Pursuing Sustainability in the Microenterprise Field: Findings from a Literature Review by FIELD

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March 2007

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This publication is made possible by a grant from the Charles Stewart Mott Foundation
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With support from the Mott Foundation, the FIELD program of the Aspen Institute conducted a literature review to explore the research and writing on the topic of sustainability. Sustainability is a crucial issue for the microenterprise field as microenterprise practitioners face a challenging and ever changing funding environment. With changes and often reductions in federal assistance, an evolution in philanthropic funding interests, and shifts in the composition of the microenterprise funding and investing community, many practitioners have turned their attention to plans for long-term sustainability, including earned income ventures.

While generating earned income has been a goal for most microlending organizations in the U.S. and for many training-led institutions as well, the results to date demonstrate that generating earned income is challenging. For example, MicroTest, a FIELD project that has collected data on organizations since 1999, shows that in fiscal year 2005, 70 reporting organizations generated between 0 percent and 69 percent of their operating expenses through program-related income. The average was 15 percent and the median was 9 percent. Looking at data for a group of 29 programs that reported data for 2003, 2004 and 2005, the median hovered around 15 percent (2003: 16 percent, 2004: 13 percent, 2005: 14 percent).

Programs tend to generate substantially greater returns on their lending activities than their training and technical assistance activities. The median for credit program cost recovery was 21 percent whereas the median for training/technical assistance cost recovery was 5 percent.

Because programs have struggled with achieving self-sufficiency through earned income ventures, they often find themselves caught between the conflicting goals of scaling up and achieving sustainability. If a program is not able to cover 100 percent of its costs through earned income, efforts at scaling up or program expansion bring an increased need for subsidy that must be raised through existing sources. This additional burden can be substantial and, in MicroTest, FIELD has observed microenterprise programs that have ceased operations because of extreme funding hardships.

This literature review attempts to organize and capture sustainability learnings to date with the hope that practitioners and funders can use this information to improve their strategies to achieve a sustainable microenterprise industry. The key findings and lessons from this literature review are highlighted on the following pages.

It’s important to emphasize that this review is based on the premise that organizations can be sustainable without being self-sufficient. Sustainability implies that an organization has the ability to meet current needs without jeopardizing its ability to
continue serving its market in the future. Sustainability can be achieved by mixing philanthropic, governmental subsidy and earned income.\(^1\) Although a program may cover some of its costs through earned income efforts, a plan must be in place for ongoing subsidy.

Self-sufficiency is a more exacting standard that can only be achieved by programs that are able to cover all of their costs with earned income. Self-sufficient organizations do not need any ongoing subsidy. Some sources examined for this literature review use the term sustainability to mean self-sufficiency. However, this document acknowledges that a program can be sustainable and still require on-going subsidy.

**Factors that Contribute to Sustainability**

The path to sustainability for microenterprise development programs involves successfully managing a set of financial factors: increasing earned income, achieving efficiency, building an appropriate capital structure, and effectively fund-raising (or what Clara Miller calls, effectively managing an organization’s subsidy business\(^2\)). It also involves a set of organizational factors, one of the most important of which is managing leadership transitions.

**Whichever of the financial strategies organizations pursue, their success will depend in large measure on their overall orientation and capacity.** In part this implies: a focus on being entrepreneurial; having what is described as an overall “business orientation,” which includes a willingness to look at “a full range of options for increasing outcomes;” an emphasis on managing by results; and a corporate culture willing to take risks and “flexible enough to reshape policies.”\(^3\) It also involves an attention to keeping organizational capacity in balance with programming and capitalization. In particular, when programming runs ahead – especially when an institution reacts to opportunities somewhat spontaneously – the effects on organizational capacity and capitalization can be adverse. The key is to think comprehensively when pursuing any and all of the strategies discussed below.\(^4\)

**Earned Income Strategies**

Microenterprise development organizations can draw upon several earned income strategies, each of which carries its own opportunities and challenges.

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The starting point for most organizations should be an examination of what can be charged for core products and services. Certainly this is where microfinance organizations are focused and, as the data above suggest, training-led programs also are looking hard at this issue. Earned revenues produce a range of benefits for organizations. Even when amounts are small, they can “dramatically increase the level of discretionary funds at their disposal, which allows them to cover more of their core costs, engage in research and development, support “unfundable” projects, and invest in other areas of an organization’s development.” And when amounts are larger, they can contribute significantly to an organization’s self-sufficiency.

Revenue derived from core products and services presents the greatest benefit to microenterprise organizations for several additional reasons. An organization has more control over its core business than any other revenue stream. It also represents the area of its greatest expertise. As the social enterprise movement has encouraged nonprofits across the U.S. to see business creation as a strategy both for mission and sustainability, it is well for microenterprise organizations, especially credit-led institutions, to recognize that their core business is a social enterprise that can support both aims.

However, cost recovery in the industry, with exceptions, has been limited due to the pricing strategies utilized by most institutions. This is true even for microfinance or credit-led organizations. In fact, an analysis by J. Jordan Pollinger, John Outhwaite and Hector Cordero-Guzman, that examined the performance of 46 US microfinance organizations, found that “the majority … do not cover their costs and it appears that cost-based pricing is a lever that MFIs are not fully utilizing.” Their analysis, which is based on comparing reported pricing with a financial model that identifies the break-even cost for providing loans to three categories of borrowers (low, medium and high risk), also finds that pricing is generally further removed from the break-even cost at the higher levels of risk. At the highest risk level (which they associate with the smallest loans averaging $2,000), they compute the break-even price at 34.7 percent. Yet, among the studied institutions, the pricing on these small loans is “very diffuse with APRs spanning 35 points.” And, 90 percent of the organizations price at least 5 points below the break-even point. While they note that some institutions appear to cross-subsidize the cost of these high-risk loans with the price they charge the low-risk borrowers who obtain larger loans (averaging $20,000), they suggest that there is some danger to this approach as it may lead to their losing their best customers to competitors in the formal sector, ultimately increasing the riskiness of their overall portfolio.

The authors further note the consequences of such underpricing on the financial position of the organizations, stating that “we find self-sufficiency is extremely sensitive to pricing gaps. A one percent pricing gap on a $20 million portfolio amounts to a shortfall of $200,000 in absolute terms. This represents some 10 percent of annual institutional

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operating costs and thus corresponds to a self-sufficiency level of 90 percent. A five percent pricing gap leads to a self-sufficiency rate that increases slowly with portfolio size to a maximum of 60 percent. A 10 percent pricing gap actually leads to declining self-sufficiency with increasing portfolio size, as the absolute operating costs increase more quickly than absolute revenues generated through such a heavily subsidized pricing scheme.\(^7\)

The authors discuss a set of reasons why microlender prices don’t align more closely with costs, and suggest they may include funder restrictions, social and ethical pressures to maintain low rates, and lack of competitive pressure. They further note that most charge below the caps established by usury laws in their states, suggesting that regulatory requirements are not the predominant influence.\(^8\)

Whether subsidies are justified, the authors leave to be determined by other research comparing social benefits and costs. What they do conclude, however, is that currently the range of pricing by microlenders is so wide that it’s unclear what a reasonable subsidy might even be for the benefits produced, leaving individual organizations to struggle with this issue on their own.

While the authors don’t treat the pricing of microenterprise training and technical assistance organizations, MicroTest data demonstrates that they are in the same situation: pricing below cost and decreasing self-sufficiency as scale increases.

For those seeking a greater understanding of their options with respect to increasing earned revenues, the findings suggest that current cost and price structures may be worthwhile avenues for examination and adjustment. In that respect, “Costing and Pricing of Financial Services: A Toolkit” from MicroSave provides a useful resource. The paper offers a thorough review of the rationale and techniques for both costing and pricing, and provides managers insight into the decisions that they will have to grapple with if they choose to make adjustments in either.

The document first discusses the importance of understanding the specific costs associated with each product or service an institution offers, and the contribution that each makes to the sustainability of the organization through the revenue it generates. It then introduces two methods for cost analysis: allocation-based costing – “a method whereby each line of the profit and loss account is allocated to different financial products on the basis of a logical criteria called an Allocation Basis,” – and activity-based costing, which “traces costs through significant processes to products.”\(^9\) The choice of which method to use (or combination of methods) depends on the capacity of the institution, the level of effort it is able to invest in the process, and the questions it seeks to answer. Allocation-based costing may be a first step which allows an institution to

\(^7\) Pollinger and others, 38.
\(^8\) Pollinger and others, 37.
determine where there might be issues, and then provide a focus for more in-depth activity-based costing later.10

In addition to these key methods, the toolkit provides guidance on marginal costing, which allows an organization to determine what the actual, incremental costs are for any given product, and which helps determine what might be saved by eliminating it.11 And while the authors generally argue that all products and services should cover their costs, they note that managers should consider nonquantifiable elements such as benefits to the client, client satisfaction and retention, and outreach to specific target markets in making this decision.12

For organizations interested in pricing, the MicroSave Toolkit identifies three approaches to the task – one based on cost, one determined with reference to competition, and one which is based on customers’ perception of value. While most microenterprise organizations may suggest that this is the type of pricing they do, it is not clear that this is the case. Proper demand pricing begins with understanding “customer definitions of value in their own words and terms,” and includes quantifying that value on a “benefit by benefit basis.” As an example, the authors note “if provision of a local mobile banking service is particularly valued by clients because it saves both travel time and a bus fare an additional charge may be levied based on a proportion of the bus fare saved.”13

The authors note the danger of low pricing with these words: “Watch out for ‘dangerous pricing’… What customers long for is value, which includes not only a good product but accompanying services as well. Pay attention to price … but pay even more attention to value when building a loyal customer base. … Avoid the temptation to under-price to get your business started. You’ll find it hard to raise prices too quickly, so you’ll pay for your mistakes for years.”14

**Taking up the challenge of better costing and pricing requires that organizations master a number of key skills.** According to David Cracknell and Hermann Messan, such skills include: detailed knowledge of management accounts and an ability to perform allocation and/or activity-based costing, technical knowledge on interest calculations and financial modeling, skills in qualitative market research to research customer preferences “and to ascertain how best to explain prices to customers,” and communication and marketing skills to produce price-related materials.15

**Third party contracts also may be an avenue for earned income, although the structure of these contracts conditions their actual potential to deliver discretionary income.** Some authors, and microenterprise programs, have argued that third-party contracts are an important piece of the sustainability puzzle. Else, for example, cites the benefit of

10 Cracknell and others, 9-10.
11 Cracknell and others, 28.
12 Cracknell and others, 32.
13 Cracknell and others, 34.
14 Cracknell and others, 48.
“breaking into” the TANF and workforce development systems under performance-based contracts because they can provide long-term, ongoing revenues assuming the organization can meet established standards.\textsuperscript{16}

From a sustainability perspective, are third-party contracts fundamentally different than grants? On the one hand, they are often based on performance, and the income is “earned” rather than “donated” or “granted.” On the other hand, securing contract income requires investment in building relationships, and ongoing receipt of the income will be based on the priorities of those letting the contract – which may change.

The terms of the contract are a key consideration. As experienced by Housing Works, a nonprofit serving individuals with HIV in New York City, cost-reimbursement contracts rarely pay for the whole cost of the service, whereas fee-for-service contracts are designed to allow profit if a service can be provided efficiently. Fee-for-service, performance-based, contracts also can change the contractor’s perception of the nonprofit organization which may lead to more such contracts in the future. As Charles King of Housing Works noted, many nonprofits fear such contracts because they often rely on meeting performance benchmarks. In response, he notes that “We have a contract with the state for job training and we are paid based on a person’s completion of the program, we’re paid based on the person being placed in paid employment, and we’re paid if he stays at least six months. We’re betting that we can keep them in the program, graduate them, give them a job, and keep them on the payroll – and can do it in a way that allows us to more than cover the costs of doing it. That’s the risk for-profit businesses take all the time.” By resisting such pay-for-performance contracts, King says, “It’s almost a concession that for-profits are more [confident than nonprofits of] their own ability to do what they claim to be experts at doing.”\textsuperscript{17}

\textit{Social enterprise is a growing movement, spurred in part by diminishing funding resources and the drive to sustainability.} There has been a significant increase in social enterprises among nonprofits, driven in large part by an interest in generating revenues in the face of a changing funding landscape. This growing interest is manifested not only in the number of businesses being launched, but in the growing infrastructure to support the field (including REDF, the Skoll Foundation and its Web site Social Edge; the Social Enterprise Alliance, an association for nonprofits engaged in social enterprise; the Yale School of Management/Goldman Sachs Foundation Partnership on Nonprofit Ventures; and others). Enterprises can be mission-related or non-mission-related. The first set are often called social purpose, or mission-focused, businesses and are designed to pursue a “double bottom line” creating both direct social benefits for clients, and financial return that allows the business to operate in a self-sustaining way. In the microenterprise field, they can include retail stores and Web malls selling client products, kitchen or business incubators, and microfinance itself. The second include businesses that are designed to deliver a financial return directly to the program, and indirectly benefit the clients it serves through its other services. Examples may include thrift shops, print shops,

\textsuperscript{16}Else, 78-79.

bookstores and other services which do not feature client products, or increase client skills through their operation.

The experience to date suggests that the prospects for profitability among current practitioners are limited. In a survey of 519 nonprofit organizations conducted by one research team, 35 percent of those with businesses reported that they were profitable, while 19 percent reported that they were breaking even. However, the authors noted that this data was self-reported, and it is not clear what methodology was used to determine costs. In another survey of 105 nonprofit executive directors with for-profit ventures, 42 percent reported having profitable ventures, 27 percent reported having achieved break-even, and 13 percent reported losing money. Other observers also believe that profitability is more limited than these numbers convey. William Foster and Jeffrey L. Bradach report that they’ve seen few businesses generate actual profits, and that many nonprofits seem to confuse revenues with profits when reporting their results. And, Edward Skloot, executive director of the Surdna Foundation, and founder of New Ventures, the first nonprofit aimed at helping other nonprofits increase earned income, notes that “of the agencies that look into developing for-profit businesses, … only one percent will go forward with them, and only about 10 percent of those will succeed.”

FIELD’s own documentation of social purpose businesses implemented by grantees of the Ms. Foundation’s Collaborative Fund for Women’s Economic Development, found that the eight businesses tracked reached at least 53 percent operating self-sufficiency and four of the eight covered more than 80 percent of their business expenses with earned revenues. These businesses, which were designed to employ low-income women, serve low-income communities, and create jobs and/ownership opportunities offering better benefits than traditional, low-wage employment, were diverse in size and age, and several operated in highly competitive industries. While the data demonstrated that they produced a set of strong benefits for their participants, including solid wages and stable employment, they also demonstrated the challenges involved in seeking to deliver on both aspects of the double bottom line, leaving open the question of whether full sustainability can be achieved, or what level of subsidy will be required to continue to produce the gains achieved. What’s also important to note about these results is that they represent the level of self-sufficiency achieved by each business, and not the nonprofit that launched that business.

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19 Miguel Unzueta, “Profitable Nonprofits,” Stanford Social Innovation Review (Summer 2004): 12. Note that the surveyed executive directors also reported that $200,000 was needed to start a business venture.
21 Szalavitz, 48.
Whether they, and others like them, achieve full self-sufficiency may be less the issue, however, as substantial revenue generation in enterprises that are mission-focused (i.e., designed to produce direct benefits to clients), may be a more sustainable way to provide client services than more traditional service models. But the decision to employ a social enterprise model to achieve these benefits requires a very hard look and clear understanding of the expected costs, potential to generate profits, and subsidy requirements of the venture. In addition, managers intent on embarking on this strategy must anticipate what Emerson and Twersky call the “profound organizational, personal, and professional changes entailed in the practice of the new social entrepreneurship.”

It also helps to understand which factors appear to contribute to the success of a social enterprise. They include:

• **Size and age:** Larger, older nonprofits with bigger staffs are more likely not only to be operating an enterprise, but also to be turning a profit. (This is likely because size and age are indicators of both internal organizational capacity and financial capacity to buy needed expertise. In fact, Jed Emerson and Fay Twersky report that the nonprofit must have access to “the technical expertise and capital resources necessary to support an effective business planning and enterprise start-up process,” requirements more readily satisfied in larger, more mature organizations.)

• **Securing sufficient capital** and having access to that capital long enough to reach the point of sustainability or success. Having the complete financing in place at launch also has been identified as critical, along with supportive funders who understand that to grow, the likely trajectory will involve early losses and multiple years of funding.

• Choosing ventures based on what staff already knows how to do.

• **The size of the venture itself:** Jim Schorr, executive director of Juma Ventures and co-founder of Net Impact, states that a social purpose business needs to generate $1 million in revenue annually to both create a significant number of jobs and be sustainable.

• The presence of significant, traditional business skills on the part of the social entrepreneur.

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23 Foster and Bradach offer a set of questions that they believe nonprofit managers should use in evaluating any social enterprise opportunity. Please see 3-4.


25 Massarsky and Beinhacker, 4.

26 Emerson and Twersky, 11-12.


28 Szalavitz, 47.


30 Emerson and Twersky, 11-12.
If the leadership of any nonprofit should be entrepreneurial and have a strong grasp on business skills, it should be that of microenterprise programs. The challenge may be more around amassing the capital, ensuring that the enterprise does draw on core competencies, does have a market, and does not drain staff energies away from mission. In this respect, it is probably best to look at enterprises that are closely related to mission, and to view them more as a potentially sustainable approach to delivering a particular service, than as a tool for generating profits to subsidize a microenterprise program’s existing or core services. And as the funding environment becomes both less favorable in terms of traditional grantmaking and more favorable toward social enterprise, managers may have little choice but to pursue this option. If that is the case, it will be important to have a much clearer understanding of what can be expected from this strategy and to proceed with deliberation, and an understanding that the timeframe for profitability may be an extended one. Michael Shuman, vice president for enterprise development for the Training and Development Corporation in Bucksport, Maine, recommends “that nonprofits start slowly, and try to make just 3-4 percent of revenues per year come from for-profit ventures.”

**Partnership strategies may also offer opportunities to earn revenue.** Only a little literature considers how the right partnerships can support revenue-generating possibilities, but there are a few suggestive examples. One strategy involves shared distribution of a desired product or service. An international example can be found in ACCION International’s development of a sustainable business training program that is based on a franchising (licensing) model. ACCION developed the materials and licensees pay ACCION both an upfront fee – which includes training for their trainers and help in creating a business plan – and a per unit fee for the workbooks, where the majority of the revenues have been generated as the program has reached over 100,000 clients in its peak years. Although it is not a requirement of participation, ACCION also seeks to help its licensees offer their training in a sustainable way, and the majority charge fees ($8-$10 for a 4-5 hour training). Those with results-oriented management and a focus on cost recovery have been able to offer the service sustainably. In the U.S., there are several examples of programs developing and selling their training product to partners (Core Four, and First Step Fast Trac) but it is not clear to what extent sustainability has been achieved by either the producer or user of the product. Still, looking for win-win opportunities of this type seems warranted.

31 Szalavitz, 48. It’s also worth noting that some literature suggests that nonprofits might be able to accelerate the business development cycle by choosing to operate a franchise. This is discussed in detail in: Community Wealth Ventures, Inc. and IFA Educational Foundation, *Nonprofit-Owned Franchises: A Strategic Business Approach* (Community Wealth Ventures, Inc. and IFA Educational Foundation, March 2004), where the benefits to both nonprofit and franchisor are outlined, along with a set of key considerations. Most important to note is that this is still a relatively new concept.


33 Gregory A. Ratliff and Kirsten S. Moy, "New Pathways to Scale for Community Development Finance," *Profitwise News and Views* (December 2004) also discuss collaborative models in the corporate sector, such as that of United Western Grocers, that enable small scale institutions to compete against larger chains by providing products and services that they can’t develop or deploy individually (see page 12).
A second strategy uses corporate partnerships focused on cause-related marketing but managers are cautioned to understand and value the full costs of participating in such partnerships. IEG, a firm that promotes cause-marketing and other business-nonprofit partnerships found, through a survey of 145 managers, that most nonprofits undercharge for sponsorship opportunities, perhaps between 15 and 25 percent, because they don’t accurately estimate the administrative costs associated with managing and marketing the partnership. As with social enterprise strategies, the key is a careful estimation of the costs and benefits of these partnerships before embarking on them.34

**In using any of these strategies, microenterprise organizations should beware the potential “crowding out” effect of earned income strategies.** The positive benefits of earned income do not come without potential downsides. A few researchers have warned that increasing earned revenues may actually reduce the amount of private donations made. One study, for example, found that nonprofits in the arts, culture and humanities lost 59 cents in donations for every dollar earned, while nonprofits in human services and “public benefit organizations” lost 55 cents for every dollar earned. Educational and medical institutions did not appear to suffer any reduction in donated revenues. The key seems to be the donors’ perceptions: If they are against sales activities, or believe that the nonprofit no longer needs their support, their donations decline.35 Another study found that nonprofits’ pursuit of commercial activities tended to be a response to falling donations, and that while it resulted in a set of benefits including greater self-sufficiency, it did not help their fundraising efforts.36

Several other researchers have identified the distraction that for-profit ventures can create within nonprofits, diminishing their attention to their original social mission, and in some instances, reducing the quality of services offered.37 Angela M. Eikenberry and Jodie Drapal Kluver raise the more philosophical and provocative question of whether the “marketization” of the nonprofit sector (defined at its move to increasingly adopt the methods of the market to guide policy creation and management) is undermining critical roles that it plays in building civil society. The paper describes four trends in the marketization process – the generation of commercial revenue, contract competition, the influence of new and emerging donors, and social entrepreneurship – and lays out how they undermine nonprofits’ ability to play three key roles in building and supporting civil society: value guardians (nonprofits often “emerge to give expression to the social, philosophical, moral or religious values of their founders and supporters”, and have historically supported the values of community participation, due process and stewardship), service and advocacy (providing public goods, and playing roles such as research, teaching, advocacy and serving the poor), and building social capital (creating venues that generate and reinforce social norms of trust, cooperation and mutual support).

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The authors also note that marketization pushes funders to reward what is easily measurable.38

For managers, these critiques are worth keeping in mind as earned revenue strategies are both designed and implemented. Just as it’s essential to approach any of them with an open eye regarding the true financial costs, it’s also essential to be aware of the potential costs to organizational mission and actively develop strategies to guard against that.

**Increasing Efficiency**

Organizations also can improve their sustainability by increasing their efficiency – by generating more with less. There is a body of literature that discusses how internal efficiency can be enhanced within microenterprise organizations; however most of this research comes from the international microfinance field, and therefore focuses on organizations that are in the “business” of lending, rather than business of providing training or other business development services. Nonetheless, there are some lessons from this literature that apply to microenterprise organizations of all types.

*Mission and competition are key drivers of efficiency.* Monica Brand defines efficiency as “a function of how well an institution utilizes inputs or available resources (measured by total administrative or non-financial costs) to maximize output (average gross portfolio).”39 The literature identifies two factors that drive efficiency: competition and mission. David Richardson speaks to the role of competition when he notes: “As larger banks ‘downscale’ to enter this seemingly profitable market niche, they will ‘cherry-pick’ the best borrowers of the smaller, inefficient NGOs by offering lower interest rates. Banks can do this because they have lower operating expense ratios.”40 Research sponsored by FIELD indicates that many in the U.S. microfinance field are now beginning to face similar competition from traditional banks, mainly through the use of credit cards.41 Although bank credit cards may not carry lower interest rates than loans offered by microlenders, their “cost” to the client is lower due to shorter turn-around time and often reduced information requirements.

From a mission perspective, Brand suggests: “Improving efficiency is also necessary to address the social mission of microfinance, to the extent that it allows MFIs to reach further down market and/or pass on the cost savings in the form of lower interest rates.”42 In the U.S. context, the mission-related benefits of efficiency would be (1) the ability to reach higher-cost clients, (2) the ability to achieve more clients with the same level of

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42 Brand, 13.
resources (supporting the goal of achieving greater scale), and/or (3), a reduction in the revenues required to support program operations.

Current levels of efficiency vary greatly within the U.S. microenterprise industry. Data from FIELD’s MicroTest project provide a picture of current levels of efficiency within the U.S. industry. In FY 2005, the median cost per client for the 70 microenterprise program that reported data to MicroTest was $2,058. However, across these 70 programs, the ratio varied from a low of $182 to a high of $9,478. In terms of other efficiency measures, the median cost per client for delivering business development training and technical assistance ranged from a low of $79 to a high of $5,018. Operational cost rates – which measure the cost for an organization to manage each dollar in its loan portfolio – had a median value of $0.45, but ranged from $0.03 to $20.82.

Variations in the values of some of these measures depend in part on the methodology or business model used by the microenterprise program. The operational cost rates for credit-led programs are typically well below those of training-led organizations, in part because the greater scale of their lending efforts appears to afford some economies of scale. The following table indicates how the median and average operational cost rate of microenterprise programs43 declines as the number of outstanding loans increases:

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<thead>
<tr>
<th>Operational Cost Rates of Microenterprise Programs, FY 2005</th>
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<tbody>
<tr>
<td>Number of outstanding loans</td>
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<tr>
<td>Median OCR</td>
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<tr>
<td>Average OCR</td>
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At the same time, it is important to note that growth does not always result in increasing efficiencies. Certainly in the U.S. the link between program scale, as defined by the number of clients, and the cost per client is unclear. Even when considering just lending activities, MicroTest data indicates that (1) there are relatively small scale lenders that have achieved strong efficiencies in lending, and (2) growth in an organization’s loan portfolio does not always yield efficiencies. This last finding also has been identified in international microfinance organizations.44

Global experience suggests several strategies for improving efficiency in microlending. These include:45

- Increasing average loan size. There is some evidence that this approach may also hold true in the U.S. MicroTest data indicates that microlenders with average

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43 The operational cost rate, as defined by MicroTest, is the cost that a program incurs to make and manage $1 in its loan portfolio. Thus, an operational cost rate of .50 would mean that it cost a program 50 cents to make and manage each dollar in outstanding loans.

44 Brand, 14.

loan sizes greater than $10,000 are more efficient – as measured in terms of operational cost rate – than those with average loan sizes below $10,000.

<table>
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<tr>
<th>Operational Cost Rates by Average Loan Size, FY 2005</th>
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<tr>
<td>Average Loan Size</td>
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</tr>
<tr>
<td>Median OCR</td>
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<td>Average OCR</td>
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- It is important to recognize that low operational cost rates alone will not guarantee greater sustainability: pricing and revenue generation on the loans are also key factors, as noted above. However, all other things being equal, greater efficiency obviously contributes to sustainability.

- Re-evaluating salary and bonus incentive structures. International microfinance organizations have used incentive programs as a means to stimulate greater efficiency by encouraging loan officers to increase their “production” of loans. This approach has been tried in the U.S. as well; ACCION New York instituted an incentive program as part of a broader re-engineering effort aimed at increasing scale and efficiency.46 Some observers note that the usefulness of incentive programs requires that they be carefully constructed: “The structure of an effective incentive scheme includes two essential components. First, to motivate desired performance, the incentive structure must be clear and consistent; multiple variables with complex weighting that change to meet management’s short-term goals only serve to confuse and frustrate the staff. Second, it must include a quality threshold; when a loan officer’s portfolio quality deteriorates beyond a certain point, s/he receives no incentives.”47

- Balancing the gain of reducing delinquency versus the costs of doing so. In international microfinance circles, some lenders pursued a policy of zero tolerance for delinquency – meaning that all late payments were pursued aggressively. However, over time many lenders realized that this approach can lead to inefficiency, as it may be cheaper to allow a greater tolerance of delinquency (up to a certain point, of course), or to completely write off smaller delinquent loans, than to invest significant staff time in reducing delinquencies to zero. While few if any microlenders in the U.S. have taken a zero tolerance policy toward delinquency, the same balancing act – between the cost of sustaining delinquency and default, and the costs of preventing it – come into play.

- Creating economic incentives for borrowers to repay early. A few programs in the U.S. have created financial incentives in a move to reduce the costs of managing delinquencies.

46 For a more detailed discussion of some of the steps that ACCION New York has taken to increase efficiency, see Monica Brand and Julie Gerschick, Maximizing Efficiency: The Path to Enhanced Outreach and Sustainability (Washington, D.C.: ACCION International, September 2000, Monograph Series Number 12).

• Access to information. More rapid access to information – often achieved through increased use of technology – also can build efficiencies in the lending process. ACCION Texas, for example, has a management information system that is available in real time to all its loan officers and underwriters, so that they can always know the current status of any applicant or borrower. Credit scoring is clearly one example of a technology that has created substantial efficiencies in the U.S. banking and finance industries, as well as in international microfinance. In the U.S. microenterprise field, ACCION USA has just developed and implemented a credit-scoring model for its microlending program. ACCION programs – both trainers and lenders – also have used communication and computer technologies to support the geographic specialization of staff described below.

• Specialization in the lending process – both in terms of the skills of loan officers (having them specialize in certain types of loans, or certain aspects of the lending process) and geographic coverage (focusing on specific geographic areas). Programs in the U.S. have begun to use specialization as a way to increase efficiency. For example, both ACCION New York and the Rural Enterprise Assistance Program in Nebraska have deployed staff in specific communities or neighborhoods, with the goal of reducing travel time between clients and a central office. And both ACCION New York and ACCION USA have created centralized back offices that handle certain administrative components of the lending process, freeing loan officers to focus more heavily on outreach and initial intake of loan applications.

Re-engineering also can be a tool for promoting efficiency. Microenterprise organizations in the U.S. and overseas have used re-engineering as a tool to reorganize and restructure their operations for greater efficiency. In their book Maximizing Efficiency: The Path to Enhanced Outreach and Sustainability, Monica Brand and Julie Gershick of ACCION International describe the re-engineering efforts of various ACCION affiliates. They note that many formerly perceived “best practices” that were assumed to both foster quality and efficiency ceased to work as well as they did in the past, largely because of changes in market conditions, and because programs that clung to these old practices (such as zero tolerance of risk, undifferentiated lending methodology and pricing) are not as efficient as others. The authors state, “The difficulty is that inefficiency has less to do with methodological ‘breakthroughs’ in terms of lending practices than it does with organizational culture and strategic orientation.”

They further note that “efficiency analysis must begin at the managerial levels, as part of the overall strategy of the institution, and carry through each business unit, in order to

51 Brand and Gershick, 5.
identify all opportunities for cost reduction and improved revenue generation. Moving through the deepening layers of analysis, it is clear that efficiency maximization involves a combination of high-level scrutiny, innovative problem solving, vigilant attention to detail, and most importantly, a plan of action.52

The key recommendations for increasing efficiency include:

- Segmenting markets more carefully to define the specific niches they will target and adjust their products accordingly.53
- “A more sophisticated understanding of pricing – including cross-subsidies, demand elasticities, risk-based pricing, etc.,” will enable MFIs to “define a strategy and a product mix that optimizes both revenues and impact, thus maximizing efficiency.”54
- Not equating cost control with efficiency. Some cost-cutting measures (such as investing in “basic market research will save costs in the short-term, but may actually result in more inefficient operations if product design is poorly aligned with the target market.” More important is focusing on the definition of efficiency – maximizing output per unit input, and looking at both revenues and expenses to see if more could be produced from the existing resource base. “In other words, even if costs are held constant, an MFI can improve overall efficiency by generating more revenues from existing capacity. For example, improving loan officer productivity, a common efficiency-enhancing strategy, increases revenues (loans generated) while holding costs (salary) constant.” Net contribution analysis – understanding the net profit generated by each resource, rather than just the cost consumed – supports this more informed analysis.55
- Having clear goals, and measuring them on an ongoing basis in terms of output per unit input is essential, and these goals must be developed on the basis of an organization’s vision, mission and strategy.56
- Increasing accountability to clients, donors, investors and regulators.57
- Bringing together key stakeholders (board members, senior management, investors, etc.) to define a clear vision, identify major problems, and undertake a rigorous financial analysis that “fully allocates the MFI’s revenues and expenses to its products and services so that the net profitability (or loss) of each becomes evident. Part of this analysis may lead to a recognition that current leadership is “entrenched in ‘business as usual,” and may require bringing in new blood to complement or replace current leaders.58
- Drawing on outside assistance: “Examples of significant change that was successfully instituted by staff without the objectivity and expertise of outside help are almost nonexistent.”59

52 Brand and Gershick, 177.
53 Brand and Gershick, 178.
54 Brand and Gershick, 179.
55 Brand and Gershick, 179-180.
56 Brand and Gershick, 180.
57 Brand and Gershick, 181.
58 Brand and Gershick, 182.
59 Brand and Gershick, 182.
• Having “bold decisionmakers” in charge of the re-engineering process who are willing to make hard decisions for the good of the institution: “effective change efforts require hard decisions about who to keep, who to bring in, who to redeploy or let go – a painful disruptive process that is critical to creating a culture that will institutionalize efficiency.”

• Focusing on results: quantify, measure and track all goals.

Effective Fund-raising

Although earned-income strategies offer the potential to reduce a nonprofit’s reliance on grant funding, the reality is that for most nonprofits, sustainability will require ongoing success in raising the grant dollars upon which they have always relied. As Clara Miller of the Nonprofit Finance Fund notes:

“Nonprofits exist to take on causes that for one reason or another are not commercially viable (their missions are the reason they stay in a commercially non-viable business). Among such businesses are discovering a vaccine for AIDS, creating an accessible dance notation system, providing health care to indigent World War II veterans, or helping workers whose small business markets disappeared after 9/11 rebuild, to name a tiny few. This requires much financial discipline, but the notion that most nonprofits can grow themselves out of contributions is largely unrealistic. (Harvard University, a leading nonprofit, hasn’t done it in over 300 years.) Planning by givers and recipients should acknowledge this and not create unrealistic expectations for profitability or achieving scale, and therefore profitability.

Thus, in seeking to achieve greater sustainability, microenterprise programs and their funders must understand the following:

Achieving sustainability will require that organizations build a strong “subsidy business.” Microenterprise organizations exist to further their mission of bringing enterprise opportunities and support to individuals who lack access to critical resources. They engage in a range of business models in pursuit of that goal: providing business development services, making loans and providing access to savings products, providing membership and market-access services, and so forth. Miller also argues that nonprofits that seek to sustain themselves and to grow must also build capacity and invest resources to developing their “subsidy business” – the work that they engage in to “make up the difference between the price it can get for mission-related services and what the services really cost to deliver. Subsidy businesses, which raise the funds required to continue and expand operations, include: fund-raising, dinner dances, special events, bingo, capital

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60 Brand and Gershick, 183.
61 Brand and Gershick, 184.
62 Clara Miller, “Gift Horse or Trojan Horse? A Thorough Physical is Critical,” Nonprofit Quarterly 11, no. 2 (Summer 2004); available from http://www.nonprofitquarterly.org/section/515.html; Internet.
campaigns, for-profit related and unrelated businesses (e.g., bookstores, gift shops, parking lots), donated services, wine and cheese parties, endowment management, and any number of creative fundraising ideas long a staple of the sector.64

**Microenterprise programs must understand and respond to changing trends in philanthropy.** Two trends in particular seem relevant. The first is the now fairly well-established movement toward “venture philanthropy.” This form of philanthropy has been driven by successful entrepreneurs – many in technology-related industries – that are entering the world of philanthropy. According to Peter Frumkin, venture philanthropists are driven by the desire to reach scale, and are frustrated by the limited scale achieved through traditional philanthropy. Frumkin describes venture philanthropy as a three-legged stool. The three legs are: (1) large of blocks of capital delivered over an extended period of time to build the capacity of nonprofits; (2) management consulting to build nonprofit strategy and capacity (sometimes occurring through “consultative engagement” with the donor, who typically has a for-profit business background), and (3) performance measurement, typically focused on measuring social return on investment (SROI).65 Some venture philanthropists are showing interest in the international microfinance field, given its record of growth and self-sufficiency, and some U.S. microenterprise programs are hoping to capitalize on that interest. For organizations pursuing such donors, however, it is important to recognize that venture philanthropists do have a very different approach and set of expectations than traditional philanthropists.

The second and perhaps more important trend is the role and growing importance of individuals as a source of philanthropic funding. According to the American Association of Fund-Raising Counsel, individuals accounted for more than $183 billion in donations in 2002, compared to just under $27 billion for foundations and $12 billion for corporations. While a large portion of individual giving – 35 percent – went to religious organizations, just under $100 billion went to other types of nonprofit organizations.66 Interestingly for microenterprise organizations, 80 percent of all giving comes from households with annual incomes of $50,000 or less.67 This indicates that, as some microenterprise organizations have found, program clients may be very willing to give in support of the organizations that have provided them with services and support. Some microenterprise programs have targeted individual donors as a key element of their funding strategy. For example, Women’s Initiative, located in the San Francisco Bay Area, built an entirely new fund-raising base over a three-year period by focusing on

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64 Clara Miller, “Gift Horse or Trojan Horse? A Thorough Physical is Critical,” *Nonprofit Quarterly* 11, no. 2 (Summer 2004); available from [http://www.nonprofitquarterly.org/section/515.html](http://www.nonprofitquarterly.org/section/515.html); Internet.


individual investors. During that time it brought in more than $1.5 million in new funding.68

**Documenting and communicating about program outcomes and the “return on investment” are central to effective fund-raising.** Successful fund-raising – from all sources – is built on relationships and results. For individual donors, who want to see and touch the outcomes of their giving, the stories of and contacts with individual entrepreneurs who are served by a microenterprise program may be the most important means of demonstrating outcomes. Institutional donors – be they public agencies, corporations or foundations, traditional or venture philanthropists – often want to see data on outcomes that goes beyond individual success stories. As FIELD documented in its publication, *Opening Opportunities, Building Ownership: Fulfilling the Promise of Microenterprise in the United States*, a range of studies have looked at the outcomes of microenterprise programs – some focused on a single program; others looking across a range of organizations.69 Yet continuing work is needed, both to grow and update the type of outcomes information that is available, as well as to conduct the types of rigorous evaluation that can demonstrate the causal link between the services provided by microenterprise programs and the outcomes experienced by entrepreneurs.70

**Appropriate Capitalization**

As the above discussion notes, building sustainability requires a hard look at both the income and expense sides of the organization’s income statement. However, the literature indicates that focusing on the income statement is not enough; it is also critical to understand and manage the organization’s balance sheet as well.

**Capital structure plays a critical role in the sustainability of an organization.** Clara Miller of the Nonprofit Finance Fund argues that for nonprofits, achieving sustainability requires the proper balance between three critical elements of mission, organizational capacity and capital.71 These three elements are parts of a triangle that form the underpinning of a healthy organization. Moreover, growth within an organization requires changes in all three elements. Often, however, organizations experience a change in one area – for example, the receipt of a new grant that affects their capital structure and perhaps mission – without fully understanding or planning for the changes that will be required in the other core elements (such as organizational capacity).

Miller notes that an organization’s capital structure (defined as the distribution, nature and magnitude of an organization’s assets, liabilities and net assets) “is a prime

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70 Edgcomb and Klein, 102.

determinant” of its capacity to take on program risk. Miller identifies four key principles to understanding nonprofit capital structure:

- Capital structure exists in even the smallest nonprofits; ignoring it puts an organization at risk.
- Capital structure always has an impact on mission and program, and on organizational capacity.
- Capital structure is linked directly to a nonprofit’s underlying business, which is distinct from, though clearly related to, its program.
- Healthy capital structures are difficult to maintain in nonprofits because there often are restrictions on nonprofit assets; this creates a “super-illiquidity,” or lack of financial flexibility, that makes it difficult to keep the “business” aspects of nonprofits functioning well.

To properly support sustainability and growth, Miller suggests that nonprofits engage in a strategic planning process that seeks to analyze its business (or businesses) and build an appropriate and supportive capital structure (she terms this approach “comprehensive capitalization”).

Similarly, the acquisition of assets that are often seen as supporting sustainability (owning a building, building an endowment) can actually undermine an organization’s financial health if they are not properly capitalized and planned for. This is because those assets are often illiquid and create expenses – for building maintenance, additional programming, or enhanced fund-raising capacity – that will create a drain on the organization’s available cash, and can therefore make it increasingly vulnerable to downturns in fund-raising success or revenue generation.

Miller also suggests a set of principles that donors can follow to improve their grantmaking to nonprofits. These are:

- Focus on the core business. Understand that you are funding an underlying business that supports, but is distinct from, program. The capital needs of this business will change over time, and funders should design financial investments that support the business over time.
- Be sensitive to transitional stages (growth, start-up, turnaround, merger). When nonprofits grow, they almost always require growth in fixed overhead costs. Organizational capacity is often built in leaps, and organizations in periods of growth are made particularly vulnerable by grants that are not supportive of the core business.
- Restrictions. The stronger the restrictions on a grant, or the greater the fixity of assets acquired with a grant, the higher the risk to the organization. Any restricted grant creates expenses for the grantee.

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• Consider the whole organization. An organization is a system; changing one part of the system changes all of the others, and funding only one part creates a draw on all of the others.\textsuperscript{75}

Endowments can support longevity, but planning is critical to success. Endowments are one tool that nonprofits use to increase their sustainability. Endowments are gifts of “funds or property donated to an institution, individual or group as a source of income.”\textsuperscript{76} Yet according to experts, endowments are not for every nonprofit, and there are a series of steps that organizations should take to adequately plan, prepare for, and build a successful endowment program.

According to Mark Hager, these critical steps include:\textsuperscript{77}

• Building a rainy day fund. Organizations should have six months of emergency funds saved separate from any endowment the organization might start. These rainy day funds are necessary for the organization’s financial health.\textsuperscript{78}

• Understand the reasons that donors provide endowments. Donors can be encouraged to give to endowments for two psychological reasons, “to experience the glow of perpetuity” (i.e., knowing that money given will support an organization after the donor is gone), and to put an “elite’s” mark on a non-profit – possibly to transfer the status the donor has to a future generation through naming rights, etc.\textsuperscript{79}

• Recognize the downsides to endowments. The most common complaint is that “endowments shortchange today’s charity for an unknown future.”\textsuperscript{80} In other words, rather than being used to fund future activities, the money could be better spent addressing programmatic needs today. The second complaint is that money is more powerful now, because as time passes the value of money erodes with inflation.

• Realize that creating, building and managing an endowment takes management attention. The organization must commit the resources needed or the endowment will be unsuccessful.\textsuperscript{81}

• Recognize the challenge that restrictions can bring. According to Hager, “permanently restricted” is a troubling phrase for non-profits that need to stay flexible in a changing environment. An organization can wind up “endowment-rich” but “cash-poor with big assets but not enough additional money to run its programs.”\textsuperscript{82} Clara Miller makes a similar point when she notes that endowments create a change in capital structure, and that any change in that structure – “even

\textsuperscript{75} Clara Miller, “Hidden in Plain Sight,” 4.
\textsuperscript{76} The Free Dictionary [dictionary on-line]; available from http://www.thefreedictionary.com/endowment; Internet.
\textsuperscript{77} Mark Hager, “Should Your Nonprofit Build an Endowment?” Nonprofit Quarterly 13, no. 2 (Summer 2006): 57-60.
\textsuperscript{78} Hager, 57.
\textsuperscript{79} Hager, 58.
\textsuperscript{80} Hager, 58.
\textsuperscript{81} Hager, 59.
\textsuperscript{82} Hager, 59.
the addition of thrillingly large amounts of capital in the form of endowment” – requires an adjustment in organizational capacity, capital structure and program as well. As she notes, “the adverse effects can be avoided by careful planning and structuring of the award. This notion that money and investment create expenses is counterintuitive for most people.”

- Realize that endowments may turn off some donors, who feel that the organization doesn’t need donations because of their significant endowment.

Managing Leadership Transitions

**Effective leadership transitions can aid sustainability while unplanned transitions or failed transitions can have a disastrous effect on an organization.** Leadership transitions can be a key way for organizations to strengthen operations, improve capacity and change directions. However, transitions are challenging by nature, especially if the transition is away from the founding director of the organization. There are great opportunities to improve an organization during a transition. However, a failed transition can substantially weaken an organization’s sustainability. For example, other staff and board members may leave, donors may withdraw, or at least take a “wait and see” approach, which can deprive the program of necessary funding or opportunities for program growth. Finally, the program may incur substantial direct costs to locate a replacement.

Organizations can take specific steps to effectively plan for and manage a smooth transition. For example, preparing an emergency succession plan pulls key information together into one document in the event that an executive director has to take an emergency leave of absence. The Center for Nonprofit Advancement offers an emergency succession plan template that can be downloaded and used to gather tax, personnel, financial, legal and facilities information together to aid an interim director.

Organizations involved in a leadership transition can maximize a transition by taking full advantage of the interim period, addressing key issues affecting the organization and developing a search plan that devotes adequate time to all three transition phases: getting ready for the search, recruitment and post-hiring.

**Conclusion**

This review of the literature leads to several conclusions:

- Building and sustaining a healthy organization is a balancing act. Managers must pay attention to issues of mission (and program), organizational capacity and capital

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84 Hager, 60.
structure. Especially when mission and program outpace the institution’s capital structure, an organization can find itself in a critical situation. Understanding how the characteristics of specific funding impact the larger institution is critical to maintaining an organization on an even keel.

- Even if an organization cannot achieve total self-sufficiency, earned revenue produces a range of benefits, and the core business of microenterprise organizations lends itself to generating revenues through interest and fees. As the social enterprise movement has encouraged nonprofits across the U.S. to see business creation as a strategy both for mission and sustainability, it is well for microenterprise organizations to recognize that their core business is a social enterprise that can support both aims.

- At the same time, the data suggests that most programs under-price their products and services, and confront a series of issues with respect to determining the right prices, some of which are technical, but most of which have to do with mission issues.

- Experience to date suggests that the prospects for profitability of social enterprises may be limited, at least in the current state of practice. What this suggests is that it is better for organizations to look at this strategy less as an add-on to drive revenue to cover the organization’s core operations, and more as an alternative mission-focused strategy designed to produce direct benefits to clients in a way that may be more sustainable than other methods.

- Improving efficiency can be another route to improving sustainability, but to achieve these efficiencies requires focused attention on the part of managers and the application of specific processes – re-engineering, using technology, applying measurement tools – to achieve real gains.

- Regardless of success in social enterprises, most organizations will need to continue fund-raising for at least part of their budget, and it’s important that both managers and funders recognize this “subsidy business” as the substantial work that it is. Managers need to think strategically about the types of funding they request, and be aware of key trends in the marketplace, as well as how different types of funding affect the organization’s overall capital structure.

- Finally, through their funding, funders can enhance or diminish an organization’s sustainability. Funding that supports the overall organization, and provides financial investments that assist its development over time, will provide the greatest benefit. Being aware that funding one element or program of an organization can create a drain on other elements of the institution is also critical, and the greater the restrictions on the use of a grant, the more challenging it is for an institution. Funders that are flexible and attuned to capacity needs of an organization in a growth or other transitional stage, will provide the greatest benefit to their grantees and lead to the type of sustainable organizations that funders want to see.
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Other Resources


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