Albert et al., 2015; Zott and Amit, 2010). In this sense, interrelated combinations of relevant dimensions yield distinct recipes or ideal types consistent with superior performance.

Most discussions of BMs in strategy, however, have focused on how complementary choices affect economic performance. Baden-Fuller and Morgan (2010: 157) consider that the purpose of BMs is to identify how firms and partners “create and distribute value in a profitable manner” (Baden-Fuller and Morgan, 2010: 157). Similarly, Teece (2010) describes BMs as alternative ways to create and capture economic value. Yet there have been calls to model processes more explicitly leading to “blended” value creation combining social and financial objectives (e.g. Zahra and Wright, 2016). What particular interrelated BM dimensions can be consistent with the joint pursuit of FP and SP?

We address this question by characterizing *BMs as ideal types comprised of intertwined, self-reinforcing business dimensions that allow entrepreneurs and investors to execute socially-oriented activities intended to profitably achieve social performance.*

Essentially, in line with our previous discussion, BMs may refer to ways in which firms can address the internal tensions involved in pursuing both FP and SP. Although some authors have started examining how models can be designed to achieve socio-environmental objectives (Boons and Lüdeke-Freund, 2013; Santos et al., 2015), we build from recent theoretical advances in strategic management on how BMs are conceived and

operationalized, and then propose alternative models based on the contextual analysis of the impact investing movement, discussed next.

### **Impact Investors and the Joint Pursuit of Financial and Social Performance through Heterogeneous Business Models**

There has been an intense debate on how investors affect social enterprises. Some argue that financial markets and financially-motivated investors encourage companies to emphasize short-term profitability with scant attention to potential externalities that those companies may generate (see e.g. Davis, 2009; Kemper and Martin, 2010). Yet financial investors are far from a uniform, monolithic group. A research stream has examined the phenomenon of socially responsible investing (SRI), which infuses dimensions of corporate ethics and social responsibility in the context of portfolio management and investment decision making more generally (Barnett and Salomon, 2006; Renneboog et al., 2008). SRI-based strategies typically adopt “screens” that either exclude (negative screens) or include (positive screens) companies according to their products and practices. Negative screens, however, are the dominant strategy employed by SRI. For instance, investors can avoid firms that sell products which are harmful to human health or that fail to implement environmentally sustainable operations. Notwithstanding the importance of the SRI movement, in most cases SRI-oriented investors have simply acted as passive actors selecting which firms to include or not in a portfolio. The *impact investing* movement, in contrast, goes beyond SRI because investors not only use screening strategies but also *actively* pursue and influence entrepreneurial ventures with a clear mandate to achieve and even measure positive SP.

The term “impact investing” was first coined after a Rockefeller Foundation meeting in 2007, and it gained substantial visibility after the publication of an influential report by J.P. Morgan (2010). This report suggested that impact investments could represent a new “asset



class” in the sense that investors could more easily identify securities with varying levels of expected impact, i.e. superior SP. The impact investing movement benefited from previous experiments in microfinance and social entrepreneurship led by a large group of private foundations, family offices, and governmental agencies (Martin, 2013). Because impact investors often support businesses with some degree of profitability, they differ from traditional philanthropists who usually establish nonprofit operations and give donations with no expectation of positive return. Family offices, for instance, manage the inherited wealth of families through myriad types of long-term investment, and have been increasingly interested in impact investing as a way to combine their traditional portfolio approach with a more active presence in sustainable businesses (World Economic Forum, 2013).

We benefit from the impact investing movement to assess how these investors have influenced the adoption of new BMs with multiple financial and social objectives. Thus, we treat BMs as mechanisms mediating the link between social orientation and profitability, and propose alternative BMs based on combinations of self-reinforcing activities and practices influenced by impact-oriented investors (Figure 1). Consider for instance the so-called social impact bonds (SIBs), launched in 2010 by Social Finance, a non-profit organization in the UK, in association with the Department of Justice. A SIB is essentially an *outcome-based* contract whereby private investors provide funding to social projects that also yield financial returns if social targets are met (Social Finance, 2013). The pilot project in the UK targeted prisons and the chosen metric of impact was recidivism. If the project manages to reduce recidivism rates, then the government economizes on the costs of keeping prisoners in prisons and shares part of these savings with investors. By 2016, estimates indicated that at least 60 SIBs had been launched in various countries and sectors (Dear et al., 2016).

SIBs therefore involve a system of complementary investing tools and measurement mechanisms targeting socially-oriented projects supported by governments and investors

which are designed to turn measured impact into actual profitability. Yet they represent one among other possible models crafted to achieve both SP and FP. For instance, in line with bottom of the pyramid and shared value strategies, some investors have alternatively tried to find socially-oriented business where entrepreneurs can reap profits more directly from the targeted populations, without an emphasis on measuring and contractually rewarding for impact (e.g. Arregui and Chu, 2013). Thus, consistent with our previous discussion, there is *heterogeneity* in the way impact investors have tried to link social orientation and profitability. Our subsequent empirical analysis essentially tries to unveil alternative BMs through which investors and their supported entrepreneurs reconcile SP and FP.

*<Insert Figure 1 around here>*

## **METHODOLOGY**

Using the nascent field of impact investing as our empirical setting, we make use of a qualitative grounded theory approach to expand our understanding of how investors support BMs to cope with the inherent tensions between financial and social goals. Corbin and Strauss (2008) recommend using grounded theory as a way of thinking and investigating novel phenomena, allowing researchers to innovate and propose a new substantive theory consisting of well established, interrelated categories. In other words, grounded theory can be seen as a set of procedures supporting theory development through data collection and analysis (Glaser and Strauss, 1967; Mintzberg, 2005; Turner, 1983; Walker and Myrick, 2007). As an inductive method, the research process does not start with a set hypotheses but instead with a question or topic of interest (Carlile and Christensen, 2004; Kelle, 2007). The research process then follows with a procedure to organize data into categories and a subsequent theorizing process through which emerging ideas are formulated in a logical, systematic, and explanatory fashion (Corbin and Strauss, 2008). We justify our choice of grounded theory based on the fact that programmatic research on BMs is at an early stage in

general (e.g. Baden-Fuller and Mangematin, 2013) and even more so in our applied context, where there is room to understand the mechanisms through which investors have linked social orientation and profitability in greater detail. The qualitative, context-rich orientation of grounded theory allows us not only to unveil alternative BMs in this field but also the complex interactions between the dimensions characterizing each type of model.

### **Conceptual Blocks**

Instead of departing from a tabula rasa (Kelle, 2007), we benefitted from discussions and findings from the existing literature to help structure our interviews and guide our data collection process (Suddaby, 2006; Turner, 1983). With our general research question in mind— *which investor-supported BMs can be used to link social orientation and financial performance* —we started with a set of “conceptual blocks” to collect and categorize the data (Turner, 1983). These blocks, which emerged from our extensive review of the literature, focus on key conceptual/topical elements serving as an initial guide for our empirical investigation (Locke, 2001).

The open-ended questions used in our interviews were anchored on seven complementary blocks (Table 1): i) types of targeted markets and recipients, ii) types of targeted entrepreneurs, iii) challenges to reconciling FP and SP, iv) investment mechanisms, v) impact measurement, vi) investor preferences, and vii) future of the industry. In general, our blocks originate from several strands in the stakeholder management, business sustainability, social entrepreneurship, and strategic management literatures. The first block draws from the literature examining on the bottom of the pyramid, shared value and derivations in an attempt to examine how firms can create economic value from socially-oriented activities (e.g. Porter and Kramer, 2006; Prahalad and Hammond, 2002). The second and third blocks derive from academic work on how social entrepreneurs deliver social and economic value (Dean and McMullen, 2007; Santos, 2012; Zahra and Wright,

2016), as well as the evolving discussion on the potential conflicts when firms and investors try to combine multiple logics (e.g. Battilana and Dorado, 2010; Pache and Santos, 2010) or juxtapose sustainability tensions (Van der Byl and Slawinski, 2015; Slawinski and Bansal, 2015). The fourth block on investment mechanisms benefitted from the existing scholarship on ethical investing and SRI (e.g. Barnett and Salomon, 2006; De Colle and York, 2009; Renneboog et al., 2008) as well as more recent discussions on the specific tools used by impact investors (Bugg-Levine et al., 2012; Santos et al., 2015). The block on impact measurement draws from the literature on contractual incentives (Hart et al., 1997; Roberts, 2010) and measurement of social performance (Bradenburg, 2012; Brest and Born, 2013; Izzo, 2013; Kroeger and Weber, 2014). The sixth block on investor preferences is based on the claim by agency theorists that investors mostly pursue shareholder maximization (Jensen, 2001), contrasted with critics who contend that such an emphasis will create ethical conflicts in financial markets (Davis, 2009; Kemper and Martin, 2010). We concluded our interviews with a more general question on how they perceived future trends in the field.

*<Insert Table 1 about here>*

### **Sample of Interviewees**

Starting from these seven blocks, we then collected our qualitative data based on interviews and interactions with different players involved in impact investing. Our sample of interviewees attempted to guarantee a diverse group that would allow us to gain new insights from the seven initial conceptual blocks, as is appropriate in grounded theory (Corbin and Strauss, 2008; Denzin and Lincoln, 2000; Glaser and Strauss, 1967; Turner, 1983). We started our initial data analysis by selecting an initial sample of professionals involved in the field of impact investment. To obtain new valuable informants, we applied the snowball or chain sampling procedure (Patton, 2005), in which new respondents are recommended by the existing informants so as to increase the richness of our sample. This enlarged sample of

informants not only provided us with important testimonies, but also often helped us get access to useful documents and examples. This process was repeated four times until we reached “theoretical saturation,” that is, when no fundamentally new information was obtained from the interviews nor from our successive interactions between theory and data (Strauss and Corbin, 1990).

Although our interviewees are from multiple countries, our interviews focus on a single country where the field of impact investing is in rapid development: Brazil. A report by the World Economic Forum (2013), for instance, indicates that the Latin America and the Caribbean region concentrates around 32% of all the impact investing activity in the world. Another study found that impact investing in Latin America had a total capital allocation of around \$2 billion dollars, with Brazil as the largest single market with around \$300 million (Leme et al., 2014). The Brazilian Social Finance Task Force, an informal network of investors, entrepreneurs, and nonprofit organizations, estimated that the total amount of socially-oriented investments in Brazil could be as high as \$15 billion dollars by 2020 (Força Tarefa de Finanças Sociais, 2015). This creates an opportunity to examine alternative BMs emerging in a growing field, while at the same time minimizing confounding effects emanating from distinct cultural and institutional contexts. Our focus on the Brazilian context notwithstanding, we decided to include interviewees from outside the country because they were either intending to enter the Brazilian market or were already implementing contractual mechanisms for impact investing. Furthermore, these interviewees enabled us to examine future trends and challenges in the field.

In total, we conducted 65 in-depth interviews and five roundtables (discussion groups), totaling 93 participants with approximately 55 hours and 25 minutes of interaction. 64.52% of all interviewees were from Brazil; 10.75% were from other countries in Latin America, and 24.73% were from other countries worldwide. Table 2 presents a summarized

description of our interviewees (the complete list is presented in Appendix A). They cover a wide range of organizational types and functional areas. We interviewed a group of impact investors involving conventional financial firms such as venture capital and private equity funds; wealth and savings management firms such as family offices and pension funds; nonprofit firms and government agencies dealing with or interested in impact investing. We interviewed not only impact-oriented venture capital and private firms but also traditional, profit-oriented funds interested in impact investing. Impact-oriented venture capital and private equity firms usually support entrepreneurs with investments ranging between \$100 thousand and \$50 million dollars.

To collect information from the point of view of the businesses targeted by these investors, we also interviewed social entrepreneurs with ventures at both an early and a more mature, established stage. Early stage entrepreneurs typically receive an amount of capital of around \$100-500 thousand dollars, whereas more mature entrepreneurs, with operations that have already achieved a scale to guarantee some degree of financial sustainability, can receive as much as \$1 million and even more in the case of established corporations with social projects. Reflecting the nascent nature of the field, most of our interviewed entrepreneurs are at an early stage. We then complemented our data with information from other stakeholders in the field: consultants helping structure projects or metrics of impact, regulatory agencies, universities, and so forth. This diverse set of interviewees allowed us to gain a more complete view of the phenomenon, incorporating multiple relevant stakeholders and benefitting from different perspectives of the same issue (Dubois and Araujo, 2007).

*<Insert Table 2 about here>*

### **Data Collection and Data Analysis: Operational Procedures**

Our interviews were semi-structured, following a guide with specific questions for each of the seven conceptual blocks discussed earlier. Semi-structured interviews involve

open-ended questions serving as a guide for the interviewer while at the same time guaranteeing some flexibility to the interviewer to make adjustments and new questions depending on the targeted interviewee (Kvale and Brinkmann, 2009; Opdenakker, 2006). Our roundtables, in turn, normally involved a group of entrepreneurs, consultants, investors and academics discussing a particular theme. We chose four themes for the roundtables: education, social housing, financial challenges, and regulatory aspects. These themes were chosen based on previous conversations with practitioners and focused on the last three blocks of our initial design (types of targeted businesses, challenges, and future of the industry). Following the recommendation of Patton (2005), during our roundtables participants reacted to our questions and discussed them with each other, thus helping us to obtain high-quality data in a *milieu* where participants could frame and reconsider their own views in light of comments from other experts. Finally, we complemented our interviews and interactions with secondary data based on our own research as well as documents suggested by the interviewees (impact reports, financial statements, videos and presentations).

All the interviews were recorded and analyzed using the Atlas.TI software. Data analysis proceeded as follows. We first codified the interviews and created “network views” of the theoretical seven blocks mentioned above in order to discover the relationships among critical codes and emerging concepts. This approach allowed us to unravel the main idiosyncrasies of the impact investment movement, as well as the conflicting themes and/or perspectives of the stakeholders. Our research team performed a constant comparison between conceptual blocks, based on emerging statements from the interviews and ancillary documents (Glaser and Strauss, 1967; Walker and Myrick, 2007). Inspired by Petriglieri (2015), and based on our analysis of interviews and documents, we then defined *axial codes* representing key constructs or issues that were frequently mentioned. These axial codes

essentially reflect core themes linked with each initial conceptual block and related to the phenomenon under scrutiny (Strauss and Corbin, 1990).

In our coding process, we followed some important procedures. Based on emerging statements from the interviews, we performed content analysis by counting the number of times interviewees mentioned each key concept. We then established connections between our initial conceptual blocks and the axial codes emanating from the interviews (Bergh et al., 2014; Krippendorff, 2004). We also employed data triangulation by contrasting multiple sources of information (primary and secondary) and by considering multiple interpretations from our team members (Patton, 2005). With this procedure, we tried to reduce bias from respondents and secondary data, thus improving the reliability of our qualitative analysis. Our final aggregate dimensions then served as the basis for our proposed elements to categorize BMs (Dubois and Gadde, 2002).

### **FINDINGS: KEY AGGREGATE DIMENSIONS OF BUSINESS MODELS**

Figure 2 summarizes the associations between our initial conceptual blocks, the axial codes emerging from the data, and our final proposed aggregate dimensions. The figure also shows the frequency of occurrence of the codes identified by our procedure. For instance, the conceptual block “types of targeted markets and recipients” gave rise to two distinct axial codes related to the extent to which interviewees perceived that achieving social performance could be rewarded in customer markets (e.g. the firm could charge a price premium in consumer segments that value the social orientation of the firm). Analyzing all the statements that frequently appeared in our data, we detected 17 instances in which interviewees would like to target a “business where a higher impact has market value” (this code appeared in 8.17% of all frequently coded statements). Based on their existing similarities, we merged these two codes with the codes appearing in the conceptual block “type of targeted entrepreneurs”—who also vary in the extent and maturity of their



operations—to form the aggregate dimension “marketability of the social proposition.” A similar process was used for all the other initial conceptual blocks.

At the end of the process, we arrived at four aggregate dimensions: *marketability of the social proposition*, *investor motivation*, *contractual incentives*, and *measurement approach*. Table 3 presents our aggregate dimensions and their definitions as well as a list of illustrative quotes from the interviews and from secondary sources of information. Below we describe each revealed aggregated dimension, which will then serve as building blocks (self-reinforcing dimensions) for our proposed BMs in the next section.

<Insert Figure 2 and Table 3 about here>

### **Marketability of the Social Proposition**

Our data confirm that there are essentially two ways in which firms could translate their social proposition into market-based sources of value. First, as emphasized by the bottom of the pyramid literature, firms could address existing market voids by more efficiently delivering products or services that are valued by low-income consumer segments. Second, firms could design products or services whose associated social impact is valuable to consumers and therefore can yield a price premium. If the BM involves activities that meet one of those conditions, we say that the social proposition is *marketable*. Using Baden-Fuller and Mangematin’s (2013) terminology in the context of BMs, marketability implies that social impact can be monetized via consumer segments directly or indirectly affected by the activity of the firm. Consider the following quote from a manager of a cosmetics firm selling products at a premium based on specialized inputs coming from low-income communities located in conservation areas in the Amazon forest:

*When we deal with low-income suppliers we explain how the project works... After the deal is closed our marketing guys go there and talk to the community. Then, the marketing department develops a new concept of why to use the product... You grasp the meaning that [the community] assigns to the forest input and translate it into a marketing concept attracting more customers. (Interview#2: Social enterprise in maturity stage, pers. comm., 2012).*

Three main obstacles, however, will limit marketability. First, consumers may have budgetary constraints to pay for high impact (Santos et al., 2015) and in some more extreme cases firms may even be unable to charge for their products or services. Prisoners, for instance, do not pay for the services they receive in the prison. Second, market-based incentives may conflict with superior social performance. This concern echoes the work of organizational economists such as Hart et al. (1997) and Williamson (1999), who claim that, if achieving superior performance is costly and operationally demanding, then the high-powered incentives of markets may induce firms to cut costs or excessively expand their operations even at the expense of lower impact. Third, entrepreneurs may simply lack the required capabilities and infrastructure to successfully cater to their targeted markets. In our interviews, we detected that this third problem is likely to occur in the case of early-stage enterprises that do not have sufficient resources to craft elaborate market channels and develop a large portfolio of clients.

### **Investor Motivation**

Our data also reveal that the type of *investor motivation* is a critical variable influencing BMs designed to reconcile FP and SP. Investors are motivated to participate in impact investing for a variety of reasons. We verified in our fieldwork that most profit-oriented investors pursue businesses where the social proposition is marketable; they tend to invest in more mature social enterprises where achieving high impact is consistent with their objective to attain superior profitability. Their motivation, in this case, emanates more from the *extrinsic* (market-based) rewards that the social business can generate (Amabile, 1997; Deci and Ryan, 1985). Other investors, in turn, report a strong, *intrinsic* interest in achieving results other than pure profitability; sometimes there is even an altruistic desire to improve the conditions of local communities and promote sustainable operations. Activities where FP and SP are not intrinsically aligned tend to receive more capital from those investors:

*Impact investment is not the silver bullet that will solve all the social problems of our society. There are some areas where philanthropy and donations will be necessary. (Interview#15: Private/venture capital, pers. comm., 2013)*

Even in potentially marketable cases, however, impact investors complain that most entrepreneurial ventures are at an early stage and that entrepreneurs lack fundamental managerial capabilities and technical knowledge to achieve financial sustainability more quickly—which is aligned with research showing that funding ventures at this stage entails incommensurable uncertainty (Huang and Pearce, 2015). This finding reveals a critical *horizon problem* (Hansmann, 2009) in that some investors will have a stronger preference towards more mature ventures that can yield more immediate results, while some social enterprises may not pursue long-term transformations in their targeted communities (Slawinski and Bansal, 2015). In this context, early-stage social entrepreneurs tend to attract capital from wealth and savings management investors, who normally allocate their portfolio using a more extended time window. Although still focusing on projects where FP and SP are more easily aligned, these investors will tend to be more “patient” and better accommodate a project where returns will take some time.

Family offices, as discussed earlier, are a typical example (Alto, 2012). Consistent with research findings that family businesses have motivations beyond short-term profitability (Berrone et al., 2010; Miller and Le Breton-Miller, 2006), we observed several offices managing the inherited wealth of families being involved in the funding of new high-impact ventures. Pension funds, which also manage long-term savings, also pursue investments with a higher emphasis on social impact and sustainability in the long-run (Harji and Jackson, 2012). In the same vein, government funds from state agencies and development banks also tend to carry subsidies that can reduce the capital constraints of projects where high SP is expected. Some even argue that such government funds should

only focus on high-impact entrepreneurial initiatives that would be difficult to execute solely with private capital (Musacchio and Lazzarini, 2014)

### **Contractual Incentives**

Our aggregated codes allow us to detect whether investors have also used various *contractual incentives* in BMs designed to cope with various challenges involved in the reconciliation of FP and SP. These contracts address the key investment issues discussed earlier: the horizon problem and the restricted profitability of some projects, which both tend to reduce the attractiveness of more extrinsically-motivated investors. Consider, for instance, the horizon problem: a critical issue is how to deal with certain social projects that will yield impact and financial return, but only in the long run (Achleitner, Braun, and Engel, 2011). To avoid committing substantial resources through premature equity purchases, some investors have used innovative financial mechanisms also found in the more traditional, for-profit venture capital industry. In our interviews, some investors reported the use of the so-called “mezzanine” operations combining debt and equity (Bugg-Levine, Kogut, and Kulatilaka, 2012). Namely, impact investors can provide entrepreneurs with a small, initial debt that can turn into equity after a pre-specified period:

*Within the [fund name] program in December 2011... we got an angel investment. That investment consisted in a loan, which we had to repay in a year if we have not achieved their social and financial requirements. But in three months after the initial investment, they [the fund] have already agreed to evolve our partnership into a bigger investment. Finally, in December 2012, we received a higher amount of capital, where they became minority partners, holding a seat on the board. (Interview#19: Early stage social entrepreneur, pers. comm., 2013)*

Contractual incentives have also emerged to deal with the tradeoffs between pursuing FP and SP directly. At a more fundamental level, impact implies positive externalities (Santos, 2012). For instance, society as a whole benefits if there is a reduction in recidivism rates in a program for inmate rehabilitation; groups affected by rare diseases will see improvements in their health after receiving drugs and vaccines at affordable prices; the

standard of living of poor and homeless citizens will increase when subject to social housing programs; and so on. Yet, cases involving low marketability imply that these positive externalities cannot be fully “internalized” in the form of economic value accruing to the social entrepreneur. For instance, a firm working with rehabilitation cannot usually charge prisoners for its services, even when they generate high impact. As suggested in our interviews, investors and even entrepreneurs recognize that in many situations achieving both profitability and high impact is extremely difficult. A way to circumvent this problem is to use of *outcome-based* mechanisms (such as the SIBs, discussed before) where governments or nonprofits help compensate investors for the impact that they generate. In other words, outcome-based contracts can critically change the perceived profitability of a high-impact project, helping attract investors whose motivation is more rooted in profit-based rewards.

### **Measurement Approach**

A final critical aspect that emerged from our field interactions is the role of *measurement mechanisms* to assess FP and SP. Essentially, alternative ways to assess impact deal with a fundamental tradeoff between precision and measurement cost (Roberts, 2010). Some of our interviewees reported the use of standardized tools, such as IRIS (Impact Reporting and Investment Standards), a library of variables that can be used to assess impact; GIIRS (Global Impact Investing Report System), a rating tool that uses some of the IRIS variables and allows entrepreneurs and investors to self-report their performance on a set of key dimensions (governance, workers, community, environment, and social focus of the overall BM); and the B Corp certification, which also uses a rating system aligned with GIIRS to assess whether firms consistently follow social and environmental performance goals. Because those tools are standardized and based on self-reporting, investors do not consider them expensive. However, some of our interviewees criticized standardized tools for being too generic; for instance, projects in education are not expected to have relevant impact

in other dimensions such as the environment, and they often require much more specific metrics on student learning. Although the GIIRS system allows for industry-specific score comparison, some interviewees also expressed a preference for indicators that are more aligned with their specific business:

*Although GIIRS is the most common methodological framework, it looks like a checklist of sustainability. So, internally, we seek other forms of impact assessment that are really related to our social goal. (Interview#21: Private/venture capital, pers. comm., 2013)*

Some investors and entrepreneurs have therefore adopted *project-specific* measures. Investors interested in education, for example, generally employ various measures of student learning. A particularly rigorous project-specific method is based on the assessment of *additionality* (e.g. Brest and Born, 2013; Kroeger and Weber, 2014). Following this method, investors assess impact by not only considering the performance of the project, but also taking into account its “counterfactual,” that is, what would have happened without the investment. For instance, in the SIB implemented in the UK, mentioned earlier, recidivism in the pilot (“treated”) prison is compared to a “control group” of prisoners at other correctional units not affected by the investment. In this case, impact is only achieved—and investors rewarded—if recidivism in the targeted prison is reduced beyond what one would normally find in comparable conditions. Some interviewees even mentioned the use of *randomized controlled trial* (RCT) to better identify the causal effect of the investment. In this method, communities or individuals receiving the benefits of the investment are defined at random. Although RCT-based assessments identify causal effects with greater precision (Duflo et al., 2007), they are seen as very costly and even unfeasible given that in most cases investors and entrepreneurs self-select the groups they want to target.

## **BUSINESS MODELS THROUGH WHICH INVESTORS HELP RECONCILE PROFITABILITY AND IMPACT**

Based on our empirical findings, summarized in Table 3, we now describe three general BMs through which impact investors help harmonize FP and SP: *selection of marketable socially-oriented activities; attraction of investors with tamed profit-based motivation; and impact internalization through contractual incentives*. These models, summarized in Table 4, essentially involve distinct self-reinforcing combinations of the aggregate dimensions emerging from our data and described in the previous section. In line with our previous theoretical discussion on BMs as systems of complementary activities (e.g. Zott and Amit, 2010), we not only describe these dimensions but also how they complement one another in each BM configuration.

*<Insert Table 4 about here>*

### **BM 1: Selection of Marketable Socially-Oriented Activities**

Investors pursuing this BM typically select more mature enterprises operating with goods and services that can deliver profits in the short run and are also expected to generate impact. An example in our data, discussed before, is a cosmetics firm operating with products whose inputs come in part from low-income supplier communities located in the Amazon forest. By explicitly advertising its environment-friendly activities and supplier development efforts (e.g. through above-market pricing of the inputs or infrastructure support), the firm can charge a price premium for its final products. Another example, more aligned with typical bottom of the pyramid strategies, involves a chain of low-cost healthcare centers that tried to capitalize on the growth of low-income segments poorly served by the existing public health network.

With this type of positioning, the social enterprise manages to attract investors who seek returns aligned with the conventional market but nevertheless want to see some form of impact assessment in their portfolio of assets. This approach is usually followed by commercial (conventional) investors who seek to signal increased attention to SP, as long as

high FP can also be achieved. In other words, their locus of motivation is more extrinsic, with greater emphasis on revealed profitability. These investors include conventional private equity firms, investment bankers, and institutional funds with a tradition of investing in mature, established firms. In addition, because they target more mature businesses where FP partially derives from SP-enhancing activities, they tend to channel funds through conventional vehicles (such as institutional funds or stock markets) with no need to adopt impact-based contractual incentives.

With respect to measurement, increased funding from traditional investors will typically be associated with relatively simple, standardized metrics. Because these investors place higher emphasis on FP, they will be relatively less interested in a more precise measure of SP. Instead, they may simply want to invest in “signals” that their portfolio includes firms concerned with the socio-environmental impact of their activities. Advertising and reporting tools emphasizing investments in poor communities or environmental conservation are typical strategies. Another possibility is to use the IRIS/GIIRS measurement system as well as the B Corp Certification, discussed before. Although considered less precise, these tools are relatively cheap to implement (a GIIRS report costs around \$5 thousand dollars). Our interviews revealed that some investors value metrics that, while imperfect, are widely adopted by investors and entrepreneurs; and some even suggest that setting industry standards for social impact measurement is one of the main strategies to attract a wide range of investors (Freireich and Fulton, 2009).

Central to our use of BMs is the complementary or self-reinforcing nature of their underlying dimensions. Indeed, these dimensions revealed in our first BM ideal type complement each other in several important ways. The pursuit of more mature, marketable businesses where superior FP naturally leads to SP helps attract extrinsically motivated investors without the need for complex contractual mechanisms to solve horizon and



incentive problems. Because investors are mostly financially motivated, they also care relatively less about precision and tend to be relatively satisfied with more simple tools to report impact. All these features help reduce costs and attract capital to support further expansion, thereby increasing the natural profitability of the social enterprise and reinforcing its attractiveness to new investors. In other words, there is strong complementarity between high marketability, attraction of extrinsically-motivated investors, scant contractual incentives for superior SP, and simple mechanisms to measure impact.

### **BM 2: Attraction of Investors with Tamed Profit-based Motivation**

The second BM involves situations in which horizon problems imply that social enterprises require time to make a profit, even when activities that generate SP and FP are relatively aligned. An excessive emphasis on FP may jeopardize the pursuit of promising social impact projects, such as in the case of nascent entrepreneurs and emerging technologies which require long-term financial commitment. In some cases, there is also a moderate risk that investors will force entrepreneurs to prioritize FP even at the expense of activities necessary to support high SP.

An example in our database is a start-up that created a new web-based mechanism to search for locations where individuals can get medicine for free sponsored by the government. Most of the revenue of the start-up comes from partnerships with health service providers, including health insurance companies. There was an internal tension arising not only from the need of the start-up to grow and achieve a stable cash flow, but also from the possibility of entering a partnership with health service providers targeting higher-income populations to simply reduce their spending on medication for their clients. This tension is, however, reduced due to the presence of an impact investing fund with clear dual mandate to achieve profitability and impact. Fund managers closely follow the strategies of the start-up and have

clearly indicated that they would not like to see the start-up partnering with health insurance companies catering to higher-income populations.

Therefore, this second mechanism is associated with projects whose nature requires a longer-term orientation and some moderate risk that FP will be prioritized at the expense of SP. These projects will attract investors with a more balanced or “tamed” orientation towards FP—that is, investors still with an extrinsic motivation to seek financial reward, but in a more constrained fashion emphasizing potential consequences for impact in the long term. Following our previous discussion, long-term investors such as family offices and high net worth individuals can help provide initial capital at a lower rate, subsequently increasing their financial commitment if the new venture is successful.

A host of contractual innovations can support attracting these investors. For instance, mezzanine capital can help increase the amount invested in social projects by reducing investors’ financial exposure (Achleitner, Lutz, Mayer, and Spiess-knafl, 2011). That is, the amount initially lent can be subsequently converted into equity, provided financial and social results are achieved after a reasonable time span. In addition, as exemplified before, investors can also set contractual incentives based on a combination of targets for FP and SP. They can also partner with more SP-oriented actors to create innovative arrangements rewarding for impact. For instance, in our sample, an investment fund controlling a chain of primary and secondary schools for low-income communities collaborated with a nonprofit firm supporting the tuition of a group of poor students conditional on the learning and development targets that the fund should pursue.

Given that such investors will have to guarantee that their supported business achieves reasonable FP, they will generally not pursue complex and costly measurement schemes. In some cases, they will use standardized tools such as the GIIRS system. However, some interviewees also indicated that standardized metrics are too general and fail to precisely

measure impact considering key drivers of SP in a given project. Thus, these investors appear to be increasingly interested in project-specific measures tailored to the nature of the social enterprises that they support. These project-specific measures, however, will generally not involve complex assessments based on additionality. Creating reliable counterfactuals or control groups is difficult and costly to execute, requiring specialized consulting and validation services by third parties.

Thus, as in the previous model, these dimensions strongly complement and self-reinforce each other. The presence of investors with tamed FP orientation help support businesses with relevant horizon problems and a moderate risk of SP deterioration. Phased financing mechanisms and SP-oriented incentives supported by collaborative arrangements with more intrinsically-oriented actors (such as non-profits) help investors realign FP and SP. While these investors tend to adopt more project-specific impact measurement tools to monitor SP, their lower emphasis on additionality avoids substantial measurement costs. All these features yield a more balanced combination of FP and SP, thereby attracting more investors with tamed profit-oriented motivation.

### **BM 3: Impact Internalization through Contractual Incentives**

Attracting profit-oriented investors, even those accepting a longer-term investment window, will be more challenging in the case of projects where the marketability of the social proposition is difficult and where pursuing FP can severely undermine impact-oriented efforts. Our qualitative data revealed cases requiring additional (and often substantial) capital from impact-oriented actors more willing to sacrifice FP for increased SP. This is the case of state-owned agencies as well as non-profit, mission-oriented foundations and institutes. These non-profits, for instance, can help lower the cost of capital of projects where achieving high SP requires investment that does not necessarily lead to high FP. We also found that these non-profits even engage in projects to guarantee that entrepreneurs will not pursue

profitability at the expense of impact, especially when these non-profits have a well-defined mission emphasizing sustainability or the social development of local communities.

Given the presence of these myriad actors, the third model involves a network-based contractual scheme where more intrinsically-motivated investors help increase and even monetize the social impact of projects, thereby attracting more extrinsically-motivated investors. As mentioned before, this BM involves mechanisms to internalize the externalities of the project, that is, mechanisms that turn impact into actual profit. In the SIBs, for instance, governments can compensate investors if they help reduce recidivism. At the time we were concluding our interviews, two distinct Brazilian states were studying possible SIBs in the areas of education and health, with support from non-profits and a multilateral development institution. We also observed a public-private partnership (PPP) in which a local government tried to attract private capital to support the preservation of a natural area through tourism and forest management techniques. In the PPP contract, the government compensates the investors based on a host of socio-environmental indicators. There was a perceived hazard that investors could simply exploit certain areas of the park while neglecting investment in conservation and engagement of local communities. A non-profit organization specialized in the management of parks also helped fund feasibility studies to structure the PPP and advertising activities to attract private investors.

Therefore, the third model revealed by our empirical analysis involves heavier support from intrinsically-motivated investors and outcome-based contractual arrangements leading to realignment between FP and SP. Although this model will be critically supported by actors with a mission to pursue SP, they will also attract more extrinsically-motivated investors as long as outcome-based schemes are in place. This tends to occur in two ways. First, intrinsically-motivated investors help subsidize costly activities and even pay for service delivery, thereby reducing budgetary or structural constraints faced by the target

recipients. Second, these investors can contribute with outcome-based payments that will essentially monetize the externalities generated by the project. Thus, by increasing the profitability of high-impact activities, outcome-based arrangements will reinforce the attraction of investors who would otherwise only target projects with high marketability. The whole financing process will therefore have a network-based configuration, with myriad actors participating at various stages. A typical process involves non-profits in the design stage, associated with more conventional investors in the execution stage conditional on outcome-based subsidies and compensation mechanisms set by governments.

The nature of such arrangements will also mandate more precise measures of impact to assess additionality. Because such assessments are costly, they will tend to be adopted when there is increased funding by investors who are relatively more concerned with SP than FP, such as non-profits and government funds. For such investors, it will be relatively more important to get a reliable measure of impact than to achieve superior profitability. They will also be more concerned with measurement precision. As long discussed by organizational scholars, measurement error tends to attenuate the effect of incentive contracts (Roberts, 2010) and may even lead to dysfunctional behavior if entrepreneurs simply try to increase their score in a chosen metric instead of devoting effort to guaranteeing true impact (Kerr, 1975). No less important, sponsors of outcome-based contracts will not want to pay for outcomes that they would otherwise achieve without the presence of impact investors and their extra capital. Thus, the reconciliation mechanism through contractual incentives will normally be associated with rigorous measurement techniques that not only emphasize clear project-specific indicators but also attempt to assess if superior impact was truly caused by the additional capital brought by impact investors. More precision will therefore help mitigate concerns that profit-based motives undermine SP, reinforcing the use of outcome-based incentives to attract a broad range of investors with varied objectives.

## **CONCLUDING REMARKS**

Despite recent discussions and examples of how firms profit from operations that simultaneously pursue socio-environmental goals, the urgency of increasing financial sustainability has also created formidable challenges for social enterprises trying to stay true to their original mission. In this paper, we draw from the BM literature in strategic management to show how firms cope with the tensions involved in the reconciliation of FP and SP differently. In our qualitative investigation of the impact investing field, we unveil an interesting interplay between the marketability of the social business, the type of investor motivation, the existence of contractual incentives, and the distinct measurement approach adopted by investors and their supported entrepreneurs. These aggregate dimensions which emerge from the coding and analysis of our qualitative data allow us to propose alternative, internally-consistent configurations through which investors can help reconcile FP and SP. As we discuss next, our results provide important contributions and leave room for subsequent theoretical development and empirical work.

### **Contributions**

At a more fundamental level, our work informs the ongoing debate on whether firms can achieve superior economic performance while at the same time addressing social and environmental needs (Barnett, 2007; Barnett and Salomon, 2006; Margolis et al., 2007; Margolis and Walsh, 2003). A large empirical literature confirms a weak association between FP and SP (Margolis and Walsh, 2003; Orlitzky, Schmidt, and Rynes, 2003; Zhao and Murrell, 2016). A possible explanation for such a weak association between FP and SP is that entrepreneurs and investors, and the mechanisms they choose to support their projects, are essentially heterogeneous across firms. In this sense, we bring insights from the strategy literature to explicitly incorporate BMs as mediating factors linking firm-level social

orientation and economic outcomes, thus essentially describing alternative channels through which firms manage potential tensions involved in the reconciliation of FP and SP. Our proposed models accommodate distinct perspectives on how socially-oriented business may or may not be profitable. Thus, consistent with discussions proposing a natural association between FP and SP (Porter and Kramer, 2011; Prahalad and Hammond, 2002), we describe a model where firms conceive marketable social businesses funded by profit-oriented investors. Furthermore and consistent with research emphasizing conflicts when firms combine hybrid goals (Battilana and Dorado, 2010; Dean and McMullen, 2007), we describe models where firms attract “tamed” investors and even develop mechanisms to internalize the social gains they generate. In other words, in line with Barnett (2007), we show how the link between social orientation and profitability depends on firm-specific choices influenced by the corporate context and its key stakeholders.

Although we benefit from recent scholarly work on BMs to inform the debate on how FP and SP can be reconciled, our contribution also goes the other way around: our application of BM logic in the context of socially-oriented activities also helps move that literature towards the analysis of socially-oriented businesses. Despite the initial focus of the BM literature on how distinct business configurations can yield economic value (Baden-Fuller and Morgan, 2010; Albert et al., 2015; Teece, 2010; Zott and Amit, 2010), our work also shows how BM logic can help assess contexts involving multiple social and economic goals. In other words, we provide theoretical underpinning to more recent debates on how enterprises can strategically create “blended” value combining social and financial performance dimensions (Nicholls, 2009; Zahra and Wright, 2016). Our proposed models and their underlying self-reinforcing traits can be used in future work to describe and study complex businesses pursuing blended value.

In addition, our framework highlights the role of investors as stakeholders who can help address inherent conflicts when entrepreneurs jointly pursue FP and SP. This shift of attention towards investors, and especially investors trying to *attenuate* the tensions arising from the reconciliation of FP and SP, represents an important departure from most of the existing literature. Scholars have generally assessed investors as either profit-oriented actors who will undermine social gains (Davis, 2009; Kemper and Martin, 2010) or passive actors who will try to avoid firms with a negative impact (e.g. Barnett and Salomon, 2006; De Colle and York, 2009). In contrast, our study describes a group of investors who actively create new mechanisms to support and help create positive impact through different BMs. Although there has been some discussion on how investors can help curb unethical strategies creating negative externalities (e.g. the SRI movement), impact investors go several steps further: they not only actively seek projects with positive externalities but also adopt mechanisms to more precisely assess impact. Hence, by focusing on the nascent field of impact investing—which has received scant attention in the literature—we contribute to this debate through a more refined portrayal of investors as actors with varied motivations and mechanisms to support enterprises with combined financial and social goals.

### **Limitations and Suggestions for Future Research**

Our study is an initial attempt to make sense of a novel phenomenon involving the active participation of investors in attempting to combine multiple performance dimensions. Future research could further examine how impact investors interact with entrepreneurs over time; we are also likely to see a segmentation of distinct types of entrepreneurs supported by distinct types of impact investors. Entrepreneurs themselves are likely to differ in the way they approach and value SP over FP (Santos, 2012). It is likely that entrepreneurs with a higher emphasis on SP will be more commonly found in projects where FP and SP are not naturally aligned; thus, the projects will also tend to be supported by impact investors with



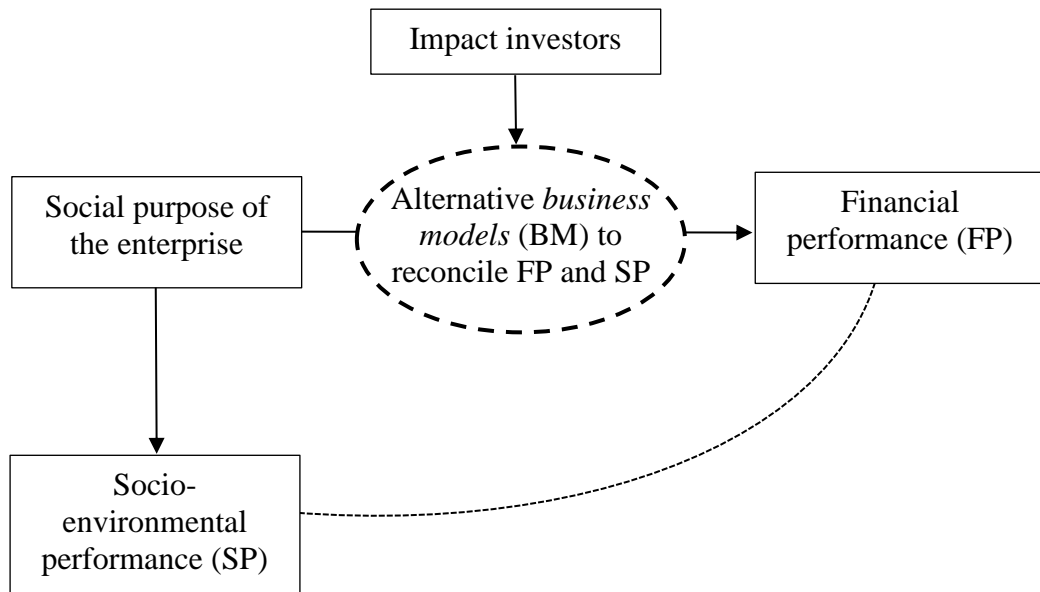
longer-term horizons and a higher emphasis on socio-environmental impact. In other words, a next step could involve a joint assessment of entrepreneurs' preferences towards SP and FP, in tandem with our proposed analysis of the distinct types of impact investors and the tools they use to fund entrepreneurs and assess impact.

Future research could also more directly describe and measure the preferences of investors towards financial and social goals. In our discussion, some investors are more intrinsically motivated, that is, they have a well-defined mission to generate impact, while others are more extrinsically motivated, that is, more interested in financial compensation for the impact that they generate. Outcome-based arrangements attempt to attract extrinsically-motivated investors who would otherwise refrain from supporting projects with high SP. However, distinct types of motivations can interact over time. On the one hand, some claim that such external incentives may “crowd out” intrinsic sources of motivation (Deci and Ryan, 1985). On the other hand, incentives may help reduce the temptation of investors to deviate from contractual targets, which can enhance trust and foster a longer-term orientation (Poppo and Zenger, 2002). A more detailed analysis of investor motivation can greatly inform the design and evolution of contractual and measurement tools for high impact.

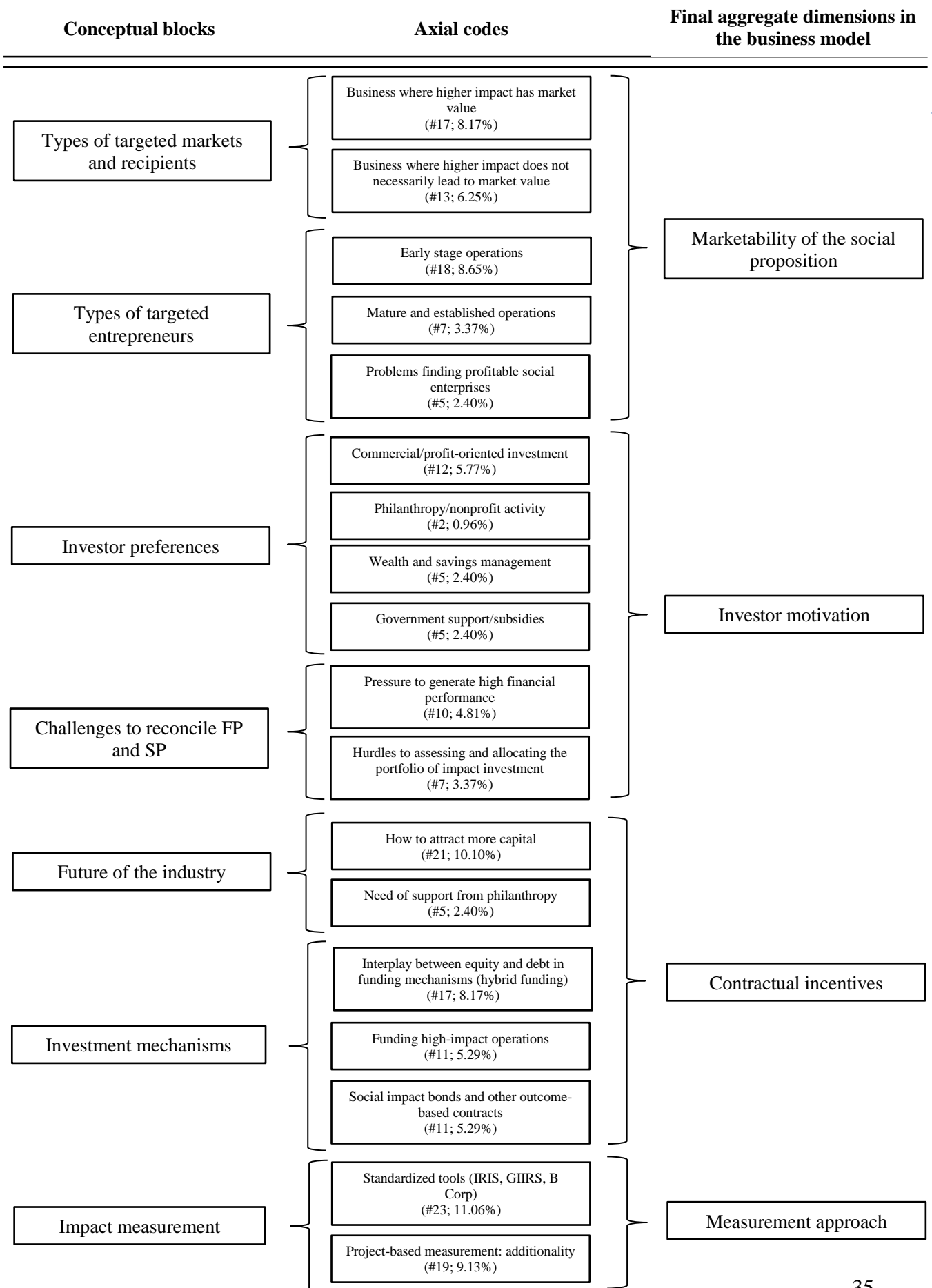
The study of measurement innovations, which has started receiving scholarly interest (e.g. Kroeger and Weber, 2014), should also be a fertile source for future research as the field progressively experiments with new contracts and metrics. A key issue in this debate is how to reconcile cost and precision; more precise project-specific techniques are more costly and tend to be adopted less than cheaper standardized tools. Yet adoption will also tend to vary depending on the evolution of consulting firms, research institutes and verification agencies who improve existing tools and help disseminate distinct measurement practices. Tracking the evolution of such a measurement ecosystem should be itself a rewarding research agenda in the field of impact investing.

Last but not least, as new projects are being adopted and new investors emerge, researchers might also be able to collect data from a larger sample and even test the alternative configurational mechanisms presented here. We hope that our study will spark future research on this evolving, nascent field with the goal of improving our knowledge on how financial and social performance dimensions interact.

**FIGURE 1 – Baseline theoretical framework**



**FIGURE 2 – Codes, frequency of appearances (#), and aggregation**



**TABLE 1 – Initial conceptual blocks used in the interviews and their connection with the previous literature**

<b>Conceptual block</b>	<b>Connection with the previous literature</b>
1. Types of targeted markets and recipients	Literature on the bottom of the pyramid, shared value, and derivations (e.g. Porter and Kramer, 2006; Prahalad and Hammond, 2002).
2. Types of targeted entrepreneurs	Literature on social entrepreneurship, specifically how social entrepreneurs and socially-oriented corporations deliver social and economic value (e.g. Dean and McMullen, 2007; Santos, 2012; Zahra and Wright, 2016).
3. Challenges to reconcile FP and SP	Literature on corporate social performance and corporate financial performance (e.g. Margolis et al., 2007; Orlitzky et al., 2003), as well as institutional logics theory (Battilana and Dorado, 2010; Ebrahim et al., 2014).
4. Investment mechanisms	Inspired by the SRI literature (e.g. Barnett and Salomon, 2006; De Colle and York, 2009; Renneboog et al., 2008) and incorporating recent work on tools used in impact investing (Bugg-Levine et al., 2012; Santos et al., 2015).
5. Impact measurement	Literature on contractual incentives (Hart et al., 1997; Roberts, 2010) and impact measurement (e.g. Bradenburg, 2012; Izzo, 2013; Kroeger and Weber, 2014).
6. Investor preferences	Agency theory as applied to the debate on whether firms should pursue SP (e.g. Jensen, 2001); versus critique (Davis, 2009; Kemper and Martin, 2010).
7. Future of the industry	Context-specific question (general perceptions of the interviewee).

**TABLE 2 – Sample of interviewees**

	Number	Percentage	Location where the interviewee is established		
			Brazil	Other Latin America	Other Countries Worldwide
<b>Impact Investor</b>					
- Private and venture capital	27	29.03%	18	1	8
- Bank/microfinance firm	4	4.30%	3	1	0
- Family	4	4.30%	2	1	1
- Nonprofit organization	6	6.45%	6	0	0
- Pension fund	3	3.23%	3	0	0
- State-owned financial institution	3	3.23%	2	0	1
<b>Social Entrepreneur</b>					
- Early stage	12	12.90%	12	0	0
- Mature/established business	6	6.45%	5	1	0
<b>Others</b>					
- Consultant	12	12.90%	2	3	7
- University	8	8.60%	2	1	5
- Governmental unit/regulator	4	4.30%	3	1	0
- Accelerator	4	4.30%	2	1	1
<b>Total</b>	<b>93</b>	<b>100.00%</b>	<b>60</b>	<b>10</b>	<b>23</b>

**TABLE 3 – Aggregate dimensions, illustrative quotes, and key findings**

Aggregate dimension	Description	Examples of qualitative evidence	Key findings
<p>Marketability of the social proposition and Investor motivation</p>	<p>Social proposition affecting market positioning: whether social delivery can be perceived by customers and monetized and Investors differing in their relative preferences for FP and SP as well as timing (investment horizon)</p>	<ul style="list-style-type: none"> <li>• When we deal with low-income suppliers we explain how the project works. We do not simply get there with a proposal to buy a certain quantity of nuts [inputs]. We develop a research project, which is going to create sharing of the benefits. However, that all happens step by step... After the deal is closed our marketing guys go there and talk to the community. Then, the marketing department develops a new concept of why to use the product... you grasp the meaning that [the community] assigns to the forest input and translate it into a marketing concept attracting more customers. (Interview#2: Social enterprise in maturity stage, pers. comm., 2012).</li> <li>• By impact investment we understand investments that combine market strengths with social goals for solving socio-environmental problems... You will get a better return not only because the companies you are investing are more risky. (Interview#10: Private equity/venture capital, pers. comm., 2013)</li> <li>• Throughout the history of [our fund] we have learnt about what the reason for our existence is. That is, investing in businesses that serve low-income populations to improve the life of these people offering products and services that help reduce inequality. The second reason for our existence is to change the common business mentality in our country... We show that it's absolutely possible to manage your business based not only on its capacity for income generation, but also on its capacity to affect the ecosystem in which it is embedded (Interview#22: Private equity/venture capital, pers. comm., 2013).</li> <li>• ...Indeed I think that there are some areas where the trade-off [between FP and SP] does not exist, because the correlation between profit and impact is pretty high. One of these areas involves services for low income populations in big cities...where the more you sell the higher your impact and profit. On the other hand, there are other areas where the trade-off is clearly present... In those cases you should add other vehicles, such as strategic philanthropy, which accelerates businesses in areas where there are no market-based models; or even this mechanism of Social Impact Bonds which can play a role in areas where is a need to improve public services. (Interview#53: University, pers. comm., 2014).</li> <li>• Our big concern is not with stratospheric profitability. Our main investor [a wealthy Swiss citizen] has a good amount of resources, and he is willing to accept a different return. A return that enables the development of the social venture he is interested in. (Interview#4: Family office, pers. comm., 2013)</li> <li>• Philanthropy targets populations, projects, and organizations that are important for the structure of a society, and which usually the government cannot reach... It is important to note that impact investing will not eliminate philanthropy or its need. (Interview#39: Consultant, round table, 2013).</li> </ul>	<ul style="list-style-type: none"> <li>• Conventional investors with some concern for impact tend to be attracted to businesses where the social proposition is aligned with marketing efforts aimed at increasing profits.</li> <li>• These investors are also more attracted to developed, mature businesses with established market channels (as opposed to early-stage start-ups).</li> <li>• Ventures whose products or services are potentially marketable but whose operations are at an early stage tend to attract more capital from wealth and savings management investors (family offices, pension funds, and so on).</li> <li>• Projects where there is an inherent risk that pursuing FP will harm SP will tend to have more capital from nonprofit organizations and governments.</li> </ul>

**TABLE 3 – Aggregate dimensions, illustrative quotes, and key findings (cont.)**

Aggregate dimension	Description	Examples of qualitative evidence	Key findings
Contractual incentives	Mechanisms through which investors allocate their capital and (in some cases) are rewarded for superior SP	<ul style="list-style-type: none"> <li>• We do prefer to start with debt than equity. Because it is easy to end when things are not good, including when the [invested] company does not have a real social impact. (Interview#9: Private equity/venture capital, pers. comm., 2013).</li> <li>• Our fund targets education, and when we talk about the concept of educating people we cannot speak the same language as when you talk about business. Sure, it is difficult to unify the language, but it is possible... You might view it in terms of targets, results, and education. So, to me, pay-for-performance makes total sense because we will only gain if we deliver better education. (Interview#82: Private equity/venture capital, pers. comm., 2015).</li> <li>• A variety of actors are using Impact Bonds to pay for outcomes as outcome payers and to amplify their impact investment portfolios as investors. Local and national governments in developed nations (e.g. United Kingdom and United States), national governments in middle-income countries (e.g. Mexico and Chile) and international donors (e.g. DFID and Global Fund) are acting as outcome payers, while international banking institutions (e.g. Goldman Sachs and Merrill Lynch) and foundations (e.g. UBS Optimus Foundation and Rockefeller Foundation) are acting as investors. (Consultant, on-line report, available at: &lt; <a href="http://www.instiglio.org/en/impact-bonds/">http://www.instiglio.org/en/impact-bonds/</a> , accessed November 15, 2015).</li> </ul>	<ul style="list-style-type: none"> <li>• In the case of early-stage ventures, investors tend to adopt phased financing combining debt and equity (“mezzanine”).</li> <li>• Outcome-based mechanisms increase the attraction of commercial investors and wealth and savings management investors into activities where pursuing FP may undermine SP and vice-versa.</li> </ul>
Measurement approach	Methodology to assess impact: standardized versus project-specific, with or without emphasis on additionality	<ul style="list-style-type: none"> <li>• “Impact” considerations usually require time and effort from the entrepreneur. They generate a lot of noise for both the entrepreneur and investor... So, if the venture is viable, generates margins, and keeps growing, then it is enough for us. (Interview#11: Private equity/venture capital, pers. comm., 2013)</li> <li>• GIIRS is far from being the perfect measurement for impact. But, until now, it is the best we have. (Interview#8: Private/Venture Capital, pers. comm., 2013)</li> <li>• First of all, you should be pretty selective of the indicator you intend to use. Instead of using a large number of indicators, you should find the best indicator for your business model. I do not feel we lack indicators; what I do feel is that you always need to discuss if those are the best indicators for the impact you want to achieve. (Interview#51: Development Bank, pers. comm., 2014)</li> <li>• There is a worldwide trend to understand and show the impact of social interventions using methods such as RCT (randomized controlled trials)... Many organizations are looking at this, and many philanthropists and investors are demanding it. Although there is still a small number of social organizations prepared to do it. (Interview #80: Consultant, pers. comm., 2015)</li> <li>• When you look at the broader portfolio of performance-based contracts, many of them just talk about incentive compatibility. But let me be more specific: we almost always find that payers, or outcome payers, particularly when they are donors or governments, when they want to pay for results, they want to pay for results that otherwise would not have happened... So, for example, in one case of education the way we addressed that problem was by setting an RCT... By comparing the results of the schools afterwards, we can see the impact of the education program in those schools. (Interview#81: Private equity/venture capital, pers. comm., 2015).</li> </ul>	<ul style="list-style-type: none"> <li>• Projects heavily funded by commercial investors and wealth and savings investors tends to increase the adoption of standardized impact measurement tools or simple project-specific measures.</li> <li>• A higher proportion of capital from nonprofit organizations and government funds tends to increase the adoption of project-specific measurement tools with higher emphasis on additionality.</li> <li>• The use of outcome-based mechanisms tends to increase the adoption of project-specific measurement tools by nonprofits and governments.</li> </ul>



**TABLE 4 – Types of business models through which investors help reconcile profitability and impact**

Dimension of the business model	Alternative business models		
	#1 Selection of marketable socially-oriented activities	#2 Attraction of investors with tamed profit-based orientation	#3 Impact internalization through contractual incentives
Marketability of the social proposition	Investors select mature, established businesses where social and market-based activities complement each other and lead to a natural and current alignment between SP and FP.	Investors select businesses where social and market-based activities are partially aligned with each other. Challenges emerge because of: <ul style="list-style-type: none"> <li>• Horizon problem (e.g. early stage social ventures).</li> <li>• Moderate hazard that the pursuit of FP will undermine SP.</li> </ul>	Investors select businesses where social activities cannot be readily translated into market value. Challenges emerge because of: <ul style="list-style-type: none"> <li>• Budgetary or structural constraints in the targeted market segments.</li> <li>• Acute hazard that the pursuit of FP will undermine SP.</li> </ul>
Investor motivation	Mostly extrinsically motivated, FP-oriented with a desire to signal SP (e.g. private equity and venture capital firms advertising some emphasis on social entrepreneurship).	Mostly extrinsically motivated, but with longer-term FP orientation (e.g. family offices and pension funds). Some participation of investors with intrinsic motivation towards SP (e.g. nonprofits).	Mostly intrinsically motivated, SP-oriented investors such as nonprofits and governments, which help attract extrinsically motivated, FP-oriented investors if outcome-based contracts are in place.
Contractual incentives	Conventional financing.	<ul style="list-style-type: none"> <li>• Financing combining phased debt and equity (“mezzanine”).</li> <li>• Pay-for-performance with a balanced mix of FP and SP</li> </ul>	<ul style="list-style-type: none"> <li>• Network-based financing.</li> <li>• Outcome-based payment mechanism where superior SP is financially rewarded (e.g. social impact bonds)</li> </ul>
Impact measurement approach	Advertising and reporting of SP-oriented investments; in some cases with standardized tools (e.g. IRIS, GIIRS, B Corp Certification).	Some use of standardized tools, with increased adoption of simple project-specific metrics without emphasis on additionality.	Project-specific metrics with higher emphasis on additionality.
	Example of firm/investor in the data		
	Cosmetics firm charging a price premium for its environmentally-friendly products and compensating its supplier communities with above-market supplier prices.	Start-up with a new web search mechanism helping individuals to locate drugs distributed through a governmental program. Most of the revenue of the start-up comes from partnerships with health service providers.	Public-private partnership attracting private capital to support natural area preservation, whereby the local government compensates investors according to socio-environmental indicators.

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## APPENDIX A – List of interviewees

ID	Description of the company	Domicile Country	Interview date	ID	Description of the company	Domicile Country	Interview date
1	SE - Maturity Stage	Brazil	December 11, 2012	40	Microfinance Institute	Brazil	August 28, 2013
2	SE - Maturity Stage	Brazil	December 20, 2012	41	SE - Early Stage	Brazil	August 28, 2013
3	SE - Maturity Stage	Brazil	February 13, 2013	42	Private/Venture Capital	Brazil	August 28, 2013
4	Family Office	Brazil	March 15, 2013	43	SE - Early Stage	Brazil	August 28, 2013
5	NGO/Institutes/Foundation s	Brazil	March 19, 2013	44	SE - Early Stage	Brazil	August 28, 2013
6	Private/Venture Capital	Luxembourg Liechtenstei n	March 27, 2013	45	SE - Early Stage	Brazil	August 28, 2013
7	Family Office		March 27, 2013	46	SE - Early Stage	Brazil	August 28, 2013
8	Private/Venture Capital	Brazil	April 2, 2013	47	Private/Venture Capital	Brazil	August 28, 2013
9	Private/Venture Capital	Switzerland	April 9, 2013	48	Consultant	USA	September 30, 2013
10	Private/Venture Capital	Brazil	April 10, 2013	49	Consultant	USA	September 30, 2013
11	Private/Venture Capital	Switzerland	April 19, 2013	50	Consultant	Colombia	October 3, 2013
12	NGO/Institutes/Foundation s	Brazil	April 22, 2013	51	Development Bank	USA	April 23, 2014
13	Consultant	USA	April 25, 2013	52	Consultant	USA	April 25, 2014
14	Microfinance Institute	Brazil	May 6, 2013	53	University	France	May 07, 2014
15	Private/Venture Capital	Brazil	May 30, 2013	54	Consultant	UK	May 28, 2014
16	Consultant	Brazil	June 25, 2013	55	Consultant	USA	May 29, 2014
17	Governmental Agency	Brazil	July 19, 2013	56	Consultant	Hong Kong	June 11, 2014
18	Governmental Agency	Brazil	July 19, 2013	57	Private/Venture Capital	Brazil	February 05, 2015
19	SE - Early Stage	Brazil	July 24, 2013	58	Private/Venture Capital	Brazil	February 05, 2015
20	SE - Early Stage	Brazil	July 25, 2013	59	SE - Early Stage	Brazil	February 06, 2015
21	Private/Venture Capital	Brazil	August 1, 2013	60	SE - Early Stage	Brazil	February 06, 2015
22	Private/Venture Capital	Brazil	August 1, 2013	61	NGO/Institutes/Foundation ns	Brazil	March 09, 2015
23	University	Switzerland	August 28, 2013	62	SE - Maturity Stage	Brazil	March 09, 2015
24	University	Switzerland	August 27, 2013	63	SE - Maturity Stage	Brazil	March 09, 2015
25	University	Switzerland	August 27, 2013	64	NGO/Institutes/Foundation ns	Brazil	March 21, 2015
26	University	Switzerland	August 27, 2013	65	Microfinance Institute	Mexico	May 20, 2015
27	Private/Venture Capital	Brazil	August 27, 2013	66	Governmental Agency	Chile	April 14, 2015
28	Private/Venture Capital	Brazil	August 27, 2013	67	Private/Venture Capital	Mexico Switzerlan d	April 24, 2015
29	University	Brazil	August 27, 2013	68	Private/Venture Capital		May 4, 2015
30	Development Bank	Brazil	August 27, 2013	69	Accelerator	USA	May 1, 2015
31	Private/Venture Capital	Brazil	August 28, 2013	70	Accelerator	Ecuador	May 19, 2015
32	Private/Venture Capital	Liechtenstei n	August 28, 2013	71	Family Office	Brazil	May 5, 2015
33	SE - Early Stage	Brazil	August 28, 2013	72	Private/Venture Capital	Brazil	April 28, 2015
34	SE - Early Stage	Brazil	August 28, 2013	73	Private/Venture Capital	Brazil	April 30, 2015
35	SE - Early Stage	Brazil	August 28, 2013	74	Consultant	Costa Rica	April 28, 2015
36	Private/Venture Capital	Brazil	August 28, 2013	75	University	Chile	May 12, 2015
37	Microfinance Institute	Brazil	August 29, 2013	76	Private/Venture Capital	USA	April 16, 2015
38	Family Office	Bahamas	August 28, 2013	77	SE - Maturity Stage	Mexico	April 29, 2015
39	Consultant	Brazil	August 28, 2013	78	Pension Fund	Brazil	May 14, 2015



**APPENDIX A – List of interviewees (Cont.)**

<b>ID</b>	<b>Description of the company</b>	<b>Domicile Country</b>	<b>Interview date</b>	<b>ID</b>	<b>Description of the company</b>	<b>Domicile Country</b>	<b>Interview date</b>
79	NGO/Institutes/Foundations	Brazil	May 6, 2015	87	NGO/Institutes/Foundations	Brazil	September 10, 2015
80	Consultant	Colombia	May 21, 2015	88	Accelerator	Brazil	October 01, 2015
81	Private/Venture Capital	UK	May 12, 2015	89	Accelerator	Brazil	October 01, 2015
82	Private/Venture Capital	Brazil	May 20, 2015	90	Private/Venture Capital	UK	October 15, 2015
83	Development Bank	Brazil	42143	91	Private/Venture Capital	Brazil	October 15, 2015
84	Pension Fund	Brazil	May 22, 2015	92	Governmental Agency	Brazil	October 20, 2015
85	Pension Fund	Brazil	May 26, 2015	93	University	Brazil	November 06, 2015
86	Private/Venture Capital	Brazil	September 10, 2015				