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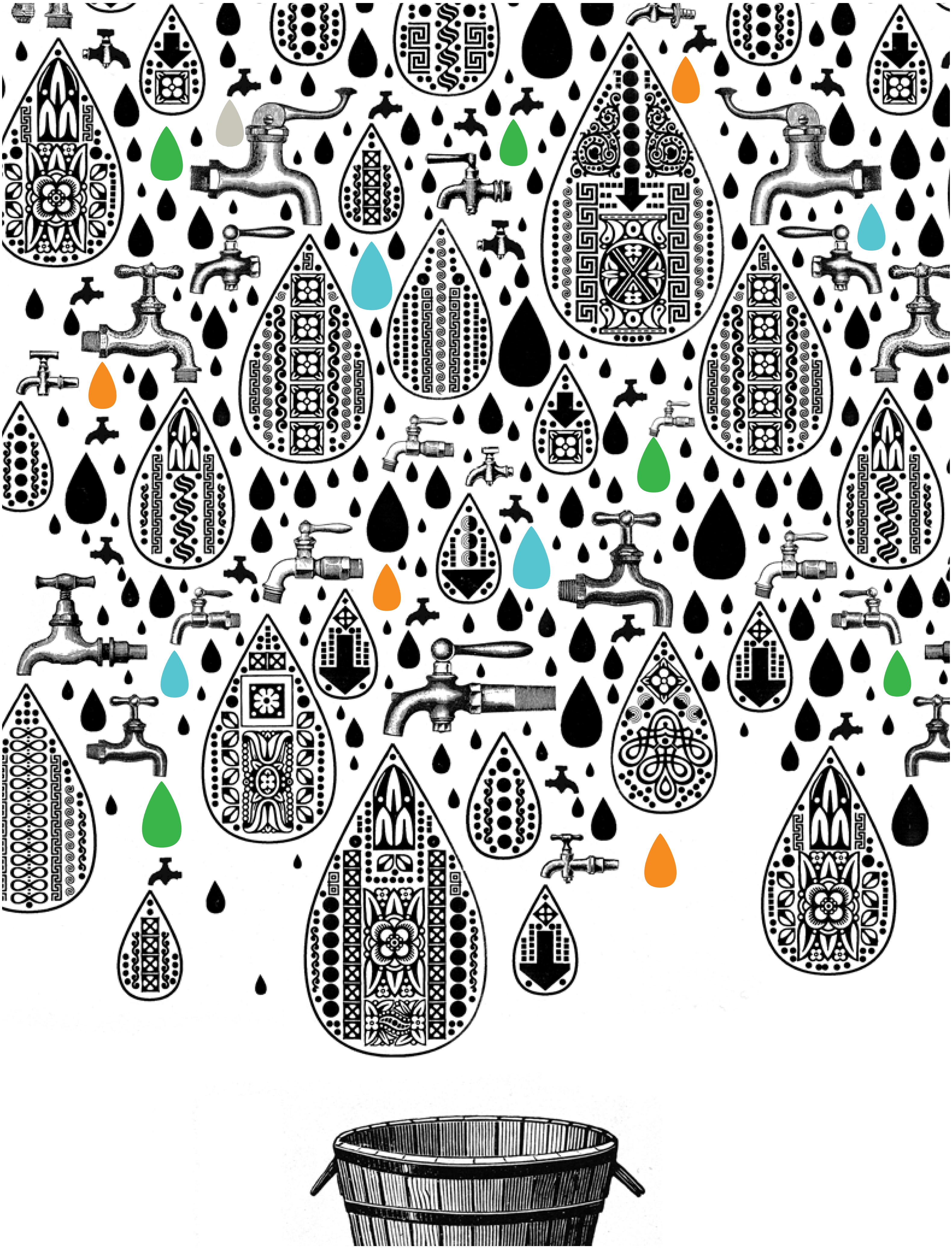
by Antony Bugg-Levine, Bruce Kogut, and Nalin Kulatilaka



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THE FINANCIAL CRISIS OF 2008 deeply damaged the credibility of financial innovation in the general public's mind. As the collapse of markets dried up credit across the system, the notion that securities such as collateralized debt obligations and credit default swaps are enablers of growth suddenly seemed implausible, if not deluded. Indeed, those instruments are often described today as weapons of mass destruction.

It's easy to forget that the same instruments have had a positive and transformative effect on society. Even as the dust from the real estate implosion lingers, we can see that homeownership would be impossible for millions of people if banks could not pool mortgages and sell collateralized bonds against those pools. It isn't only the middle classes in developed nations that have benefited from debt pooling. Microfinance is now a $65 billion market, serving more than

90 million borrowers in some of the world's poorest countries. Its growth was accelerated by the ability of investment banks to pool the microloans of many lenders and issue collateralized debt obligations against them in the international financial markets, freeing up the capital of those lenders and allowing them to make additional microloans.

Financial engineering, then, can be a powerful force for change. It can permit the mobilization of more capital for investment than would otherwise be available. It can generate rich opportunities to fund projects that fuel economic growth and improve people's lives.

In the following pages we'll explain how financial engineering can make it possible to channel investment from the financial markets to organizations devoted to social ends—organizations known as social enterprises, which have traditionally looked to charity for much of their funding. With the right financial innovations, these enterprises can access a much deeper pool of capital than was previously available to them, allowing them to greatly extend their social reach.

A growing number of social entrepreneurs and investors realize that social enterprises of all sorts can generate financial returns that will make them attractive to the right investors.

The Businesses of Blended Returns

Social enterprises are entrepreneurial organizations that innovate to solve problems. They include nonprofit and for-profit ventures, and their returns blend social benefit and financial revenues. They come in many flavors, but they all face the same fundamental question: Can they generate enough revenue and attract enough investment to cover their costs and grow their activities?

Some social enterprises can earn a profit that is sufficient to get the business funded by investors. They might provide goods and services to customers willing to pay a premium for a socially beneficial product—green energy, say, or organic food. They might sell an essential service to poor customers at a decent profit while still providing that service more affordably than other suppliers do. But many, if not most, social enterprises cannot fund themselves entirely through sales or investment. They are not profitable enough to access traditional financial markets, resulting in a *financial-social return gap.* The social value of providing poor people with affordable health care, basic foodstuffs, or safe cleaning products is enormous, but the cost of private funding often outweighs the monetary return. Many social enterprises survive only through the largesse of government subsidies, charitable foundations, and a handful of high-net-worth individuals who will make donations or accept lower financial returns on their investments in social projects. The ability of those enterprises to provide their products and services rises or falls with the availability of capital from these sources, and their fundraising efforts consume time and energy that could be spent on their social missions.

The lack of funding opportunities is one of the major disadvantages social enterprises face. A conventional business can use its balance sheet and business plan to offer different combinations of risk and return to many different types of investors: equity investors, banks, bond funds, venture capitalists, and so on. Not so for many social enterprises—but that is changing. An increasing number of social entrepreneurs and investors are coming to realize that social enterprises of all sorts can also generate financial returns that will make them attractive to the right investors. This realization will dramatically increase the amount of capital available to these organizations.

Essentially, the insight is that you can treat the funding of a social enterprise as a problem of financial structuring: The enterprise can offer different risks and returns to different kinds of investors instead of delivering a blended return that holds for all investors but is acceptable to very few. This new approach to structuring can close the financial-social return gap.

Social Enterprise's New Balance Sheet

To see how the process works, imagine that a social enterprise operating in Africa requires an investment of $100,000 to build new health clinics and expects the clinics to earn $5,000 a year—a return of 5% on the investment.

Unfortunately, 5% is too low to attract private sources of capital. Traditionally the enterprise would obtain the $100,000 from a charitable foundation instead. But suppose the enterprise asked the donor for only $50,000. It could then offer a financial investor a 10% return on the remaining $50,000. The donor would receive no repayment—but it would have $50,000 to give to another socially worthy enterprise.

You can think of a charitable donation as an investment, just as debt and equity are investments. The difference is that the return on the donation is

Idea in Brief

The economic crisis of 2008 deeply damaged the credibility of financial innovation in the general public's mind.

But financial engineering can bring important resources to social enterprises—organizations that deliver both social and financial returns. Tools that unbundle the two kinds of returns can help these organizations access the financial markets to the fullest.

Forward-thinking social investors like the Bill & Melinda Gates Foundation, Bridges Ventures, and BlueOrchard are already finding new ways to leverage their funding for maximum social benefit.

Stakeholders in the social sector must build the market infrastructure and legal frameworks needed to harness the power of these innovative approaches. This is a crucial step toward creating a greener, healthier, and more equitable world.

not financial. The donor does not expect to get its money back; it expects its money to generate a social benefit. It considers the investment a failure only if that social benefit is not created. And with a donor-investor willing to subsidize half the cost, the social enterprise becomes valuable and less risky to conventional investors. The traditional model of social enterprise leaves this value on the table. Donors lose out because they fully subsidize a project that could have attracted investment capital, and investors do not participate at all.

What we've just described is, of course, analogous to the way conventional companies are financed. By raising a portion of the capital it needs from equity investors, a risky business can then borrow money from debt investors who seek predictable returns.

In the emerging model of social enterprise capital markets, donors play the role of equity holders, providing capital that supports an enterprise and that makes the debt taken on by financial investors safer, with better expected returns. Let's look at the tools that are taking social enterprises in this direction.

Innovation in Practice

Some of the more forward-thinking foundations and social investors have realized that the current methods of financing social enterprises are inefficient, for the enterprises and themselves, and have started working to broaden the access to capital. Here are some of the mechanisms they're employing.

Loan guarantees. The Bill & Melinda Gates Foundation now issues loan guarantees, rather than direct funds, to some of the enterprises it supports, recognizing that this is an efficient way to leverage its donations and provide organizations with more-certain funding. Its first guarantee allowed a charter school in Houston to raise $67 million in commercial debt at a low rate, saving the school (and its donors) almost $10 million in interest payments.

Quasi-equity debt. Some organizations have developed financial vehicles that combine the properties of equity and debt. A quasi-equity debt security is particularly useful for enterprises that are legally structured as nonprofits and therefore cannot obtain equity capital. Such a security is technically a form of debt, but it has an important characteristic of an equity investment: Its returns are indexed to the organization's financial performance. The security holder does not have a direct claim on the governance and ownership of the enterprise, but the terms and conditions of the loan are carefully designed to give management incentives to operate the organization efficiently. Social investors purchase these securities, which perform the function of equity and make it possible for social enterprises to offer banks and other profit-seeking lenders a competitive investment opportunity.

Consider the Bridges Social Entrepreneurs Fund—one of several social funds of the UK investment company Bridges Ventures. The fund has some £12 million to invest in social enterprises. Recently it committed £1 million to a social loan to HCT, a company that uses surpluses from its commercial London buses, school buses, and Park & Ride services to provide community transportation for people unable to use conventional public transportation. This social loan has a quasi-equity feature: The fund takes a percentage of revenues, thereby sharing some of the business risk and gains. Because the loan is tied to the top revenue line, it provides HCT with strong incentives to manage the business efficiently. Covenants on such loans are often added to avoid mission drift from the social goals.

Pooling. Techniques that involve pooling funds have also opened new financial doors to social enterprises, because the pooling institution can tailor its liabilities to the needs of different kinds of investors. The Switzerland-based social capital investor BlueOrchard, for example, assembles portfolios

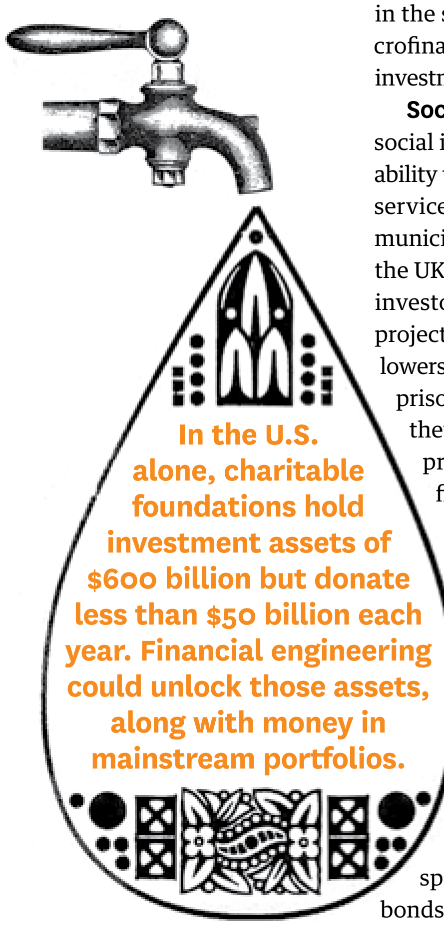
Financing Social Enterprises

Social enterprises potentially have a larger universe of investors than conventional firms do. If they can structure their funding to treat charitable donations as a form of capital that seeks social, not financial, returns, they can then tap all the conventional sources of capital: venture capital firms, banks, mutual funds, bond funds, and so on. And with access to these sources, all the financial-engineering tools for transferring risk and return become available, allowing social enterprises to free up capital and grow.

TYPES OF FINANCING

	Charitable	Equity	Quasi-Equity Debt
PAYMENT STRUCTURE	None	Variable	Tied to revenue
CLAIM ON ASSETS	None	Residual	Subordinated
TYPE OF RETURN	Social good	High financial risk and return	Medium financial risk and return

from many microlenders and bundles them into three tranches. The bottom tranche is BlueOrchard's equity, which offers high returns but takes the first loss. The next tranche offers a lower expected return but has less risk. It takes the second loss, after equity is wiped out, and is analogous to a convertible bond. The top tranche promises a low but relatively safe return; it is purchased by conventional debt investors. The pooling model has spread globally, with innovators such as IFMR Trust, in Chennai, engaged in the securitization and structured finance of microfinance loan portfolios in which they retain an investment share.



Social impact bonds. Another innovation, the social impact bond, deserves special notice for its ability to help governments fund infrastructure and services, especially as public budgets are cut and municipal bond markets are stressed. Launched in the UK in 2010, this type of bond is sold to private investors who are paid a return only if the public project succeeds—if, say, a rehabilitation program lowers the rate of recidivism among newly released prisoners. It allows private investors to do what they do best: take calculated risks in pursuit of profits. The government, for its part, pays a fixed return to investors for verifiable results and keeps any additional savings. Because it shifts the risk of program failure from taxpayers to investors, this mechanism has the potential to transform political discussions about expanding social services. From the U.S. to Australia, national and local governments are developing pilot bonds to fund interventions targeting homelessness, early childhood education, and other issues. The U.S. could even use this approach to support its finance-starved space program—for instance, issuing "space bonds" that would pay a return only if a manned mission were to reach Mars on schedule and under budget.

Developments like these are stretching the boundaries of social enterprise financing. It isn't hard to imagine that at some point social enterprises will have an even broader universe of funding options than conventional businesses do. If you think of charitable donations as a form of investment, and if an appropriate legal structure is created, then you have, by definition, a new class of investors and a new type of return (see the exhibit "Financing Social Enterprises"). An organization delivering a social return could obtain seed capital from donors without giving the donors any claim on assets. The seed capital could then be augmented by equity capital with a residual claim on assets and by debt capital with a prior claim on assets and cash flow. With all these types of liabilities available and with the possibility of securitizing and selling them, the funding and growth possibilities for social enterprises start to look very promising indeed.

And the benefits aren't limited to social enterprises; financial markets stand to gain, too. The emerging model broadens the range of asset classes investors can tap to diversify their portfolios. Investors can now obtain returns from completely new sets of products and customer groups, often in new countries. This is precisely why securitized bonds issued against microloans proved so popular.

Making It Happen

If the financial crisis taught us one thing, it's that the machinery and infrastructure of financial markets matter a lot. Without standards and ratings, investors can't distinguish between good investments and bad ones, and lawmakers can't provide frameworks to regulate and protect investors and companies alike.

When it comes to evaluating a social enterprise, the challenge is doubled. In many areas the market

Convertible Debt

PAYMENT STRUCTURE
Fixed with conversion

CLAIM ON ASSETS
Preferred

TYPE OF RETURN
Medium financial risk and return

Debt

PAYMENT STRUCTURE
Fixed

CLAIM ON ASSETS
First

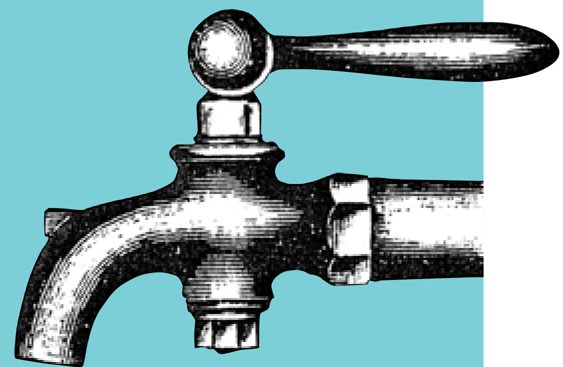
TYPE OF RETURN
Low financial risk and return

Securitized Debt

PAYMENT STRUCTURE
Fixed

CLAIM ON ASSETS
Off the balance sheet

TYPE OF RETURN
Tailored to investor types



machinery and infrastructure for evaluating social risks and returns are barely developed. This can have two effects: It can starve good organizations of funding and leave investors focused solely on financial returns.

As Harvard Business School's Robert Kaplan and Allen Grossman argued in these pages (see "The Emerging Capital Market for Nonprofits," HBR October 2010), investments in social causes will remain chronically inefficient unless the social sector comes up with transparent ways to measure, report, and monitor social outcomes. Recognizing the need for such transparency, the Rockefeller Foundation joined with many of the most important social venture investors in launching a major effort to finance the development of institutional machinery and infrastructure for social enterprise capital markets.

Part of this effort involved the creation, in 2009, of a nonprofit called the Global Impact Investing Network. One of the organization's first initiatives was the Impact Reporting and Investment Standards (IRIS) project, which seeks to establish criteria for double-bottom-line investing, where the first line is financial and the second line is social. What, for example, is the right way to measure childhood literacy? For an enterprise involved in primary education, the second line might be the number of children enrolled in schools, or how many can read. By specifying what items should appear on the second line, IRIS has taken the first step toward the development of common standards for reporting social outcomes—just as GAAP provides a common language for comparing investment options.

Greater precision and transparency with respect to social outcomes will make it easier to disentangle the social returns and risks of a blended business from the financial ones. This in turn will allow a social enterprise and its investors to determine the appropriate balance between charitable and noncharitable capital, and from there the enterprise can use the machinery and infrastructure of the financial markets to the fullest. All parties will benefit. Donors will be able to leverage their gifts to support more activities, and they will be better able to assess the effectiveness of their donations. Social enterprises will have access to the capital they need for growth consistent with their social missions. Financial investors will have a hugely expanded range of investment opportunities.

LET US BE CLEAR: We do not underestimate the challenges involved in creating fully functioning capital markets and legal frameworks to serve social enterprises. It's hard enough creating them to serve for-profit entities that do not have social missions. We also recognize that some of the innovations we've discussed will not be suitable for all organizations. We need to figure out how to sustain those organizations as well. But with the right market infrastructure and legal framework in place, enormous amounts of private capital could be mobilized for social enterprises. In the United States alone, charitable foundations hold $600 billion in investment assets but donate less than $50 billion each year. Effective financial engineering could unlock those endowment assets and also attract some of the trillions of dollars currently held in mainstream portfolios. The ability to tap these deep pools of capital will be a significant contribution to creating a greener, healthier, and more equitable world.

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A former managing director of the Rockefeller Foundation, **Antony Bugg-Levine** is the CEO of Nonprofit Finance Fund, a U.S. nonprofit community-finance institution that provides loans and financial advice to nonprofits. **Bruce Kogut** is the Sanford C. Bernstein & Co. Professor of Leadership and Ethics at Columbia Business School. **Nalin Kulatilaka** is the Wing Tat Lee Family Professor of Management at Boston University.