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TEACHING NOTE FOR FELIPE VERGARA AND LUMNI: LAUNCHING AN INNOVATION IN A DEVELOPING ECONOMY

Summary of the case

The story of Felipe Vergara and Lumni has several fascinating elements that can be used in a variety of ways in a variety of courses including those in entrepreneurship, social entrepreneurship, innovation, financial innovation and growth. In sum, Lumni has managed to launch the first human capital fund (modeled on venture capital funds) to finance six undergraduate students in top Chilean universities. I find this case works particularly well a little later in the entrepreneurship course because it not only gets students to grapple with the practical aspects of entrepreneurship as a force for social change, but also brings to fore key issues in moving from the early entrepreneurial stage to a more growth oriented and established firm. In particular, the decision facing Vergara is one of how fast to grow and how exactly to grow a complex, controversial, international, innovative idea that straddles for-profit and not-for-profit sectors with the potential to re-shape the landscape of business as usual in both.

I recommend using this case in conjunction with the technical note UVA-ENT-xxxx: Ought to Can: Open Questions for an Entrepreneurial Economy.

List of discussion questions and teaching points

- Who is Vergara? Does he have what it takes to make Lumni a large success? What does it take to recover from a failed internet startup and launch a venture such as Lumni while paying one's bills through another ongoing venture?
- What is Lumni? Is it a social venture? If so, how is that different from "ordinary" ventures? Do those differences matter? How? Why?
- What are human capital contracts?
- What are the lessons Vergara learned through his other ventures? How are these related to causal and effectual logic?

This case was prepared by Saras Sarasvathy, Associate Professor of Business Administration, and Elliott Weiss, Isadore Horween Research Professor of Business Administration, with assistance from M. Ishrat N. Ali (MBA 06). It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

- Who are the major stakeholders in Lumni? What is the value proposition for each? How can each of these be improved? How should each be communicated?
- What are the growth opportunities for Lumni? What are the major bottlenecks for achieving this growth potential? And how can Vergara overcome them?
- As a potential investor in Lumni, what would you care about and what would concern you the most? And what would clinch the deal?

The ensuing teaching plan is for a standard one-day class session of approximately 90 minutes. Alternately, the case itself can be used for a 90-minute discussion followed by a separate 90-minute session on the technical note that lays out other examples of entrepreneurship as a force for social change as well as recent developments in non-standard credit markets. In preparation for the second session, students can also be assigned an independent research task to come up with specific examples that can then be used for a broad discussion of social ventures and innovative funding in the social sector and in developing economies.

Five Pastures of Discussion

There are broadly five fertile pastures of discussion that interlock in this case. One can therefore begin the class discussion with any one of the five and move through them in different orders depending on which course the case is used in, at which point in time and with which group of students. For example, early in a course on social entrepreneurship, I would begin with the for-profit/not-for-profit issue and then move to Lumni, the entrepreneur and the decision (intertwined with scaling up issues). In a course or module about innovative financial instruments, I would begin with Human Capital Contracts, the ins and outs of designing a venture around it, the issue of for- and non- profit combined with growing pains in each, and end with the role of the entrepreneur and his or her mindset in the fortitude it takes to launch and grow such innovations. Here I simply present the five pastures in the order I would use them in a standard entrepreneurship course – later, rather than earlier in the syllabus – maybe even as the last or second-to-last class session – as a way of getting students to see the “big picture” potential of *all* entrepreneurship to enable and even drive positive social change.

1. **The entrepreneur and his or her mindset (10-15 minutes)**

In light of what we have covered in class so far, and the various attributes and learned experiences of entrepreneurs, let us examine whether Felipe Vergara has what it takes to make Lumni a success:

Passion
Resilience
Embracing, even celebrating “failure”
Others???

What has Vergara learned through his previous entrepreneurial experiences – and how is he implementing these lessons in Lumni? How do these connect with the elements of effectual logic (i.e. how do these connect with how expert entrepreneurs act?)

Effectual logic:
- Working with what you have readily available
- Investing only what you can afford to lose
- Getting the "buy-in" of stakeholders and working with them
- Leveraging surprises
- Proactively driving the prospects of the venture

2. Human capital contracts (15-20 minutes)

What are human capital contracts?
Lending against debt versus lending against equity – pros and cons
What does it mean to take equity in students' future earnings?
What are the main concerns/objections that come to mind? How can Vergara and Lumni address these?

Here a board plan listing different stakeholders and their points-of-view may be useful – both to point out overlapping interests and to highlight potential conflicts and contentions. The first three major stakeholders, of course, are the students/customers of the venture, the founders of the venture, and the investors in the venture. But other groups such as NGOs and non-profits in the education sector, the universities at which the students study, the governments (local and national) of the countries the funds engage in, even churches/religious and legal/humanitarian organizations may have strong opinions. The role of the press is important to bear in mind too.

This is also a good time to get students talking about any personal examples of non-standard funding ideas and/or entrepreneurial ventures they may have encountered in their home countries and/or through readings and recent press accounts.

If time permits, it is good to round out this discussion with thoughtful speculations about what other domains one could use human capital contracts in – and what a world in which this was common practice would look like.

3. Scaling up issues (15-20 minutes)

I usually begin this discussion by getting students to list standard problems of growth – this is an opportunity to integrate learning from other courses such as strategy, marketing, management, accounting and finance. Economies of scale and scope combined with SWOT (Strengths, weaknesses, opportunities and threats) analyses can also be brought in. Problems peculiar to entrepreneurial growth include cash flow issues, giving up equity in return for investment, preserving culture as the team grows too fast, difficulties of “targeting” particular market segments and not watering down the “brand” – all these are grist to the mill for this discussion.

After listing these issues from a variety of functional areas, we can then set out to apply them explicitly to the peculiarities of Lumni and its current stage of development.

At this stage of the discussion, it might be valuable to call on students who have been part of startups in a growth phase and/or students with private equity experience, who know of ventures re-structured by venture capitalists and others (including rearranging or firing the founding team) in efforts to grow the venture to the point of profitable exit for the investors.

4. For-profit and not-for-profit – Design issues in a social venture (15-20 minutes)

Lumni is a for-profit firm. Yet it takes investments (donation?) from both private and not-for-profit groups. Should Lumni be a non-profit venture? Why? Or why not?

There is a large literature on the subject of why we need not-for-profit organizations. The three main reasons include: market failure, contract failure and government failure.

Market failure occurs when a free market enterprise fails to provide an essential good or service. Usually these types of goods are called “public” or “non-rivaled” and “non-excludable” goods – namely, goods that do not get exhausted by those who pay to consume it and therefore cannot be provided exclusively to those who pay for it. In other words, when a public good is made available, both people who pay for it and those who don’t can avail of its benefits. NPR (National Public Radio) is a well-known example – of course, pure market failure, or for that matter pure failures of all three kinds are difficult to *prove* in the real world. That is one of the reasons for the rise of the notion of *for-profit* social ventures. Yet the idea behind market failure is an intuitive one and has been used to explain the need for and existence of non-profit organizations.

Contract Failure. This is an argument put forth by Henry Hansmann in the book *The Ownership of Enterprise.* People turn to nonprofit organizations when they find it difficult to measure the quantity or quality of contracted goods or services and to enforce future contracts. It is believed that non-profit organizations, because of the nondistribution constraint (namely that profits cannot be distributed to any one group of “owners”), will not or have no need to sacrifice quality for avarice or undue gain. The implication, of course, is that for-profit firms have both incentive and opportunity to exploit the ignorance and weaknesses of their stakeholders in favor of lining the pockets of stockholders.

Government Failure is an interesting one. It is expected that sometimes, neither the government nor free markets can provide certain essential goods and services, not because of doubts about the enforceability of contracts, but the sheer complications of customization and expertise required to provide the particular services. Development of new technologies related to climate change, for example, may require massive investments of the kind government can provide more easily than the private sector, yet the government cannot possibly know which particular technologies to invest in at which stage of development. A public-private partnership may be called for. But non-profits might very well fill in gaps in terms of certification and the developments of standards and other functions.

A robust discussion of organizational form that goes beyond legal issues related to incorporation is useful, not as an exercise in political or social philosophy, but in terms of teaching students that entrepreneurs "design" ventures and sometimes even invent new organizational forms. It is important to emphasize that entrepreneurs are not merely rule-followers, but that they can be rule-changers in a very real and practical sense.

In my class discussions on this subject, I usually push the students to think about using a for-profit format for every kind of venture they can think of, for there is one thing that for-profit ventures do very well that is valuable not only to the entrepreneurs who found them but for the societies in which these ventures come to be. And that is what I call "the closing of the revenue circle." In designing a for-profit business model, entrepreneurs have to ingeniously and creatively come up with ways to raise funding through the very activities that solve the social problem they care about. In other words, if the entrepreneur does his or her job well, the venture need not continually deplete its energies in separate fund-raising activities – the things that the venture does as part of its mission will in themselves raise the funds required for the next round of activities. In the case of Lumni, for example, not only can the investors make a profit and the students get to go to schools of their choice and ability, but the students themselves could become investors down the road – thereby closing the revenue circle – and freeing Lumni from having to go fund raising all the time.

As part of this discussion, I have found it useful to call on students working on social ventures to talk about their venture ideas and help walk the class through why they chose not-for-profit organizational forms. In a social entrepreneurship class, the discussion may be reversed to examine whether particular student ventures could be reconstituted as for-profit firms instead. If not, why not?

5. The decision facing Lumni (15-20 minutes)

Three choices:

Organic Growth	Other types of (moderate) growth	Massive growth
From 6 to 12	Franchises? (6 to 100?)	How to grow to
to 50-80 students	Large NGO underwriting (500?)	10,000 or more?

What are the pros and cons of each?

What would it take to do each?
What would be the major bottlenecks? And how to overcome these?

What are good ways and bad ways to arrive at the decision? Take a poll and get students to explain how exactly they arrived at their decision.

Felipe Vergara and Lumni: What happened after….
Vergara decided to grow the venture organically.

Here are the responses from Vergara on my follow-up interview with him in May 2009.
In light of "release" issues, Amy, could you please rewrite this info in third person – or any other way that would work for the teaching note?

1. What happened since October 2002?

- we had a tough start years, developing our tools, launching the first funds, and proving that the first students could graduate and pay.
- By 2005 we started working in Colombia.
- In 2007 we got the opportunity to start working on the US and in Mexico. In the case of Mexico this was done through a partnership with a Mexican Foundation and a group of prominent Mexican business people committed to advancing education in their country. In the US I worked with someone I knew for a long time and she later became our country manager.
- Overall, we have been working to lay the foundation and now we are in a year where we are preparing to grow significantly. We expect the following years to be of high growth and consolidation.

2. How many countries are you currently operating in?

4 countries: US, Mexico, Colombia and Chile

3. How many students have you funded so far? 156

4. How many of those have graduated -- and are they paying as promised?

70 69 are paying, just 1 is not.

5. How much money have you raised in total? From how many investors?

We have raised $2 million for working capital of the four fund management companies and the holding (lumni, Inc), and to build our infrastructure (IT, key processes,...). These $2 million include a $587,000 grant from the Inter American Development Bank).

In terms of the funds, we have raised $2.7 for the funds and have additional commitments of $3 million.

6. How is the current financial crisis affecting Lumni?

We see it as an opportunity as many traditional sources of student funding have dried out and now organizations and universities are more open to working with Lumni to finance their students.

7. What is your reaction to the bankruptcy of MyRichUncle?

For the last few years MRU wasn´t in Lumni´s specific industry. By 2003 or 2004 MRU decided to enter the private loan business in the US and stop doing HCCs (I think those required much more patience, and the private student loan industry was booming with many opportunities). Their bankruptcy is part of a larger wave of bankruptcies of private loan companies in the US, as funding has become more limited for them.

7. What are you key challenges and opportunities as you move forward?

Our opportunity is to leverage the current financial crisis and what Lumni has learned in the past years, to grow our system in the countries where we work. We have lined up resources to finance close to 1,000 students in 2009. We want to finish the year having financed more than 1,000.

The challenges are to execute well, to manage growth, to maintain the same positive benchmarks (minimal attrition, minimal default, returns above expectation) as we grow 5, 10, 20, 50 times our current size.