

# Unlikely Takeover: A Third Way to Scale Social Enterprise

by Jon Huggett

It may seem counterintuitive for a nonprofit to effect the takeover of a floundering business and turn it into a social enterprise. But, as this article proposes, there are enterprises that could function better as nonprofits. This should offer food for thought for people in all three sectors: if we could dispense with blanket assumptions about the relative competence of one sector over the others, we might see the comparative advantages achieved by placing an endeavor in one sector versus another.

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**W**HEN WE ATTEMPT TO SCALE social enterprise, we usually try one of two paths: growing small organizations or spreading ideas across a range of organizations to scale impact. A path less traveled is to leapfrog by converting a large business into a nonprofit social enterprise that can more easily and effectively thrive and grow at a larger scale.

There is no practical reason why such a strategy should not be considered more regularly. Large social enterprises are not new, especially in distributed businesses; consider The Co-operative, in the United Kingdom, or the Mondragon Corporation, in Spain, each with \$19 billion U.S. in revenue. In the developing world, microfinance has spawned brawny social enterprises like BRAC of Bangladesh, with its half-billion dollars in revenue.

Here's the story of how Social Ventures Australia led a consortium of nonprofits to create a scale social enterprise out of the wreckage of a bankrupt business, and what lessons can be learned from their efforts.

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When Evan Thornley, a businessman and member of the state parliament of Victoria, Australia, heard that ABC Learning, a for-profit business with \$600 million in revenue, was floundering, he saw a "once-in-a-generation opportunity."<sup>1</sup> Could the chain of day care centers serving over seventy thousand children across Australia—a full 15 percent of the market—also deliver early learning under new ownership?

Michael Traill, the head of Social Ventures Australia (SVA), a \$10 million nonprofit, saw a chance to leapfrog to scale while improving the quality of what was being offered. SVA nurtures small social enterprises, and acquiring ABC Learning would be the largest takeover yet of a for-profit by a nonprofit. But Traill had an eye for the task; he was no stranger to mergers and acquisitions. Before founding SVA, he had spent fifteen years leading private equity at Macquarie Bank.

## The Social Context

In international comparisons, Australian education performs well for the average

child but poorly for the disadvantaged one. According to the Programme for International Student Assessment (PISA) statistics from the Organization for Economic Cooperation and Development (OECD), the average fifteen-year-old Australian scores better than the average American, German, or British counterpart in reading, literacy, and mathematics. The only large nations with better scores for the average fifteen-year-old are Canada and Japan. Scores for disadvantaged fifteen-year-old Australians, though, are closer to their disadvantaged peers in the United States and the United Kingdom.<sup>2</sup>

Australia spends less on preschool education than its OECD peers, measured by percentage of GDP. In 2010, with only 51 percent of children enrolled in early childhood education, Australia ranked thirty-fourth out of thirty-eight OECD and partner countries, and well behind the OECD average of 79 percent. Could focused, for-purpose early learning help disadvantaged Australian children catch up to the impressive results achieved by most average Australian high school students?

## The Challenge

On November 6, 2008, ABC Learning went into “voluntary administration,” which U.S. readers will find more familiar as “Chapter 11.” Its assets were for sale. Traill believed that the early learning centers would be more effective, more sustainable, and happier with a non-profit parent that could focus on social impact, and cut costs, too.

There is a good deal of research that suggests that in some fields nonprofits perform better than for-profits, both in terms of programmatic outcomes and cost containment. In the field of education, Canadian research shows that child care is likely to be better run by a non-profit than a for-profit, finding “strong patterns of non-profit superiority in producing quality child care services,”<sup>3</sup> and a 2012 study of charter schools from the National Education Policy Center, in the United States, found nonprofits more likely than for-profits to meet federal Adequate Yearly Progress (AYP) benchmarks.<sup>4</sup>

Without access to equity capital, though, nonprofits have a harder time raising cash for investment. Acquiring ABC Learning Centers would require a lot of money, quickly. While SVA is Australia’s leading venture philanthropist, it was too small to swallow ABC Learning. It needed partners large enough to raise the capital and leaders decisive enough to run at the pace of an acquisition. Traill pulled together a consortium of four nonprofits to buy the assets of ABC Learning, take them into the nonprofit sector, and refocus the organization around a social purpose.

## The Consortium

Goodstart Early Learning is a coalition of SVA and three large Australian nonprofits: The Benevolent Society (with \$76 million of revenue); the Brotherhood of St Laurence (\$61 million); and Mission

Australia (\$295 million). The combined revenue of over \$400 million and solid balance sheets gave the group the credibility to borrow the funds needed to buy the assets of ABC Learning. Keeping the consortium to just four nonprofits with excellent administrative capacities meant that Goodstart could move quickly.

The team that SVA assembled to create Goodstart learned four lessons that may help other consortia of nonprofits trying to buy for-profits.

### *Lesson 1: Pick a hard goal to tighten collaboration among nonprofits.*

Even among four handpicked nonprofits, collaboration was hard. There was the risk that profit could trump purpose. The finances of any deal would be demanding. To keep the consortium together, the team members strove to agree on exactly what they wanted to do for children. If they shared a purpose, it would help them surmount differences—for example, over money. The team wanted a well-defined goal as a tool for making decisions.

Together, they iteratively developed a foundation document (unpublished) titled “Connecting Head and Heart: A Framework for How Goodstart Childcare Centres Will Drive Improved Early Childhood Educational and Social Inclusion Outcomes in Australia.” Its ten pages of facts and figures detailed how Goodstart could help children.

The process of writing the document and agreeing upon purpose brought the four nonprofits together. “It made it easier to have the fierce conversations,” Traill commented. “Communication was important because the decision-making process of each member was different.” U.S. research into nonprofit mergers stresses the importance of “strong working relationships between executives prior to merger” in delivering good outcomes after the merger.<sup>5</sup>

The Goodstart team set three clear overriding goals according to which it now manages the business:

- Raise the **quality** of early learning;
- Enable all children’s access to and **inclusion** in early childhood programs; and
- Ensure financial **stability** to generate a surplus to reinvest.

### *Lesson 2: Pick the board to “move and shake,” not “represent interests.”*

With the social purpose embedded in shared goals, not the representatives’ roles, the team could move just quickly enough to secure the capital. Traill recalled, “Communication was critical, and we connected weekly, if not more often. At one point, deciding the governance structure was hard. We made speed of decision making a gating factor.”

Per MAP for Nonprofits and Wilder Research, research into other nonprofit mergers echoes the importance of prior “strong board involvement.” For Goodstart to function well, it needed a board that could be an effective decision-making service. It was not enough that stakeholders were represented; the board needed a range of skills to guide Goodstart, both to do good and to do well. Along with expertise in education, it needed the experience of running distributed networks sustainably.

Assembled, the board was bicultural—comfortable in both the for-profit and nonprofit worlds. Traill himself had been a successful leader in both sectors. Robin Crawford, the chair, was a successful banker with years of consistent engagement with nonprofits. Tony Nicholson, head of the Brotherhood of St Laurence, and Toby Hall, head of Mission Australia, had each run a large business. Two of the member nonprofits did not put their own CEOs on the board, but an Early Learning and Care Reference Committee advised the board.

### *Lesson 3: To secure the deal, use the most robust M&A skills from business.*

If mergers and acquisitions are hard in business, they are harder in the third sector. Studies have shown that most business mergers and acquisitions actually destroy value.<sup>6</sup> To deliver value, they must drive costs down, squeeze more from customers, or push the share price up. It is even harder for nonprofits as over-heads are usually already lean, there are few chances to raise prices, and capital can dry up if donors do not transfer their loyalty from the old organization to the newly merged one.

The mergers and acquisitions skills that Traill learned during his years in private equity were tested. It was not clear how to structure this deal. Few like it had closed before. Crawford, a senior banker at Macquarie Bank and a long-time supporter of SVA, attracted the attention of Michael Ullmer, deputy chair of the National Australia Bank, and other heavy hitters. Traill and Crawford were also able to drum up such platinum-quality advisors as Gilbert + Tobin, Champ Private Equity, and Pacific Equity Partners, who put fees at risk and worked pro bono to complete the transaction. The firms agreed to a total fee cap of \$750,000 for work worth \$2 million.

Traill's view was that they "really needed contributions in terms of deeply discounted fees. We used the moral high ground to squeeze rates down, asking whether or not they wanted to be part of this once-in-a-lifetime opportunity to help the children of Australia." Merger expertise is critical, and U.S. research also shows that most successful combinations required consultants with specific merger skills.<sup>7</sup>

On December 9, 2009, Goodstart was announced as the preferred bidder, and in April 2011 it took over the last of the centers. Goodstart bought 660 centers for \$95 million in a carefully layered

deal. The members invested \$7.5 million, angels bought \$22.5 million of social capital notes, National Australia Bank bought \$50 million of senior debt, and the Australian government chipped in \$15 million of subordinated debt. (The social capital notes were a new unsecured debt instrument bought by forty-one social investors.)

### *Lesson 4: Manage toward hard goals.*

Completing the acquisition was a notable accomplishment but the bigger challenge was the road ahead. With fifteen thousand staff, Goodstart wanted both to improve outcomes for children and to stabilize the finances. These two goals do not always sit well together. While most sites in poorer areas are financially sustainable, some are not yet. Goodstart has explicitly cross-subsidized some less financially sustainable sites in areas with great opportunity for social returns.

It was hard to squeeze costs, as economies of scale are hard to extract, but Goodstart is making a good start on the road. In its first year, it managed to improve occupancy and trim costs enough to repay \$21 million of debt on time and deliver a net surplus of \$5.6 million. In 2012, Goodstart increased its surplus to \$8.3 million and strengthened its balance sheet with an accumulated surplus of \$21 million. It has now managed to repay \$66 million of the \$110 million borrowed at the time of acquisition.

Now that Goodstart is proving financially sustainable, it has been able to invest in early learning beyond simple child care. It has invested \$51 million in extra staff, including one hundred teachers, who can work in each center. It has invested \$10 million in professional development with its own training college. Leading its professional practice is a professor splitting her time fifty-fifty with Australian Catholic University.

Monika Henry, director of Goodstart

Early Learning Tamworth-Hercules Street, in New South Wales, said, "Watching a child learn something new is a special wonder of my job, and it is a great pleasure to be part of children's, families' and educators' learning journeys."<sup>8</sup>

### **The Hopeful Conclusion: For-Purpose Can Work Well at Scale**

Goodstart CEO Julia Davison commented, "I am proud of the positive impact our early-learning programs are having on the 73,000 children who attend our centers." In Goodstart's 2011 annual report, Crawford commented, "The next stage of our journey presents us with significant opportunities to lift the quality of our early learning, do more for disadvantaged children, and engage with the sector and other relevant stakeholders to deliver our vision for all Australia's children to have the best achievable start in life."

Being a social enterprise does lend credibility in the eyes of parents and of the government, two groups that must support early education if Goodstart is to have the impact it intends for disadvantaged children in Australia. As a nonprofit, Goodstart may have greater ability than a for-profit to deliver both fair financial returns and good social returns. With respect to education, many parents prefer nonprofits to for-profits, as evidenced by the suspicion cast on for-profit schools in the United States, the United Kingdom, and Australia.

This restructuring may strike some as odd or counterintuitive, so it offers food for thought for people in all three sectors. Are there enterprises that could function better as nonprofits, saving taxpayer dollars and providing better service? It may be that blanket assumptions about the relative competence of one sector over the others need to be dispensed with so that we can look with clear eyes at the comparative advantages

achieved by placing an endeavor in one sector versus another.

#### NOTES

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