FUNDING INNOVATION OF THE SOCIAL SERVICES THROUGH VENTURE CAPITAL

George Niculescu, Prof., Ph.D, "Constantin Brâncuşi" University of Târgu-Jiu,
AmaliaVenera Todoruţ, Assoc. Prof., Ph. D,"Constantin Brâncuşi" University of Tg-Jiu,
Dumitru-Cătălin Rogojanu, Postdoctoral Researcher, Faculty of Sciences and Letters, "Petru Maior" University of Târgu-Mureş

Abstract:This article proposes an innovative model of financing social services for mitigating the negative consequences of economic and financial crisis on social services The first part presents the terms of social innovation, innovation in social services and the major actors participating in the social services (social enterprise, social entrepreneurship) and the tools for dissemination and promotion.This article describes a new model for the social venture capital acquisition process, from the viewpoints of both the venture capitalist and the entrepreneur, which examines the process in a less-developed network. This model can be used to examine the regions that are suspected of having less-developed networks, to determine which of the model aspects are less and more developed in any given study region. The research has theoretical and practical implications. The model can be used as a benchmark to determine how many and which aspects of any venture capital network are well-developed and which are less-developed, so that improvement initiatives can be directed accordingly. Venture Capital for community development is a genuine way for change and social innovation. The venture capital model would accelerate the flow of resources to truly innovative solutions, in addition to involving funders and other resource providers in thinking about how to solve social problems locally. Social venture capital involves: applying venture capital models to social enterprise, innovations in business models and blended value returns. The social venture-capital-backed start-ups are the best engines of innovation.

Keywords:social services, social innovation, social entrepreneurship, social enterprise, social venture capital.

Introduction

Innovation is more than just the result of research and development.

Innovation is the successful exploitation of new ideas, transforming them into social and economic value. It is about developing and inventing new technologies, services, business and social models and operational methods. Sometimes it is a big leap forward, mostly about continuing renewal and amelioration. Accepting change and risks is essential.

The Europe 2020 Strategy aimed at a smart, sustainable and inclusive growth attributes a relevant role to the transformative services, and, more generally, to service innovations that are considered drivers of innovation.

The effects of the current financial crisis on social services are major.The areas need to promote entrepreneurial activity in order to stimulate regional economic and social development.

We try to create a framework for describing the social venture capital acquisition process, not just in well-developed but also in less-developed networks. The framework sought to examine the network environment in the context of system characteristics, government and people factors as well as processes, and was applied to the social venture capital acquisition process.

A social innovation is a new configuration of social practices in certain areas of action or social contexts prompted by certain actors or constellation of actors in an international, targeted manner with the goal of better satisfying or answering needs and problems than is possible on the basis of established practices' (Howaldt and Schwarz, 2010, p. 20).

Innovation in social service is a dynamically evolving phenomenon stimulated both by the growing pressures from social challenges and by cultural and institutional changes involving the welfare state, the social, security and care categories.

Social entrepreneurship creates innovative solutions to immediate social problems and mobilizes the ideas, capacities, resources, and social arrangements required for sustainable social transformations.

Social entrepreneurship focuses on solutions that are not only effective but also sustainable, and ideally, replicable in a variety of contexts around the world.

We propose a generic network platform, as an ennabling support for the initiation and development of social services. The social platform takes a wide vision to reflect the complexity of the different perspectives on social services and how they work together in today's social systems.

Also, in this article we propose a model for the social venture capital acquisition process, as well as for the venture capital network environment in which the process occurs.
Social network theory is used to illuminate aspects of the social venture capital acquisition process that are related to network ties and establishing relationships.

There are a variety of factors in the network environment, including the level of entrepreneurial activity, the composition of the local labour force, the availability of professional advice, and the level of R&D.

The relationships between social venture capitalists and social entrepreneurs and regional development provide an excellent basis for describing a regional network.
There is a shortage of managerial advice and expertise among social venture capitalists on start-up investment.

System characteristics include proximity and clustering, network ties, industry and developmental effects, community factors, financing gaps and information gaps. Clustering and its impacts on the formation of successful relationships between entrepreneurs and venture capitalists is a new area for research.

The social venture capital acquisition process is described in terms of viewpoint of the entrepreneur or of the venture capital.

From social innovation to innovation in social services

"[Social innovation is . . .] a novel solution to a social problem that is more effective, efficient, sustainable, or just than existing solutions and for which the value created accrues primarily to society as a whole rather than private individuals. A social innovation can be a product, production process, or technology (much like innovation in general), but it can also be a principle, an idea, a piece of legislation, a social movement, an intervention, or some combination of them" (Phills, Deiflmeier, & Miller, 2008).

Social innovation is described as new ideas (products, services and models) that simultaneously meet social needs and create new social relationship or collaboration' (Murray, Caulier-Grice, Mulgan, The Open Book of Social Innovation, 2010, p. 3).

Social innovation refers to a novel solution to a social problem that is more effective, efficient, sustainable, or just than existing solutions and for which the value created accrues primarily to society as a whole rather than private individuals. A social innovation can be a product, production process, or technology (much like innovation in general), but it can also be a principle, an idea, a piece of legislation, a social movement, an intervention, or some combination of them' (Phills, Deiglmeier and Miller, 2010, note2, p. 10). Social innovation also applies to public institutions because of the societal and political pressure to align their way of working and products to the requirements of citizens and companies.

„Social innovation is path-dependent and contextual. It refers to those changes in agendas, agency and institutions that lead to a better inclusion of excluded groups and individuals in various spheres of society at various spatial scales. Social innovation is very strongly a matter of process innovation – i.e. changes in the dynamics of social relations, including power relations' As social innovation is very much about social inclusion, it is also about countering or overcoming conservative forces that are eager to strengthen or preserve social exclusion situations. Social innovation therefore explicitly refers to an ethical position of justice.. The latter is of course subject to a variety of interpretations and will in practice often be the outcome of social construction" (Moulaert et al. 2005)

For other researchers, the definition of social innovation is linked rather to its source, the nature of its "milieu of origin", "social innovation emerges most frequently from citizen-led initiatives and, both upstream and downstream, from the results of research in social and human sciences, even arts and letters" (Dandurand, 2005, p. 382). Other research emphasises the role of social actors who are stimulated to "move to confront what they consider to be rising inequality in a market-dominated society" (Degavre, Nyssens, 2008, p. 82). Thus, social innovation is connected to social transformation, marked by its 'capacity to envision options other than reproduction, and to contribute to the transformation of organisations and institutions' (Bouchard, 2006, p. 1).

In the context of the Europe 2020 strategy, social innovation is defined as indicating 'new responses to pressing social demands, by means which affect the process of social interactions. "Social innovations are social both in their ends and in their means" (Bureau of European Policy Advisers (2010), socialinnovation as part of the Europe 2020 strategy).

With regard to service innovations and innovations in social services, various types of innovations exist and there is a different degree to which individuals or organizations enabling innovations are entangled in a given social construction or network that might be: relational, structural, cognitive, cultural, political, territorial, temporal, institutional, moral or normative, emotional embedding including also social class and gender inequalities structures. Furthermore, in the process of generating and spreading innovation the interaction dimension - within a complex system (society as a whole) and between different systems, contexts or implementing environments - is fundamental.

Innovation in social service is supposed to change a social practice in order to reach aims and objectives of innovation (the normative dimension of innovation) that, as pointed out, are contextual and 'local' negotiated.

Conceptual framework which explains the relationship between social innovation and innovation in social services is:

- situating innovation in social services within a social innovation framework. Innovation in social services can be defined as a type of social innovation process. Innovation of social services is delivering services in another way as an answer to current and future challenges in society. Values and the socio-cultural foundations of innovations in the social sphere should be considered.

- situating social services within a social innovation framework means to focus on ways, processes and mechanisms activated by social services that are able: (a) to cope with more pressing social needs, (b) to stimulate new solutions mobilizing people's creativity and connecting people, ideas and resources to a context of limited resources and rising costs; (c) to be able to see social challenges also as opportunities (EC, 2010; Murray, Caulier-Grice, Mulgan, 2010).

Innovation in social services can be referred both to the social services delivering (new services, new forms of organizations; resources hybridation; targeted action) and to the process of service delivering, including effectiveness of service delivery, quality of provision and potential impact, on the one hand on the provider organization and user, and on the other on institutional, political, organizational, cultural environments and the civil society.

Distinctive of social service innovation are the processual dimension - the process of innovating and the diffusion or adoption of the innovation and the role attributed to the technological dimension.

As far as the diffusion, dissemination and implementation of innovations a useful conceptual model pointing out the interactional dimension has been proposed by Greenhalgh et al. (2004) with reference to health service organizations. The author defines social service innovations (in the area of health care-related services) 'as a novel set of behaviors, routines and ways of working that are directed at improving health outcomes, administrative efficiency, cost effectiveness or user's experience and that are implemented by planned and coordinated action' (ibid., 2004, p. 1). According to the model, the innovation process is placed in the interaction between 'the resource system, knowledge purveyors and change agency on one hand, and the user system on the other hand. The user system is, during the design and implementation stages of the innovation, linked to the resource system and the change agency by e.g. shared meanings and mission, effective knowledge transfer, user involvement in specification, communication and information, user orientation, product augmentation and project management support' (Keller, Gare, Edenius, Lindblad, 2010, p. 1).

It might be useful to extend this model (developed from the point of view of the provider organization) including, at an organizational level, aspects related to the social service system (the welfare system model, the various types of service providers) and to include in the societal (macro) dimension both those institutional processes (legal acts, regulatory rules) designed to explicitly influence environment for innovation and the scope and effectiveness of existing frameworks and tools defining, measuring and assessing the quality of social services.

Social entrepreneurship as creating social enterprise

The words social entrepreneurship, although constituting the essence of the field (Mair and Marti, 2006), are often regarded as spanning a tension-field, as being mutual exclusive.

Two very different domains are combined through the dualistic aim of creating social value and at the same time achieving economic sustainability (Nicholls, 2006; Hockerts et al., 2010). Therefore social entrepreneurship research has to cater for a dual logic, social and entrepreneurial, and often fails in delivering methodological robustness by omitting one or the other (Edmondson and Mcmanus, 2007).

Social Entrepreneurship is an emerging research field which has been well received by authors from a variety of disciplines (Ireland and Webb, 2007; Short et al., 2009) such as:

- *sociology* (Hockerts*et al.*, 2010)
- *entrepreneurship* (Corner and Ho, 2010)
- *(public) management* (Meyskens*et al.*, 2010)
- *ethics* (Cornelius *et al.*, 2008)
- *finance* (Austin *et al.*, 2006)
- *politics and institutions* (Dey and Steyaert, 2010)
- *psychology and education* (Chand and Misra, 2009)

Social entrepreneurship has gained renewed currency in a world ever more divided between haves and the have-nots. They distinguish themselves from other social venture players by doing, not talking. They are relentlessly focused on impact.

Social entrepreneurship focuses on solutions that are not only effective but also sustainable, and ideally, replicable in a variety of contexts around the world.

Several scholars such as Nicholls (2010) or Hervieux (2010), following Kuhn (Kuhn, 1996) calls social entrepreneurship a field in a pre-paradigmatic state, a field that thus lacks an established epistemology. Through the lenses of the structuration theory, Nicholls for example, identifies how institutions try to gain control over the field through their narrative-logic in an reflexive isomorphism.

Hervieux examines the legitimization of social entrepreneurship through a discourse analysis. Short, Moss and Lumpkin (2009) further examine the field of SE research in a functionalist fashion and consequently find a lack of formal hypotheses and rigorous methods. However this would imply that a) social entrepreneurship is grounded within the domain of entrepreneurship and b) that its definitions and boundaries are already carved out in a way to allow for quantitative theory testing. However, even in current years, most social entrepreneurship scholars begin with what seems a quest for definition and a careful exploration of the field, for example in Zahra et al. (2009).

The transformation of social entrepreneurs into more managerial oriented social enterprises and sub sequential scaling, for example through franchising (Tracey and Jarvis, 2007), is still an almost un-researched and promising field.

Social entrepreneurs share characteristics and techniques with traditional business entrepreneurs, such as utilizing time-tested business theories and practices, and their focus on innovation. However their work and impact spans across the private, non-profit and governmental sectors.

Social entrepreneurs are individuals with innovative solutions to society’s most pressing social problems. They are ambitious and persistent, tackling major social issues and offering new ideas for wide-scale change.

Rather than leaving societal needs to the government or business sectors, social entrepreneurs find what is not working and solve the problem by changing the system, spreading the solution, and persuading entire societies to move in different directions.

Social entrepreneurs often seem to be possessed by their ideas, committing their lives to changing the direction of their field. They are visionaries, but also realists, and are ultimately concerned with the practical implementation of their vision above all else.

Social entrepreneurs present user-friendly, understandable, and ethical ideas that engage widespread support in order to maximize the number of citizens that will stand up, seize their idea, and implement it. Leading social entrepreneurs are mass recruiters of local changemakers— role models proving that citizens who channel their ideas into action can do almost anything.

Social entrepreneurs act as the change agents for society, seizing opportunities others miss to improve systems, invent new approaches, and create solutions to change society for the better. While a business entrepreneur might create entirely new industries, a social entrepreneur develops innovative solutions to social problems and then implements them on a large scale.

Social entrepreneurs are society's change agents, creators of innovations that disrupt the status quo and transform our world. By identifying the people and programs already bringing positive change, we empower them to extend their reach, deepen their impact and fundamentally improve society.

Social entrepreneurs drive social innovation and transformation in various fields including education, health, environment and enterprise development. They pursue poverty alleviation goals with entrepreneurial zeal, business methods and the courage to innovate and overcome traditional practices. A social entrepreneur, similar to a business entrepreneur, builds strong and sustainable organizations, which are either set up as not-for-profits or companies.

A social entrepreneur is a leader or pragmatic visionary who(Sharma, D, Sharma, V and Regar, 2014)*:*

- Achieves large scale, systemic and sustainable social change through a new invention, a different approach, a more rigorous application of known technologies or strategies, or a combination of these.
- Focuses first and foremost on the social and/or ecological value creation and tries to optimize the financial value creation.
- Innovates by finding a new product, a new service, or a new approach to a social problem.
- Continuously refines and adapts approach in response to feedback.

Social platform on Innovative Social Services,tool for development and promotion of innovative social services

The conception of a generic network platform, as an ennabling support for the initiation and development of social services. This platform is meant to catalyse the shaping of an effective private public collaboration, bringing under the same vision for development the key stakeholers in order to define the medium and long term knowledge priorities and to develop the social services. The design of the plaform means conceiving (1) the whole conceptual architecture of the system and (2) the corresponding set of instrumente, the enabling toolkit as a supporting system for a collaborative network learning. The resulting infrastructure will may function especially using the new information and communication technologies of the collaborative network working over the internet.

The Social platform is focusing on identifying the future potential of innovative services including the multifaceted activities of different stakeholders as well as the policy frameworks at different levels of governance geared to address the needs of citizens.

The social platform takes a wide vision to reflect the complexity of the different perspectives on social services and how they work together in today's social systems. It look at services as a process of socialisation by which responsibility is accepted by societal institutions to support individuals in their daily life and seeing individuals not as isolated beings but as part and parcel of social entities of different kinds.

Overall, the platform isorganised around four aspects (Eurich, J, InnoServ):

• Investigating, identifying, evaluating and reflecting upon innovative practice in the provision of social services across Europe,

• Identifying and systematising the theoretical discussion on innovation in service planning and delivery,

• Linking up the empirical evidence and theoretical discourse to identify gaps, inconsistencies and demand for further research,

• Assessing the issues identified and proposing research agendas for various aspects of service planning, provision and evaluation.

The model for the social venture capital acquisition process

It is a model for the social venture capital acquisition process, as well as for the venture capital network environment in which the process occurs. As a result, the level of development in any venture capital network can be described using this model, with specific identification of those process or contextual factors that are less developed (Melanie MacLean, 2005). This study will model and interpret the process and its contextual network environment from the viewpoints of both the entrepreneur and the venture capitalist. The venture capital acquisition process has been repeatedly described from either the viewpoint of the entrepreneur (Mantell, 2003) or of the venture capitalist (Fried and Hisrich, 1994, Tyebjee, 1984). The process has also been explored using agency analysis, to examine the communication process as it relates to contract optimality between the entrepreneur (agent) and the venture capitalist (principal) (Reid, 1999).

The social venture capital investment is defined as investment by parties (social venture capitalists), on behalf of downstream investors, in entrepreneurial ventures, whether in a new or existing business, in exchange for equity as opposed to debt. So, venture capital and debt provided by banks is found not to be complements but rather substitutes.

The venture capital acquisition process (Kaulio, 2003; Mantel, 2003; Carter and Van Auken, 2001; Ruhnka and Young, 1987) takes place within and is affected by the regional network in which the process occurs. People factors include entrepreneurial activity, the labour force, professional advice, and research and development (R&D). The effects of scarcity of managerial advice and expertise among venture capitalists on start-up investment, where entrepreneurs are comparatively plentiful, are examined (Kanniainen and Keuschnigg, 2001). System characteristics include proximity and clustering, network ties, industry and developmental effects, community factors, financing gaps and information gaps. Clustering and its impacts on the formation of successful relationships between entrepreneurs and venture capitalists is a recently developing area for research . Social network theory is used to illuminate aspects of the venture capital acquisition process that are related to network ties and establishing relationships (Burt, 2000; Granovetter, 1982; Hansen, 1999; Shane and Cable, 2002).

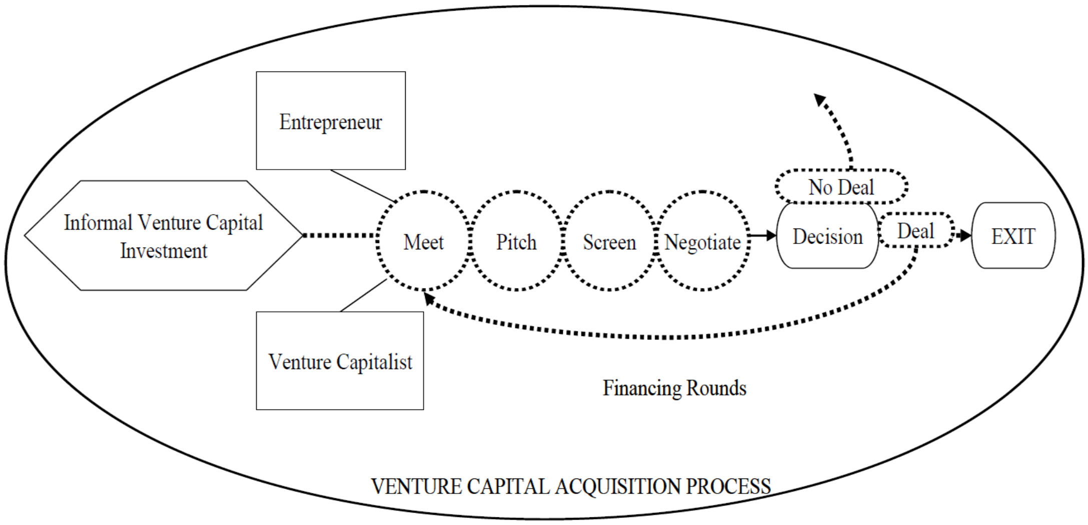
There is a lack of information discussing how less development in the venture capital network affects the venture capital acquisition process for both entrepreneurs and venture capitalists.

The venture capital acquisition process begins with the meeting of an entrepreneur and a venture capitalist (a financial intermediary, engaged in managing funds in high-risk investments for investors), followed by a pitch by the entrepreneur (the presentation or proposal that the entrepreneur makes to the venture capitalist; pitch is typically short, perhaps thirty minutes at most, and must be of sufficient quality and impact to generate interest in the venture capitalist or the process may terminate), a screen by the venture capitalist (may occur in seconds or over a period of time, depending on how the pitch is received), negotiations, and a decision (phase described in this model refers to the ultimate decision of whether or not a financing agreement will occur.) resulting in a disagreement (no deal) where both parties return to the environment, or a deal, followed ultimately by subsequent financing rounds or exit (cessation of the financing relationship due to buyout or failure). The way that this process occurs is very dependent on its context.

The venture capital acquisition process is well documented, but generally only from the viewpoint of either the entrepreneur or the venture capitalist. Mantell (2003) uses the entrepreneur's viewpoint to describe the entrepreneurial solicitation process as a series of solicitation events each consisting of the search for a promising venture capitalist, a proposal, and the elicitation of a commitment or a rejection. Tyebjee's (1984) description is strictly from the venture capitalist's point of view in terms of a five-step process: 1) deal origination, where prospective deals are introduced, 2) deal screening, where prospects are qualified and a few are selected for further pursuit, 3) deal evaluation, where a risk and return analysis determines whether or not the prospect is attractive to the venture capitalist, 4) deal structuring, where terms including ownership, capital levels and timing are negotiated, and 5) post-investment activities, such as management, governance, stewardship, or preparation for an initial public offering (I.P.O.). Fried and Hisrich (1994) describe the process in six stages: origination, firm-specific screen, generic screen, first-phase evaluation, second-phase evaluation, and closing, basically expanding Tyebjee's (1984) second screening step into two distinct phases. Like Tyebjee's (1984) model, Fried and Hisrich (1994) only describe the viewpoint of the venture capitalist. The discussion that follows examines the process from both viewpoints, where 1) the parties have a meeting, 2) a pitch is presented and 3) screened, followed by 4) negotiation, and there is a 5) decision that results in a deal or not. Wasserman (1999) likens the process to classical negotiations, where the sides have both common and conflicting interests. All these factors compose the model of capital venture acquisition process (figure 1).

Figure 1: Model of Venture Capital Acquisition Process

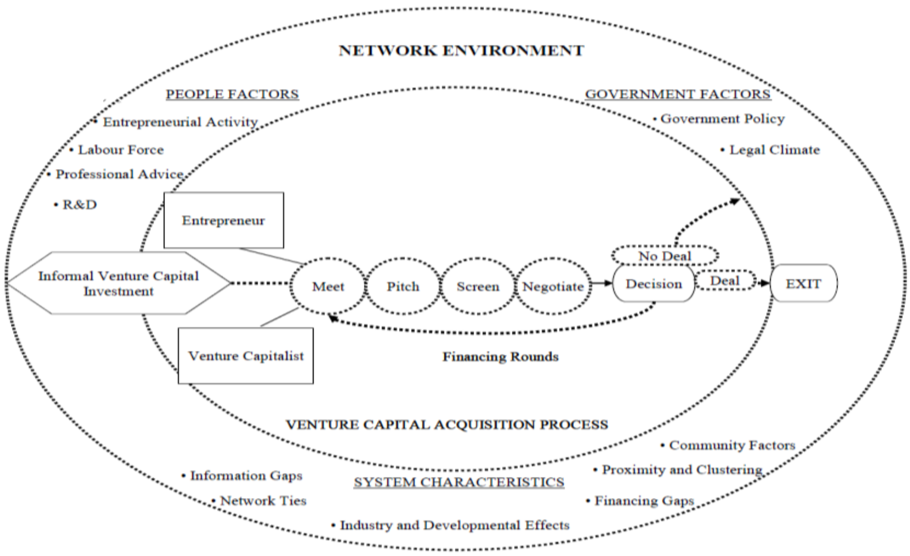
(Melanie MacLean, 2005), Venture Capital process in new Brunswick, The University of new Brunswick**,** p.10**).**



There are a variety of factors in the network environment. The venture capital acquisition process occurs within a network, where contextual factors are strongly influential (Figure 2). This network environment is made up of people factors, government factors and system characteristics. People factors include entrepreneurial activity, labour force, professional advice and R&D. Government factors include government policy and legal climate. System characteristics include proximity and clustering, network ties, industry and developmental effects, community factors, financing gaps, and information gaps. In this model, all of these factors can significantly impact the process.

Figure 2: Process Overview

(Melanie MacLean, 2005) Venture Capital process in new Brunswick, The University of new Brunswick**,** p 21).



A graphical representation of the key variables relevant to the venture capital acquisition process is used to describe and summarize the typical well-developed network in comparison to the proposed less-developed network (Table 2). This proposed model can be used to evaluate the venture capital acquisition process in any venture capital network to determine if it is less or well-developed.

Table 2: Well-developed network model versus less-developed network model

			W.D.N.	L.D.N.
Processes		Informal V.C.	Ample angel organizations	Few if any angel organizations
		Meet	Ample opportunities for meetings	Insufficient opportunities for meetings
		Pitch	More pitches, more refined pitches	Fewer pitches, less-refined pitches
		Screen	Formal screening process; investment in high-growth, later stage ventures	Few/no investment preferences; investments in multiple industries/stages
		Negotiation	Established methods for valuations; extensive due diligence (average four month duration)	Valuations also based on qualitative factors; less or more extensive due diligence; barriers in deal structure
		Decision	No seed investment; objective, quantitative decision criteria; 1-2% deals	Seed investment; subjective, qualitative decision criteria; more or less % deals
		Exit	Exit in 5-7 yrs (I.P.O. or acquisition)	Difficulty in exiting
NETWORK ENVIRONMENT	People Factors	Entrepreneurial Activity	Higher self-employment rates; more patents; higher employment; stronger economic growth and employment characteristics	Lower self-employment rates; less patents; lower employment, weaker economic growth and employment characteristics
		Labour Force	Abundance of skilled labour	Inadequate supply of skilled labour
		Professional Advice	Specialized legal and accounting resources; other specialized resources	Shortage or lack of (experienced) resources
		R&D	Presence of a noted research facility	Absence of or distance from noted research facility
	Gov't Factors	Government Policy	Policies contribute to /support process	Policies complicate/ hinder process
		Legal Climate	Neutral or conducive to process development	Inhibitive to or in conflict with process development
	System Characteristics	Proximity and Clustering	Many complex, well-developed clusters, high network proximity	No/few/ less-developed clusters; low network proximity
		Network Ties	Dense local networks; abundance of interaction	Less network members, less organizations, less relationships
		Industry/Dev Effects	More high technology firms	Fewer high technology firms
		Community Factors	Strong infrastructure; demonstrably high quality of life	Lacking infrastructure; fewer or less demonstrable quality of life factors
		Financing Gaps	Two distinct gaps	Less distinct gaps
		Info Gaps	Excellent information exchange	Lack of knowledge/advice

Source: Melanie MacLean, (2005) Venture Capital process in new Brunswick, The University of new Brunswick, pp 40-41.

The processes of social venture capital acquisition and informal venture capital investment in well-developed venture capital networks have been described extensively and this existing body of research is used as a counterpoint for creating a model for a less-developed venture capital network, about which there is little existing literature (Bliss, 1999; Silva, 2004).

Conclusions

Venture capitalists (VCs)combine the investments into a sort of mutual fund of start-ups. As the start-up passes through various well-defined stages of development, other investors are brought in to fund the company, thereby lessening the risk, and also the potential reward, as the fund matures. It turns out that most investors won't fund an operation before it has a measurable cash flow, so it takes a special investor to put money into a company at its earliest stages of existence.

Venture capitalists talk about funding rounds in alphabetical order. Series A investments are backing something that's little more than a technology and a team. The business will need to acquire other skills, such as sales, marketing, customer service, and operations management, to be successful. Series B investments are the order of the day when a company has a working prototype product and initial orders, as well as a more complete management team with diverse business skills.

Series C investments are made when a company has more than one customer, working products, marketing and sales channels in place, and a growing pipeline of sales prospects. Pricing and gross profit margins on those sales are no longer mysteries, and working capital is needed mainly for components and support.

Series A funding is usually in relatively small amounts-there are often fewer than 10 people employed by the company, and the biggest expense is their salaries. Series B is typically much larger; not only is more money needed, but it's easier to get, because risk has decreased. By the time of series C, the dollar figures have increased again, to meet the heavy expenses of raw materials, components, and inventory; moreover, risk has decreased even further. The number of potential investors increases with each funding round, and each new investor at each round tends to commit more than the earlier-round investors did. These stages aren't haphazard. A start-up usually plans the different funding rounds right from the get-go-it hopes to increase its valuation between funding rounds and therefore to give up less of its equity per dollar of capital invested.

Most Venture capital businesses are limited partnerships, in which well-heeled investors-large pension funds, university endowments, and wealthy individuals-agree to invest as limited partners. The funds are organized by experienced fund managers, also known as general partners.

These managers decide how the funds are invested.Fund managers get where they are by demonstrating an ability to generate high returns, based on their track records in previous funds. Typical funds are organized for a finite life, often six or seven years, after which the fund is required to wind down operations-and distribute any proceeds to the limited partners.

Limited partners are looking for a higher rate of return than they could get in the stock market but with not much more uncertainty. And general partners are playing with other people's money.

General partners are compensated in two ways. First, they receive management fees for running the fund, typically 2 percent of funds managed.

Second, the general partners receive a share of any profits after the limited partners are paid back their initial investments and their share of the profits. These VCs add substantial prestige to start-ups, so they tend to see the hottest action. A-list VC firms get to charge more 3 percent management fees instead of 2 percent, and a 30 percent carry instead of 20 percent.

But Not Every Fund makes $5 for every $1 invested. A fivefold payback is, in fact, remarkable, even in the extraordinary world of VC. According to Venture Economics magazine, the typical 20-year average industry return is around 16 percent annualized-still not bad nowadays, when the average return from stocks and bonds is in the single digits.

Now consider that this 16 percent return comes from a blended average of successes and failures. A general partnership might invest in 10 to 20 companies. The VCs, of course, are betting that the successes will more than pay for the failures; in fact, their idea of a successful company is one that generates a 10-fold return on investment within five years. That's equivalent to a 58 percent return per year.

If a successful investment gives a 58 percent annual return, it could have three failures as well and still do better than the VC industry average. It can reduce your risk further by investing a limited amount of money, often as little as $5 million or $10 million, in the earliest, high-risk, high-reward funding rounds and putting in bigger bucks in later rounds when a company is beginning to look like it will succeed.

All this structure seems designed to maximize investment in true innovation.

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The research presented in this paper was supported by the European Social Fund under the responsibility of the Managing Authority for the Sectoral Operational Programme for Human Resources Development , as part of the grant POSDRU/159/1.5/S/133652.