The U.S. Nonprofit Capital Market: An Introductory Overview of Developmental Stages, Investors and Funding Instruments

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Foreword

In recent years, major shifts have taken place in the nonprofit sector:

- The Advent of Devolution, whereby federal authority and funding for an array of social, educational and other programs is being transferred to the states
- The Rise of Social Entrepreneurism within the sector which, while still evolving, in all its versions embraces some blending of business skill and perspective with community and social values
- The Evolving Practice of Venture Philanthropy, a new framework for giving driven by new donors who, having created significant economic wealth in recent decades, are now turning their attention to charitable issues—often making use of the very skills that made for their success in the for-profit sector to guide their work in the nonprofit sector, and
- The growing awareness that even in this, our longest period of sustained economic growth in decades, the United States is still confronted with the reality that for many Americans prosperity is not just around the corner, but rather in a completely different community of which they are not a part.

Many are concluding that the approaches of the past, while important to numerous efforts at addressing critical social problems, are in need of expansion, revision and re-design.

This chapter was written following a series of discussions held by funders concerned with developing a deeper understanding of their role in the nonprofit sector during this period of transformation. It presents a basic framework for understanding the work of funders and practitioners, and the resources that connect the efforts of both. It uses as its basic frame of reference the for-profit capital market, drawing parallels and lessons from that comparison.

This chapter is an effort to help inform the thinking of those concerned with understanding the strategic use of philanthropic capital in the pursuit of charitable goals. It is offered as a contribution to the refinement of basic ideas regarding philanthropy, as an attempt to minimize confusion regarding the wide array of players and types of support they both require and provide, and as an effort to achieve general consensus regarding how funders are approaching the challenges of being effective players in the field. The paper's primary audience is funders and individual donors whose efforts support much of the activity in the nonprofit sector. Regardless, it is hoped the ideas and conceptual framework presented will be of interest to a much wider audience, including practitioners, public policy advocates and others concerned with the development and implementation of funding strategies that may result in greater social returns for valuable philanthropic "investments."

In recent years, the philanthropic community has increasingly addressed itself to questions regarding its effectiveness. Greater attention is being given to concepts of "strategic" philanthropy, "outcome" funding, engaged grant making and grant making for effective organizations. Indeed, it would seem there is a growing sense that the approaches of the past have not resulted in the change or impact funders have sought. In some ways, it would appear many people feel something is lacking in the current approach, but we seem unable specifically to state what. Some would have us believe there are not enough funds to support the potential and necessary growth of the nonprofit sector—but we must ask by what standard they make this claim. Others would say limited resources make it difficult for successful programs to "go to scale"—yet we are not clear on exactly what "scale" means or why it is thought to be of value. And still others state that existing resources are not being allocated effectively overall—however, we seem to lack the metrics to assess this supposition and take appropriate steps to respond.

Indeed, it should be understood at the outset that while the American philanthropic tradition is decades old, in many ways the Nonprofit Capital Market is neither matured nor fully developed. Therefore, our understanding of that market is still evolving. This chapter does not seek to provide definitive answers to the array of challenges confronting

the Nonprofit Capital Market, many of which are detailed in its conclusion. Rather, it is offered as a starting point, a frame of reference that may help inform future discussion and debate.

Our position is that the nonprofit sector benefits from a rich variety of approaches to philanthropy, ranging from traditional Classical to emerging Venture Philanthropy and beyond. It is the composite of these various understandings of and approaches to philanthropy that gives the philanthropic field as a whole its richness. And it is the difference in the field's many approaches which gives rise to the need for greater definition and understanding among its many actors.

Furthermore, as the United States prepares for a major transfer of wealth to an aging generation of "Baby Boomers," and successful entrepreneurs of recent years seek out new challenges in the pursuit of their personal philanthropy, many newcomers are entering the ranks of the philanthropic community. By providing a basic overview of how funds flow through this charitable market place and the various instruments used by funders to assist in the work of the sector, we hope that those new to the field will be supported in making informed and effective contributions to many issues of collective concern to our society.

We welcome all those who would work to better define the Nonprofit Capital Market. It is only through common debate, discussion and analysis that we may hope to better understand how it operates and the opportunities it holds for us all—funder, practitioner or concerned stakeholder.

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Introduction to Capital Markets and Philanthropy

In the for-profit community, much has been written about the structure and functioning of capital markets. Business ventures at various stages of development require different types of capital, as well as other coordinated support, to move from start-up to sustainability. Historically, discussions of funding in the nonprofit sector have touched primarily on grants, annual fundraising campaigns, direct mail and endowment funds. Only recently have these discussions evolved toward a realization that the resources supporting the work of the nonprofit sector are more than simply a variety of charitable fundraising efforts, but actually form a distinct capital market—The Nonprofit Capital Market. Dollars used to support community and other nonprofit activities, while "charitable," are still capital investments of precious resources. As such, it is critical that these investments be managed with the same strategic thinking and due diligence one would apply in the for-profit financial services and investment communities.

While this Nonprofit Capital Market shares some elements with its for-profit counterpart, there are a number of significant differences between the two. As opposed to financial returns, the "returns" sought by donors are for the most part social returns on investment. Nonprofit organizations, by their very nature, may not provide a direct financial return to those who invest in them. Nonprofits are often under-capitalized or hold few "hard" assets and may

therefore be perceived as representing greater risk to commercial lenders. Finally, nonprofit organizations must learn to operate without, or create replacements for, the access to equity investments that form the financial lifeblood of for-profit corporations pursuing business strategies.

Despite these limitations, billions of dollars are directed each year to thousands of nonprofit organizations pursuing goals in the fields of economic development, education, the environment and human services, to name but a few. A complete, definitive analysis of the Nonprofit Capital Market and its various actors is beyond the scope of this paper; however, institutions such as the Hauser Center for Nonprofit Institutions at Harvard University, Independent Sector and other organizations, as well as individual researchers, are generating more and more information on the nonprofit sector and the capital market that supports it.[1] At a minimum, it must be acknowledged that the Nonprofit Capital Market of the past will not be that of the future.

While government funding will continue to remain the cornerstone of support for many nonprofit organizations, the rate at which government funding increased between 1992 and 1996 was only 2.9% as compared to 8.4% between 1987 and 1992. Many of the projected cutbacks of government support have yet to be enacted however, such cuts may be easily anticipated in coming years since a growth rate of 2.9% at best allows for the rate of inflation. By contrast, private contributions grew at an overall rate of 3.3% from 1992 to 1996 as compared with only 1.4% from 1987 to 1992.[2] When the wealth creation of the past 15 years is considered together with the significant wealth transfers anticipated as a result of the Baby Boomers' inheritances being realized, the Nonprofit Capital Market will likely continue to undergo serious shifts over coming years. Some experts project this wealth transfer to exceed $1 trillion over the next 20 years. The funds that move through this capital market come in a variety of forms, are controlled by different types of funding institutions and are "invested" in nonprofits that fall across a wide continuum of size and capacity.

This section presents a basic framework for understanding the Nonprofit Capital Market,[3] discusses the types of organizational players active within it, and outlines the various capital instruments used to support the sector as a whole.[4]

Fundamentals of the For-Profit Capital Market

There are a number of ways for-profit, small businesses meet their needs for the capital investment required to "bootstrap" the start-up and expansion of their venture. One classic scenario is as follows:

> *An individual with vision sees an opportunity in the market place and has an idea for some product or service offering she feels will be better than other offerings presently available to customers. She approaches friends and family members for support, offering either a loan payback (with a fixed rate of return) or an equity position (an unsecured investment with some type of owner share in the business provided in exchange for the requested funds). This is known as "first stage" or start-up financing.*
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> *As the enterprise grows the owner requires access to funds to support the cash flow requirements of a growing business. These funds may be used to support the purchase of additional equipment, fund lease improvements to an expanded production or other space, and any number of other front-end expenditures that must be made if the venture is to develop to its next level of growth.*
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> *The business may finance this expansion incrementally through small lines of credit or more substantially through securing outside, equity financing. This is commonly referred to as "stage two" or "mezzanine financing." Three sources of funding may be available at this point. The owner may find a "business angel" (usually an individual with some significant amount of personal wealth to invest*

in promising start-ups). This "angel" will often provide not only the funding required, but will often also offer technical assistance and access to his or her own business networks in order to leverage additional contracts and industry contacts.

A second source of funding may come from venture capitalists. Venture capital funds provide significant capital investment and access to industry support for the growing business. In exchange for these funds, the business owner will surrender a significant amount of equity. Venture capital funds operate with fairly aggressive goals for return on investment and, in exchange for their pursuit of significant returns, take on substantial risk that the funded venture will perform at a low-rate of return or generate a loss.

A third source of funding is available through a variety of small business loan programs. For example, the owner may apply for 7-A lending (loans awarded through local banks, but secured by the Small Business Administration) or, depending on her credit rating, the owner may pursue a traditional small business loan from a bank or credit union. These types of financing are not mutualy exclusive and may be undertaken together.

Finally, many larger businesses will further diversify their funding through issuing bonds, stock offerings or other, more sophisticated forms of debt and equity to underwrite capital requirements. Even if the business remains "privately held" (i.e. does not offer its stock to the general public), an array of equity options may be offered individual investors. With access to this last, final stage of financing, most businesses in America become fully mature in the capital market, able to finance capital requirements through a variety of investment and loan instruments which trade financial risk for the promise of some level of future financial return. If the capital instrument is a loan, it is tied to a fixed rate of return and usually secured with some underlying assets of the corporation.

Capital requirements beyond what may be directly supported by debt underwritten with assets may be met through additional equity offerings, such as various classes of shares. These additional offerings, while usually unsecured, offer an ownership position in the business and the possibility of greater, future financial returns.

While this scenario is relatively common, it does not represent the only way capital is secured by for-profit corporations. Indeed, a very small number of companies actually qualify for venture capital support and many of America's leading corporations never received any investments from the venture capital community. Most corporations in America still grow their ventures through some combination of

1. Equity raised from a small circle of investors ("friends, family and fools," as the saying goes!)

2. Internally generated funds (e.g., various operating surpluses that may be booked as retained earnings)

3. Bank loans and/or other public or private debt offerings.

It has become popular in recent times to glorify the "initial public offering" that makes the founders rich and secures additional amounts of operating and other funds to support business expansion. However, the truth of the matter is that many corporations never go public and are made successful through bootstrapping their capital requirements with very modest initial investments. In this way, there is great similarity between the capital development of for-profit and nonprofit corporations.

With regard to securing commercial lines of credit, it is important to understand that depending upon the type of business and industry in which it operates, there are certain percentages of "debt to equity" which are considered prudent and reasonable. Banks, in assessing whether a given corporation is creditworthy, will assess such factors as the debt/equity ratio in order to evaluate the relative risk in any given loan proposal. Taken together, the amount of debt and equity present in a business that underwrites the financing requirements of the corporation is referred to as the business's "capital structure."

In addition to assessing the debt/equity and other relevant ratios, of perhaps equal importance is the analysis of cash flow. A business can sustain high levels of debt service if the cash flows of the enterprise are sufficient to cover both its debt and operating fund requirements. Indicators of cash flow for a business

may be found by assessing EBIT (Earnings Before Interest and Taxes) and EBITAD (Earnings Before Interest, Taxes, Amortization and Depreciation). For obvious reasons, a lender or investor will look more favorably upon an investment opportunity with strong cash flows and significant debt than one with little debt, but no cash flow.

Access to investment capital and cash flow funds are not sufficient in and of themselves for success. However, it is that capital structure, together with the presence of talented management and staff along with a little luck in the form of market timing, which makes for success or failure in the for-profit world. The various players, investment instruments and institutions that bring various amounts and types of capital to the table together form what is known as the capital market.

The following sections of this paper use the for-profit capital market as a basis of comparison with the Nonprofit Capital Market. At the outset, however, it should be recognized that one central, historic difference in the source of funds for these two markets is the role played by the public sector, which is to say the role played by governmental funding. The nature of this role and the degree to which government should support community and other activities of the nonprofit sector are certainly topics up for continuing debate. However, the presence of the public sector in providing direct funding (e.g., capital) to nonprofits is significantly different from what is seen in the for-profit capital market.

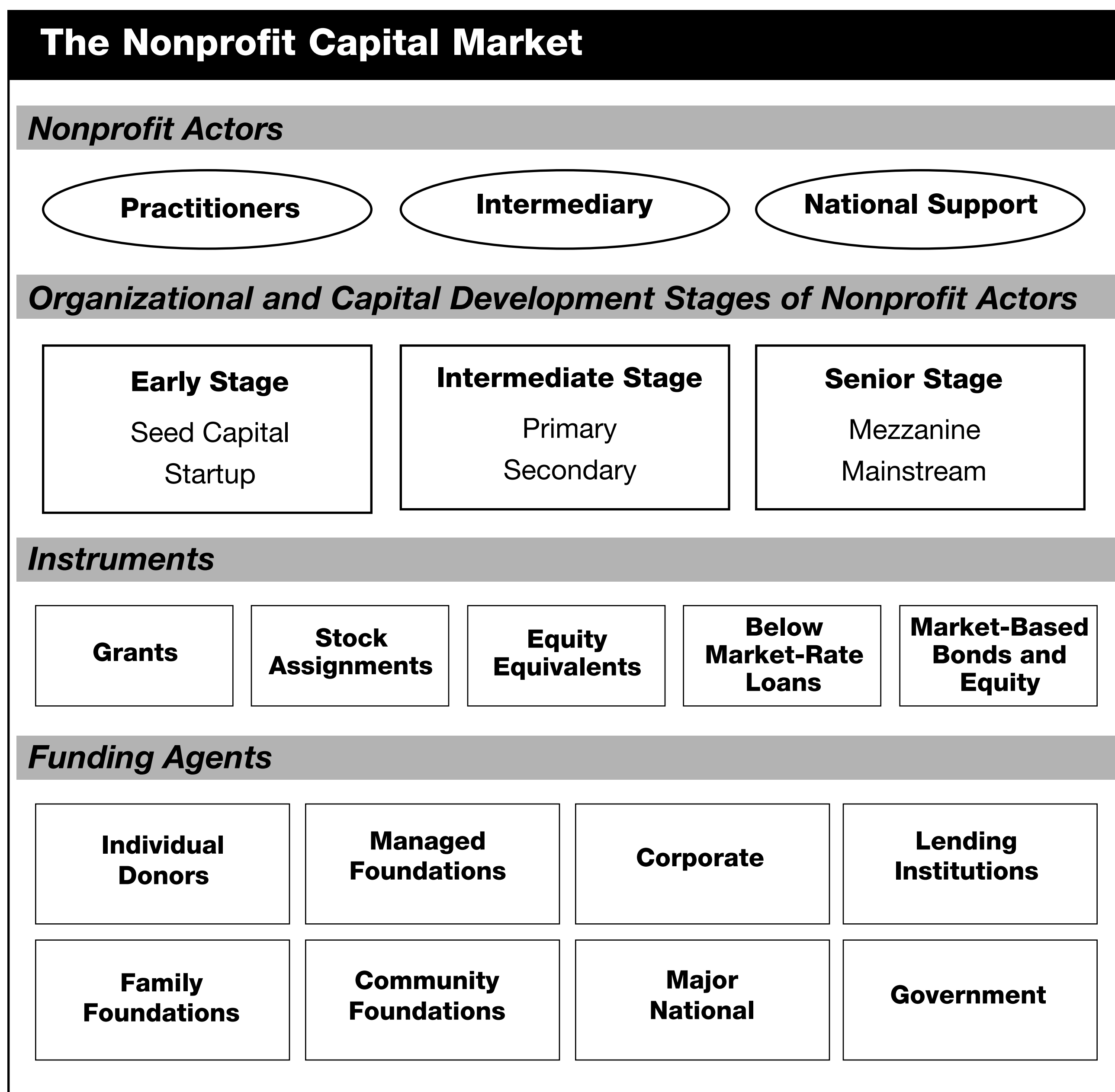
Certainly, the government provides an array of supports to the for-profit community (such as SBA loan guarantees, direct contracting opportunities, tax and regulatory abatements, vendor relationships and a host of subsidies in the form of everything from the building of roads through Forest Service land to the federal funding of basic research); however, as a direct actor in the capital market itself, federal and state government has and,in all likelihood, will continue to fund the overwhelming majority of activities in the nonprofit sector. This fact has a significant and major impact upon the Nonprofit Capital Market and its actors.

Before leaving the for-profit market place, we must acknowledge that increasing numbers of for-profit businesses are adopting "socially responsible" business practices and becoming more community-oriented in their pursuit of traditional, for-profit goals. While there is ongoing debate regarding the true social impact and future implications of both socially responsible businesses and socially responsible investing, the fact is that increasing numbers of for-profit managers and entrepreneurs are reflecting upon the community impact of their economic activities. While the focus of this chapter is the interactions of nonprofit organizations and philanthropic "investments" in contributing to strengthened communities, families and environments, the real impact and potential social or other benefits of the traditional, commercial sector cannot be overstated either.[5]

Stages of Nonprofit Organizational and Capital Development

The Nonprofit Capital Market may mirror many of the elements of the for-profit market, however there are a number of differences. Traditional frameworks for understanding the for-profit market are useful, but must be modified to accommodate the legal, organizational and equity limitations of the nonprofit sector. The following outline is a modification and extension of the traditional for-profit stages of capital financing widely referenced by business financiers. In this case, the modified framework applies to nonprofits and is loosely based upon a for-profit framework presented in "A Study of the Availability and Sources of Venture Capital in Maine."[6]

In general, it must be understood that nonprofit organizations move through various stages of development and capacity. The type and form of capital required to support the work of a variety of nonprofit organizations along this continuum differs as well.



Early Stage Organizations:

Seed Capital

Seed Capital is small amounts of funding used to develop a basic concept and begin to build a base to qualify for start-up funding. It may be used for initial program development and assistance in creating an organization or program, but usually not for actual start-up of the venture. This type of funding is provided in order to give practitioners the "time to think," convene planning sessions with other practitioners or consumers of services and potential stake holders, or run "trials" to test an idea.

Start-up Funding

Provided to organizations that have demonstrated potential and initial marketing of a concept or program idea, Start-up Funding assists groups that require funding to "go the next step." In theory, at this level, organizations have conducted basic research on their concepts, have assembled key managers and advisors, have developed an enterprise or organizational development strategy, and are ready to move toward initial implementation of their idea or program initiative. In practice, many groups may have successfully addressed some of these factors, but often have others that remain unaddressed.

Intermediate Stage:

Primary

Having demonstrated the potential value of their concept, organizations use Primary Funding to "roll out" their program. While their program has demonstrated the potential to achieve significant social impact, Primary Funding is placed in organizations which are felt to have clear potential, but have up to this point lacked the support necessary to fully execute their strategy.

Secondary

Building upon the demonstrated success achieved with Primary Funding, Secondary Funding support enables the organization to further build capacity and expand program offerings. Secondary Funding allows organizations to grow their initial program or organization significantly, but for the most part,it does not provide "stable" capital resources to guarantee a sustained presence in the market place. Many nonprofit organizations are successful at achieving this stage of expansion, but confront significant capital market and organizational barriers to moving beyond it to Senior Stage support.

Senior Stage:

Mezzanine

Provided to organizations in order to "go to scale," Mezzanine Funding supports significant expansion of current operations, replication of programs to other geographic areas and other development activities. Funds at this level are used to support expansion of office and program space, inject needed working capital or improve program operations.

Mainstream

At this stage of funding, an organization has "made it." Mainstream funding means the organization is viewed as financially "sound"and, while there may continue to be program modifications, the fundamental "product" or program of the organization is viewed as credible and providing significant value to society.

Furthermore, organizations at the Mainstream capital stage will have:

- A Diverse Base of Financial Support

  Organizations receive funding support from an array of sources: foundations, government, individual donors, fee-for-service contracts, earned income and annual fundraising events. This diversity helps protect the organization from shifts in the Nonprofit Capital Market.

- Commercial Lending Relationships

  Organizations qualify for lines of credit, major capital and equipment loans and other forms of traditional lending from mainstream banking and other financial institutions.

- Individual Sponsors

  Organizations may have developed large membership or sponsor pools that provide, through direct mail or other means, ongoing contributions. While this support usually comes in smaller increments (ranging from annual contributions of $25 to $1,000),the size of the pool is often great enough to provide a major source of general operating support.

- Self-Capitalization/Earned Income

  Organizations may have grown earned income and "for-profit" activities to the point of being able to re-direct net income from those ventures into supporting the parent corporation and its social purpose. These sources of capital support may take the form of for-profit subsidiary corporations or "social purpose" enterprises that, while generating surplus income, also employ a target population in fulfillment of the organization's charitable purpose.

While the above continuum of funding required by the nonprofit sector is offered as a helpful framework for discussion of the Nonprofit Capital Market, it should be understood that organizations may actually fall simultaneously at various points along the continuum. For example, a parent nonprofit may itself have achieved the level of Mezzanine Funding, while a given program being developed by that same organization may languish at the Start-up Funding level. One implication of this shortcoming in the traditional approach to the funding of nonprofit organizations is that whereas many nonprofits may be successful at receiving start-up support, the availability of general operating support is often lacking. This reality makes it extremely challenging to secure the necessary financing to expand core capacities necessary for a parent organization to manage replication or expansion strategies. Indeed, part of the traditional challenge for nonprofit managers has been that of finding adequate support for the many diverse programs often housed within a single organization while maintaining the general operating support necessary to manage such programs.

A Capital Caveat: Market Shifts and Player Positioning

Over the past 40 years, many nonprofits achieving a matured, Mainstream level of capital development have relied upon government funding as one significant source of capital to support the national expansion of their work and/or replication of program models. The philanthropic community has, in many ways, evolved its own approaches to nonprofit organizations to support this goal of a future government "take-out." Increasingly, however, government funding will no longer play the role of primary provider of Senior Stage, Mainstream capital support.

Indeed, in a recent address at a national community wealth forum, former Senator Bill Bradley described the role of government funding as one of testing interesting, social programs, nurturing those programs through early stages of development and then taking them to the private sector for long-term funding support.[7] This perception of the relative roles of government and private sector funding is exactly the reverse of the role understood by many of those in the foundation community who have historically viewed themselves as the front-end funder of community ideas and government as the long-term supporter of such programs.

Considerable media and other attention has been brought to bear upon the long-term implications of these shifts in the role and structure of government funding in the Nonprofit Capital Market. In fact, the Nonprofit Capital Market Working Group, which has contributed to this chapter, could not agree as to whether government actually has played the central role in providing the majority of capital for nonprofits to go to scale, whether or not government funding will continue to play a central role in supporting nonprofit organizations or what the real long-term impact will be upon the Nonprofit Capital Market and its actors. Clearly, this is an area in need of further research and analysis.

While there is a need for further research into the specific role and functioning of government support within the nonprofit sector, the fact remains that shifts are taking place in the Nonprofit Capital Market. New players are entering the market, older players are re-

assessing their support, and competition for what funds are available in that market will only grow more fierce as the nonprofit sector continues to grow. The current and future implications of these facts cannot be overstated. Even though the actual dollar reductions in government funding have yet to work their way fully through the Nonprofit Capital Market (for example, while welfare reform will have a long-term effect of decreasing funding available for public assistance and other programs, the short-term effect actually has been an increase in funding of state welfare programs), many believe that this shift in the role of government funding has helped precipitate a crisis in the Nonprofit Capital Market.

And as a result of this perceived crisis many nonprofit organizations will have to significantly alter their understanding of what a "successful" nonprofit capital structure may look like—namely different amounts of government support and expanded types of capital support from other sources. Additionally, private funding actors in the capital market will be forced to reconsider their role and position in the market place. The balance of this chapter will address who these changing actors and investors are, how they interact, and the very real challenges confronting them as they seek to fulfill the mission of the nonprofit sector.

The Nonprofit Capital Market: Actors and Investors

The Nonprofit Sector is made up of thousands of organizations, each addressing a range of issues and whose work is supported from an array of sources. While such diversity is what makes the sector strong, it can also challenge anyone (whether funder, nonprofit professional or layperson) attempting to understand how to interact with and support the organizations within it. There are scores of books and many institutions that attempt to capture the richness of the sector and a full presentation of it is beyond the scope of this paper.[8] In addition to other efforts, such organizations as the Program on Nonprofits and Philanthropy at the Urban Institute, the Institute for Nonprofit Organization Management and the Foundation Center are each engaged in identifying and analyzing the wide array of players in the nonprofit sector. More specifically, Project 180 (New York,NY) is involved in a "mapping" process that will attempt to identify and categorize various players and trends in the nonprofit sector, with particular focus upon those engaging in the emerging practice referred to as social entrepreneurship.[9]

However, for the purpose of this discussion,the Nonprofit Sector is made up of those who do and those who fund the doers. While there are, as will be presented below, some examples of blending between these roles, in general the sector consists of

- Nonprofit Organizations (which is further divided among three groups: Practitioner, Intermediary and National Support), and
- Funding Agents (Individual Donors, Family Foundations, Managed Foundations, Community Foundations, Major National Foundations, Corporate Foundations, Governmental Funders and Lending Institutions).

The following section will briefly present and attempt to define each of these actors in the Nonprofit Capital Market.

Nonprofit Organizations

Practitioner

The heart of the Nonprofit Sector is those organizations engaged in the direct pursuit of

a charitable or social purpose. These can range across fields as diverse as social service delivery, to education, to cultural arts,and the environment. Practitioners may engage in advocacy around an issue, but also may be involved in directly addressing the issue itself through the operation of a program or provision of services. For example, environmental groups include those attempting to change environmental public policy and those creating public land trusts to preserve wilderness or endangered habitat. Youth programs may support after-school tutorials, summer recreational activities or direct street outreach to homeless youth. Cultural arts groups may sponsor writers, underwrite performances or operate in schools to bring the wonder of arts to young people.

Practitioner organizations generally fall into three categories: community-based, community-based/nationally affiliated and non-place based. Community-based organizations are active in a single geographic area, whether neighborhood or regional, while non-place based organizations operate without reference to a specific,individual community. An example of a local, community-based organization would be a traditional community development corporation, charged with advancing the economic vitality of a given neighborhood. An example of a community-based/nationally affiliated organization would be the Girl Scouts or Big Brother/Big Sister that, while working through local chapters,are advancing an overall program across the nation. Non-placed base organizations include Greenpeace, Amnesty International or the American Cancer Society.

The main link among all practitioner groups is that they are attempting to address directly an issue of societal or community concern—they are,in every sense of the term, "doing" the work of the sector.

Intermediary

Intermediary organizations are support organizations that work to bring added resources to the efforts of the practitioner community. These resources may include financial support, technical guidance or network support for a particular initiative. Intermediary organizations may operate at either a regional or national level, and they work with a number of practitioner organizations. Examples of intermediary organizations are The Enterprise Foundation, The United Way, The Corporation for Supportive Housing (CSH), or the Local Initiatives Support Corporation (LISC).

Many Intermediary organizations operate within the classic approach to community and organizational development in that they embrace a "model" which has been found or is believed to be effective in addressing an issue. The Intermediary then moves to implement that particular model through a variety of local affiliates. Examples of this approach are:

- LISC's Franchise Initiative (which is implementing a model of community economic development that focuses upon linking for-profit, national franchisors with local, for-profit individual entrepreneurs); or

- CSH's Supportive Housing Initiative (which works with community-based organizations to create a national network of nonprofit-managed affordable housing programs that offer on-site support services).

Other intermediaries operate within models which promote a "sectoral approach," a regional economy approach, or other similar strategies—all of which are conceived in one region and brought to another for execution by local organizations. In order to support the practice of their model, many intermediary organizations also provide technical assistance to help local practitioners involved in model replication.

Intermediary organizations may be thought of as a type of "hybrid" organization between "doers" and "funders," in that they often receive grant support from foundations that they then re-grant to organizations that then actually provide a service or program. In this way, Intermediaries are actors in the Nonprofit Capital Market. Since they in turn receive their funds from foundations or governmental sources, they are not truly a funding agent in their own right. In addition to the provision of funding, intermediary organizations also provide various levels and forms of technical assistance, managerial

education and training, and general information. In many ways, the traditional role of intermediary organizations shares some elements in common with that of "venture philanthropy," presented later in this document. What distinguishes one from the other is the degree of donor involvement, the basic conceptual framework within which they operate and other factors discussed below.

In recent years a new form of intermediary organization has evolved that operates programs providing the nonprofit sector with both leadership and organizational development assistance within the context of a strong market-based orientation—something not seen in traditional intermediary organizations. Social Venture Partners, Eureka Communities, the echoing green foundation, Grace, The Fund for Social Entrepreneurs, New Profit Inc., and The Denali Initiative all represent efforts to support individual, social entrepreneurs while increasing the operational capacity of the nonprofit organization of which they are a part. This "integrated" approach to intermediary functions (whereby funding, leadership training/support, administrative capacity and a host of other issues are addressed simultaneously) represents a promising strategy for maximizing both the leverage of philanthropic investments and the potential for future social returns.

National Support

National support organizations are those organizations active at the national level in support of a field as a whole. These would include national associations, "think-tanks" or policy organizations. National support organizations may act as a convening entity for practitioners, intermediaries and funding institutions. While some national support organizations are active in direct advocacy around a given issue, they often act in a wide variety of ways to address issues raised by their member or constituent organizations, whether with regard to public policy, funding, research or general efforts at "building" the field.

Examples of national support organizations are the National Congress on Community Economic Development, The Child Welfare League of America or the Community Development Venture Capital Alliance.

Funding Agents

Across the table from nonprofit organizations sit an array of individuals, foundations and institutions that provide financing which allows the nonprofit to pursue its work. Funding agents include:

Individual Donors

While not technically a funding "agent," individual donors form the basic building block of the Nonprofit Capital Market, constituting financial support well in excess of foundations and other sources of grants/contracts. In truth, an individual donor is anyone who makes a charitable gift to a nonprofit; however, in this case we are referring specifically to those high-net-worth individuals who make substantial gifts to nonprofit organizations. Developing a solid base of individual "small donor" support is important in the diversification of any organization's funding base. Individual donors constitute 83% of private giving in the United States and as such represent a major source of diversified funding for nonprofit organizations attempting to take their efforts to greater size and sustainability. However, while significant on an aggregate level, such donors' personal leverage is largely fragmented, remaining at the "Do I renew at $50 or $100?" level. Until such time as these individual donors may be organized as nonprofit "share holders," their ability to leverage influence within the sector is largely diluted.

High-net-worth donors, on the other hand, have an immediate impact upon both an individual organization's activities (through directly underwriting a particular program) and, increasingly, upon the larger Nonprofit Capital Market itself through their ability to underwrite large-scale, multi-organization funding initiatives. They may begin their activities by making initial charitable gifts to individual nonprofit organizations or various "causes," or may move directly to the establishment of a family foundation or other funding vehicle through which to make larger, more strategic charitable contributions.

Family Foundations

Family Foundations (a subset of Private Foundations) are established by high-net-worth individuals willing and able to endow an

ongoing institution to carry out their support of the nonprofit sector. Family foundations are usually endowed at some level and, in adherence with IRS tax codes, must annually disburse 5% of their assets. While most foundations use grants as their primary charitable investment vehicle,increasing numbers of foundations are examining how to more creatively support the causes that interest them (for example,through Program-Related Investments and other instruments discussed below). Family foundations can range greatly in both size and culture. Some maintain large,fully staffed offices, while many others are staffed on a volunteer basis by family members or managed for a fee by the foundation's trustees or attorneys.

Managed Foundations and Philanthropic Advisor Services

An emerging actor in the Nonprofit Capital Market is the Managed Foundation and Philanthropic Advisor Service. Managed foundations are those foundations, often family foundations, which are collectively managed by a single organization specializing in such services. Philanthropic Advisor Services are those independent foundations that make use of individual advisors (often legal trustees, individuals with personal experience in the field of philanthropy or other independent actors) to guide their grant making activities. Depending upon their operating structure, both Managed Foundations and Philanthropic Advisor Services make it possible for donors to receive individual attention and assistance, but do not require the presence of full-time staffing for each individual foundation or donor.

This form of organization is increasingly important as "new" donors come to the market seeking guidance, yet wanting to maintain influence or control over fund distribution. This approach to managing foundation activity is also important in that those who coordinate such funds have the potential to broker a number of independent foundations to a single philanthropic transaction. Examples of Managed Foundations and Philanthropic Advisor Services are The Tides Foundation (San Francisco, CA), The Philanthropic Initiative (Boston, MA), and Pacific Foundation Services (San Francisco, CA).

Community Foundations

While a relatively recent growth segment of the Nonprofit Capital Market, Community Foundations have existed for a number of decades and provide an important vehicle for the support of nonprofit organizations, as well as a way for donors to target their support. Established with "independent community" boards, community foundations maintain an endowment, but also offer individual donors the potential for the creation of donor-advised funds. Under this structure, an individual donor makes a charitable contribution to the foundation, which then controls the capital; however, the donor may then act to "advise" the foundation on how those funds should be disbursed and through what strategies. As the name implies, community foundations seek to reflect not simply the wishes of the donor, but broader issues and concerns in the region of which they are a part.

Private Operating Foundations

A variation on the traditional private foundation, private operating foundations are those that do not make grants to outside organizations, but rather directly fulfill their charitable purpose through the direct operation of programs or other activities that advance their cause. Private operating foundations usually set aside designated funds for a defined program managed by the foundation. An example of a private operating foundation is the Schwab Foundation for Learning, founded by the Charles and Helen Schwab Foundation. The Schwab Foundation for Learning provides counseling, support services and an array of programs specifically targeting the needs of the learning disabled.

Major National Foundations

With household names like Rockefeller and Ford, large national foundations are those most often identified by the general public as involved in philanthropy. These institutions, in addition to funding important capital and other campaigns, may play an important role in matching locally committed funds. In addition,they have the perspective that comes from operating at a national level that often allows them to see connections and opportunities present in various regions of the country. With the benefit of size, however, come

challenges of pursuing appropriate philanthropy that supports and augments, but does not replace,that of local communities. Major national foundations have had a significant impact in helping to both replicate successful regional programs and support broad public policy initiatives to inform the larger society of critical social, health, environmental and other issues.

Corporate Foundations

For-profit corporations establish Corporate Foundations as a vehicle to engage in charitable support of nonprofit organizations. They also may have a parallel mission of advancing the goals and marketing strategies of the parent corporation. While in some cases corporate foundations are endowed, many have budgets tied directly to the financial performance of the parent corporation.

In addition to providing direct financial support, corporate foundations also have the ability to leverage significant contributions of goods, services and volunteers. Indeed, while the majority of corporate philanthropy is pursued through charitable giving, increasing numbers of corporations are examining how to engage in "strategic"[10] philanthropy to leverage the total resources of the corporation in support of a charitable goal. For example, such efforts might include not simply grant support, but the mobilization of large numbers of volunteers, the outsourcing of contracts to nonprofit social purpose business ventures, or the practice of loaned executives to assist in nonprofit marketing, financial analysis or other areas of need. While similar to traditional "pro bono" efforts,strategic corporate philanthropy represents an approach to philanthropy that allows the corporation to have a much greater impact in the nonprofit sector than grants alone might allow.

Governmental Funders

In the "old days" (i.e. prior to 1980!), many of those involved in the field of philanthropy liked to view themselves as the "venture capitalists" of the nonprofit sector who would seed initial ideas which would then be replicated and provided significant funding by public sector funders. No more. As devolution and anticipated cutbacks in government funding become the norm,many governmental funders view themselves as those seeding ideas and local or private sources as the vehicle for ongoing financial support. Since governmental sources of funding far outstrip those of the philanthropic community, government remains an important source of capital for the nonprofit sector. However, learning how to blend the two streams of capital remains a challenge as both foundations and government maintain their own categories of interest and terms for organizations seeking to receive financial support.

Lending Institutions/Credit Unions

Organizations that provide lending support to nonprofits remain an important and evolving component of the capital market. These consist of either mainstream commercial lenders or nonprofit lending institutions, such as community development finance institutions and revolving loan funds. Many of these groups provide loans at market rates of return,though others charge rates greater than the market average—reflecting the greater levels of risk sometimes involved in lending to nonprofit organizations. For the most part, these loans historically have been made to support affordable housing, commercial real estate development or, increasingly, small business development, but have been largely unavailable for the support of nonprofit general operations, cash flow or social purpose enterprise development. The lack of capital for these areas represents a gap in the capital market for those nonprofits lacking assets that might secure such loans or engaging in activities, such as business development, that are viewed as too risky to be supported with loaned capital.

Recent Developments in the Nonprofit Capital Market

As is true of most markets, the Nonprofit Capital Market is not a static organism, but is dynamic, with new players entering, old ones exiting and new approaches to philanthropic strategies coming into play. While there are a number of trends one might identify, it would seem important to acknowledge at least three at this point.

Of increasing concern among those who create family foundations is the issue of control and whether a foundation established to operate in perpetuity will continue to reflect the vision and values of its primary donor. Recently, more foundations have been established with a strategy that includes a clearly stated "sunset" clause requiring that all the assets of the foundation be disbursed within a given, usually relatively short-term, time frame. Claude Rosenberg[11] has done a great deal to challenge conventional wisdom as it relates to the pursuit of philanthropy and the role of foundations in advancing such efforts. The Rosenberg Foundation, Annenberg Foundation and Aaron Diamond Foundation are all examples of foundations that, to various degrees, are pursuing or have pursued strategies which include the total disbursement of the foundation's assets within a set time frame. While viewed as radical by some, this perspective addresses many of the concerns held by high-net-worth individuals regarding how their assets will be used in the years following their passing.

A second strategy being pursued by foundations is the creation of centers and other organizations specifically founded to support the broader development of the field or area of interest. Similar in many ways to the medical research organizations established by John D. Rockefeller, Sr., these centers move well beyond the traditional "naming opportunity." Foundations implementing this approach directly assist in the shaping of a field through convening, educating or supporting the research of leading practitioners to address emerging issues in their field. Examples of this practice are the Center on Entrepreneurship (created by the Kauffman Foundation), the Aspen Institute (created largely through the support of foundations interested in research on the nonprofit sector), and Wingspread, a conference center founded by the Johnson families. These institutions work to foster better thinking and practice in the nonprofit sector as a whole.

Largely as a result of the influx into the philanthropic community of "new wealth" created in recent years, the Nonprofit Capital Market has recently witnessed the emergence of a new and challenging approach to philanthropy, Venture Philanthropy. Given the impact of this strategy and its much-debated place in the market, Venture Philanthropy will be addressed in a separate section following the discussion of investment instruments below.

The Nonprofit Capital Market: Investment Instruments

The primary link between nonprofit organizations and funding institutions is the capital that moves from one to the other. A basic premise of this document is that all forms of charitable support provided to nonprofit organizations represent forms of charitable investment in those organizations. The specific form taken by these investment instruments can vary in source, size and structure.

Furthermore, just as capital in the for-profit capital market moves along a continuum, so, too, does capital in the nonprofit market. It must be recognized at the outset that funding institutions may use an array of investment vehicles to achieve their organizational goals. By extension, the financially healthy nonprofit organization will have a mix of funding represented on its financial balance sheet—grants, loans and program-related investments all play a role in capitalizing successful initiatives in the nonprofit sector.

Before approaching any discussion of capital investment instruments used in the nonprofit sector, it must first be acknowledged that in the nonprofit sector the distinction between capital investment and operating revenues is much less clear than in the for-profit capital market. In many cases, "investments" in the nonprofit sector often are used to cover current operating expenses and in such cases resemble business revenues more than "capital investments." Investors in for-profit corporations will cover operating expenses temporarily, usually during start-up or expansion stages when operating cash flows are expected to be

negative. However, these investors expect that operating revenues in the business eventually will exceed operating expenses. This expectation is not common with nonprofits. Beyond these limited time periods, for-profit capital investments usually are intended to cover specific capital expenditures for such things as property acquisition, equipment purchase, long-term research and development, etc. Each of these represents cash outflows not regarded as "expenses" for a given accounting period. Banks and other lenders may extend short-term loans to cover such expenses as well, but these loans generally are not considered part of the overall capital structure of the organization.

A basic premise of this chapter is that those who support the operating expenses of nonprofit organizations (foundations, individual donors, etc.) are making investments in the nonprofit organization. In fact, one might also argue that just as many for-profit businesses, such as HMOs or auto repair shops, receive cash inflows from third-party payees (such as government revenues, insurance companies, corporations buying benefits for employees, etc.), nonprofits do as well. These revenues often cover the operating expense of an organization providing services, programs or support to others who often do not pay the full cost of such services. This fact and its impact upon the operation of the Nonprofit Capital Market are worth noting and clearly require further research.

It is the author's position that program grants or third-party reimbursements do, in fact, represent nonprofit operating revenue, whereas grants received as part of a multi-year, organizational development strategy represent social and capacity-building capital investments. Additional inquiry into this distinction and the specifics of how it is reflected in the capital market is needed. For the purposes of this discussion we simply will acknowledge the existence of this "blurring" between revenue, investment and third-party payees. For the time being, we will overcome this potentially complicating issue by simply saying that all cash inflows to the nonprofit will be viewed as "investments," unless they are the result of explicit contractual payments or the result of fees for services rendered.

Regardless, as will be discussed below, while the presented investment instruments are all part of the Nonprofit Capital Market, it is widely felt that the market itself (as it is presently constituted) does not offer enough capital in the size, form and appropriate stages needed by the nonprofit sector. This is reflective of the fact that the Nonprofit Capital Market is in many ways neither fully developed nor mature. The for-profit capital market has evolved over a period of centuries, whereas nonprofit organizations have existed for a matter of decades and organized public support of their efforts for perhaps fewer years than that. As a result, the Nonprofit Capital Market lacks certain types of funding at exactly those places where the market place and its actors could make the most use of it. The challenge of addressing those gaps and developing more effective capital instruments is a major focus of this chapter.

However, before addressing the inefficiencies of the nonprofit market place, we must first understand the fundamental investment instruments presently in use. Those instruments are: Grants, Stock Assignments, Equity Equivalents, Below-Market Loans (PRIs), Market-Rate Loans and Lines of Credit, and Market-Based Bonds and other Equity Investments.

Grants

The most popularly used and understood charitable investment instrument is the grant. Grants are made to nonprofit organizations following an application process and some level of due diligence by the grant making institution. Grants may be of any size, ranging anywhere from under $5,000 to $1,500,000 and above.

Because grants will not be paid back to the funding institution and carry no interest rate, they are often viewed by actors in the market as "free" or "no-cost" capital. This assumption is deceptive, however, in that the application process by which grants are awarded and the "strings" which may be attached to such funds can quickly turn a "free" capital instrument into very "expensive" form of capital.

For the most part, grant funds are used to support the delivery of a program offering or nonprofit product. Therefore, grant support is often "money in, money out" for the recipient organization. Donors give funds in order for those funds to be applied

directly in support of the stated "cause" and generally do not want the organization to "sit" on those funds any longer than is necessary. On the whole, the effect of grants is that, unless specifically targeted for such, they do not provide assistance to the organization's overall effort to expand its operating or administrative capacity.[12] Grants may be used to acquire real estate or equipment that may then be carried on the organization's books as an asset. However, for the most part, grants represent a "liquid" investment that comes in one year and is gone the next.[13]

Given that grant dollars dedicated to project as opposed to general operating support represent a significant part of the Nonprofit Capital Market, it is no wonder practitioners find it difficult to build assets or the overall financial health of their organizations. This reality represents a critical factor effecting the Nonprofit Capital Market—namely, that the grant-making strategies of a majority of funders have not adequately targeted the development of the assets of the organizations pursuing our nation's community, environmental or social values. Indeed, most funders do not view their grant-making activities as true investments, but rather as charitable program or other support targeting a specific project or provision of services. While it may be unfair to state it in such bold terms, one wonders if unless and until the funding community embraces an understanding of grants as a form of charitable investment, the Nonprofit Capital Market will continue to be significantly hindered in its capacity to support the efforts of practitioners in pursuing their vision for individual organizations, local communities and society as a whole.

Stock Assignments

While still rare, as a result of the stock market boom of recent years some organizations and donors find the gift of stock to be an increasingly attractive charitable investment instrument. While not as liquid an asset as a grant, stocks may be sold by the nonprofit organization or held in the hopes of securing an appreciated value over time.

One intriguing twist on this historic practice is being pursued by the Entrepreneurs Foundation (Menlo Park,CA), which is soliciting contributions of stock from emerging entrepreneurs in Silicon Valley. These entrepreneurs make a contribution of 1% of their total shares early in the formation of their corporation. This contribution then grows over time, creating an expanding endowment for the foundation, which will then use its annual disbursement to support its work with social entrepreneurs managing local nonprofit organizations.

The "Equity Gap" and Use of Equity Equivalents

As stated earlier, most for-profit businesses carry some mix of debt and equity. Depending upon the type of business and the overall financial health of the corporation, certain target ratios (such as the debt/equity ratio) are used to measure how much debt a business can sustain. Debt is usually tied to some underlying asset of the corporation, with various lenders taking a position relative to those assets. Subordinated debt, for example, takes a secondary position to senior debt that has "first dibs" on the liquidation of any assets in the event of bankruptcy. It should be noted, however, that all debt has a priority claim (before that of any shareholder) on cash flow of the corporation.

The problem is that any business will probably require more capital than it can or is profitable to borrow. Therefore, business owners often sell a part of the ownership in the company in return for additional capital needed to make up this difference. While there are various forms of equity, such investments are unsecured and fully at risk. Those holding that equity hope to receive a market-rate or better return. For-profit investors are willing to take exposure to risk in exchange for possibly greater financial returns in the future. This is the central difference between lending and investing.

Nonprofit organizations must work under the same economic rules and realities as their for-profit counterparts; however, nonprofit organizations must overcome two fundamental challenges to building the "capital structure" necessary to support their work:

- Nonprofits are prohibited by law from providing "private inurement" to outside or internal investors—thus eliminating the profit incentive for potential investors of capital.[14]

- Most funds provided to nonprofit organizations are immediately used to achieve some short-term program or other goal. The "return" generated by the organization's capital is most often a social return on investment as opposed to a financial one.

Depending upon whether one's perspective is as an investor or practitioner, this situation creates either an "equity gap" or an "asset gap" in the financial/capital structure of nonprofit organizations. This gap represents the fundamental challenge of capitalizing nonprofit organizations—it is the very reason an activity is considered charitable and pursued by a nonprofit corporation. There remains some debate as to whether it is appropriate to term this lack of funds a "gap" since grant funds may be used to operate nonprofit organizations and, as described below, there are various ways one may structure financial support of nonprofits to address the essential need for capital support. However, the existence of this gap in financing is and will remain a central challenge for practitioners and those involved in supporting their work.

Regardless of how this gap might be addressed, it should be understood that in a traditional for-profit business the increasing value of the corporation is entered on the financial books initially as profit and later as retained earnings. Traditional, for-profit corporations receive both outside equity investments and generate internal equity through these retained earnings. The nonprofit sector, by contrast, has very little, if any, capacity to generate such retained earnings as a vehicle to capitalize the corporation and fund future expansion. In many ways it is this "double-whammy" of an inability to secure outside equity investments together with the chronic inability of most nonprofits to generate internal equity that creates the "equity gap" and is a central challenge in adequately capitalizing nonprofit corporations.

To further hinder the nonprofit manager in her efforts to build her organization's financial health, when such funds do accrue in the nonprofit world they are most often viewed as "surpluses" or fund balances—terms and accounting practices which don't lend themselves to building the assets of an organization. It is no surprise, therefore, that these funds are most often used to fund a program or operating expense within a given year and that the "charitable assets" of the nonprofit sector are seldom viewed as investments or cultivated as such.

However, that gap may be filled, at least in part, through the use of "equity equivalents." An equity equivalent is a grant made to a nonprofit with the provision that it is "recoverable." While some PRIs (discussed below) are unsecured, all recoverable grants are unsecured—with payback usually pegged to the nonprofit enterprise achieving certain financial benchmarks at some agreed-upon future date. Therefore, they are fully "at risk" and in that way play a role similar to for-profit equity investments—thus, the term "equity equivalent." The "payback" on an equity equivalent to the philanthropic investor comes both in the form of principal and social return on investment (SROI), whereas for a grant the payback is simply SROI, and in a PRI it is (at least in theory) principal plus interest.

In this way an equity equivalent is not truly an equity instrument in the for-profit sense of the term (since in the for-profit sector the investor would be rewarded with a significant risk premium of some type); however, since they are unsecured injections of investment capital, they function in a manner similar to equity for the nonprofit enterprise. The amount of the equity equivalent (e.g.,. the principal invested) may be recovered at some future date and revolved back into the support of charitable work. In this way the recoverable grant plays the role of long-term equity, allowing the organization to pursue its social mission and build capacity. However, as previously stated, an equity equivalent does not guarantee either a return on principal or pay interest on the use of that principal, both of which are present in the structure and application of Program-Related Investments (PRIs). In fact, many PRIs do play a role similar to equity equivalents (given their extended terms and high risk status as loans); as discussed below, however, there is the expectation that they will be paid back regardless of whether the funded project is a success and since they are entered into as secured financing vehicles are fundamentally loans and not equity.

Below-Market Loans (PRIs)

The next step up from recoverable grants or other equity equivalents is below-market

loans. Any donor or institution may make a loan to any other organization that carries interest payments below the market rate. When made by business people, such loans are referred to as a "favor" or as having made "a really stupid loan" (since the market rate of return is much greater and one could earn better returns elsewhere). However, when a foundation engages in this practice it is referred to as a program-related investment! Under a PRI,funds may be taken out of either the foundation's annual grants budget or its endowment; however, if funds are paid back, they are usually returned to the foundation's endowment or corpus.

Pioneered over 20 years ago, largely through the efforts of John Simon of the Taconic Foundation, the John D. and Catherine T. MacArthur Foundation and the Ford Foundation, PRIs open up the potential for foundations to bring significant,new infusions into the Nonprofit Capital Market. While these loans carry an interest rate which is below the market rate (usually ranging from 2-4%) and have an extended payback period of seven or more years, they are often secured by assets or other means. In this way, PRIs allow nonprofits to access needed capital, while tying that capital to assets of the nonprofit organization. The funds, while carrying some significant degree of risk, are not as risky as an unsecured loan, recoverable grant or other equity equivalent.

It is interesting to note that while often thought of as a strategy for foundations to "extend" the impact of their endowment through lending as opposed to simply providing grant support,PRIs that are not paid back to the lending foundation may be "charged" by that foundation as contributing to the 5% annual grant payout requirement.

Along this line, it is also interesting to note that the interest rate structure for most PRIs runs completely counter to traditional lending or investment practice. In the "real world" of investing, deals are governed by the law of "high risk,high reward," yet in this case the nonprofit sector functions with greater reference to its own law of "high risk, low reward." While on the one hand this is understandable in that traditional commercial lenders won't come near many of these deals, so there really is no market for such loans and they therefore have no true value in terms of their potential future rate of return, on the other hand these loans do not reflect the true market realities that govern capital and economics. By contrast, loans originated by many nonprofit loan funds often carry a market risk premium that in some way compensates for the greater risk of making loans to high-risk, nonprofit clients.

Market-Rate Loans and Lines of Credit

Once a nonprofit organization has achieved a certain scale and capital structure, it may qualify for market-rate loans and lines of credit. These types of capital are most often used to finance either cash flow and working capital requirements or the acquisition of property. Such forms of capital carry standard market terms and interest rates. Furthermore, they require that the organization have sufficient assets to underwrite the loans in case of default. While not available to all, such capital is an important part of an organization's capacity to finance its efforts and build its balance sheet over time.

Market-Based Bonds and other Equity Investments

A final, and for some perhaps unachievable, stage of the Nonprofit Capital Market is that of bonds and true equity investments. Many hospitals, educational institutions and museums are able to secure this type of "high-end" financing. There are many types of bonds potentially available to nonprofit organizations as a means of securing expansion and other capital. Market-based bonds might include secured and unsecured bonds, various types of municipal bonds and industrial development bonds. Such instruments are in many ways out of reach of most smaller or developing nonprofits and may require fairly sophisticated financing;however, they do provide one option for securing significant,long-term capital resources for nonprofit organizations.

While rare,joint ventures and other equity partnerships are also a consideration for some nonprofits. In this scenario, a subsidiary, for-profit corporation would be formed and outside investors brought to the table in partnership with the nonprofit. Up to the present, few groups have developed the degree of sophistication required to structure

and manage such deals. With the influx of business managers into the nonprofit sector with for-profit finance experience, the market may see an increasing number of such capital structure "deals" in the years to come.

The Role of Venture Philanthropy in the Nonprofit Capital Market

In recent years, the Nonprofit Capital Market has witnessed the growth of a new approach to philanthropy, popularly referred to as "venture philanthropy." Other documents are available which discuss the fundamental tenets and practice of venture philanthropy, as well as how the core principles of venture capital funding and management support might be applied within a philanthropic setting.[15] For the purpose of this document, let us simply say that venture philanthropy is not a fad approach to funding limited to individual, fringe players, but is increasingly influencing a wide variety of actors in the Nonprofit Capital Market: community foundations, individual donors, corporate foundations, and other institutions.

Venture philanthropy's basic aspects include such elements as:

- Multiyear funding support
- Attention to organizational capacity-building
- Use of "new metrics" as a management tool to inform better practice
- Use of "new metrics" to calculate a Social Return on Investment that focuses upon the outcomes resulting from philanthropic "investments"
- Awareness and pursuit of appropriate exit strategies
- Deeper, more engaged relations between the funder and practitioner
- A "portfolio management," as opposed to "isolated grantee," approach to grant making
- Awareness and application of grants as capital investments

While the above factors represent important qualities of a venture philanthropy practice, it is critical to understand that the basic strategy of venture philanthropy may be applied in a variety of nonprofit contexts to address the full breadth of players present in the practitioner community. Individual venture capitalists and venture philanthropists maintain specific focus and expertise within a given area of interest (high technology or supported employment, for example); however, it is their investment strategy that really distinguishes their work from that of "classical" philanthropy. While it is a generalization, in some ways, venture philanthropy is less concerned with what social issue or challenge is being addressed than it is with pursuing an effective approach to how relevant capital and other support are provided to nonprofit practitioners.

This difference in orientation represents a fundamental contrast between the approach of intermediary organizations previously described and that of venture philanthropy. Intermediary organizations focus upon a particular area of interest (for example, community economic development) and how a particular model may be applied within it (for example, franchising or supported employment strategies). By contrast, venture philanthropists focus upon building the capacity of the practitioner to execute their framework and grow the ability of a given organization to sustain its work in the nonprofit sector.

Clearly, venture capitalists are successful in part due to their in-depth understanding of a given market and ability to see how a particular business strategy may bring very real value to that market place. Having made that commitment to a particular market, however, for-profit venture capitalists shift their emphasis from what is supported to how their support is provided. They are, in a phrase, fully engaged investors. Venture philanthropy is naturally concerned with the application of

innovative strategies to addressing social and other issues of societal concern; however, the values presented above reflect an approach to the support of organizations pursuing those strategies that is fundamentally different from that of both "classical" philanthropy and traditional intermediary organizations—namely, it is a form of engaged grant making which is felt to bring greater long-term value to the nonprofit market place.

Finally, it must be acknowledged that much recent debate in the philanthropic community has focused upon whether a classical or venture philanthropic practice is "better." However, such discussions miss the fundamental point that both approaches are necessary for the proper operation of the Nonprofit Capital Market. Just as the for-profit capital market includes venture capitalists,local bank lending institutions, mutual funds and investment banks, the Nonprofit Capital Market must also affirm the relative value of all its players, each of which fulfills a need within that market and operates with reference to its own "investment" goals.

Examples of foundation initiatives that pursue a venture philanthropy approach are Social Venture Partners (Seattle, WA), The Roberts Enterprise Development Fund[16] (San Francisco, CA), the Entrepreneurs Foundation (Menlo Park, CA) and the Robin Hood Foundation (New York, NY).

Challenges of the Nonprofit Capital Market

Financing the growth of any small, for-profit business is not easy. Attaining the owner's vision takes tenacity and often requires significant financial risk. The potential and promise of independence and financial reward are what make the risks worthwhile. Financing nonprofit ventures may be even more difficult, for two main reasons.

First, as previously stated, nonprofit organizations usually lack adequate assets with which to secure (or underwrite) loans. Many such organizations are "grant driven," with funds being made available annually in return for the fulfillment of commitments made by the organization to provide certain services or programs to the community—often to "consumer markets" which do not have the funds to otherwise pay for those services. Youth programs, food banks and low-income health centers are just a few examples of such programs.

In many ways nonprofit activities are driven by the fact they have no primary financial market capable of supporting such work—this is what makes them "nonprofit," since you can't make money off it. To wit, most nonprofits operate with "weak" balance sheets, carry few assets (such as buildings or other holdings that might be used to underwrite loans) and are often without large endowments that might fund enterprise or other social purpose activities.

Organizations that do have real estate assets with which to secure a loan often have used that existing asset to secure lines of credit to support the operating cash flow of the agency. This is often necessary due to the "risky"nature of supporting an organization with grants that may or may not be renewed the following year. However, this situation has the secondary effect of making those assets unavailable to finance other organizational priorities, for example, a new program start-up or expansion of a social purpose enterprise.

A second barrier to providing capital to nonprofits is the lack of equity/asset options, previously discussed. When a nonprofit "goes out of business," all of its assets are distributed to other, existing nonprofit organizations to continue the pursuit of charitable works. Remaining assets may not be sold to or given to outside investors, although in the event of bankruptcy they may be sold off to cover the outstanding debts of the organization. (The exception, of course, is that a nonprofit may liquidate its assets at market-rate prices in order to pursue its mission through other means. One example of this practice is that of nonprofit hospitals converting to for-profit corporations and endowing major health care foundations. While controversial, this practice is legal and does allow for the sale of a nonprofit's assets to outside investors.)

A counterpart to this lack of equity/asset options is the fact that to date there has been little demand for such options; most nonprofit organizations want those funds for current operations and programs as opposed to supporting the accumulation of assets. This lack of demand serves to underscore and, in some ways, support the lack of equity/asset options available to both potential philanthropic investors/ donors as well as nonprofit practitioners.

Business "angels" or other individuals who might otherwise fund various stages of a business start-up are rarely interested in taking on such a nonprofit "high-risk, no-reward" proposition. Even though a nonprofit may have some access to "loan dollars" through buildings or other assets, it cannot secure true equity investments—the life blood of any business enterprise. The gap in financing represented by this lack of equity is what we have termed the "equity gap" in the nonprofit sector. "Equity gap" is not meant to infer that the Nonprofit Capital Market itself is without access to such equity or equity equivalents, but rather that individual nonprofit organizations themselves experience a gap in their capital structure which in the for-profit sector is filled by equity injections from various sources. The existence of this gap stands as a critical challenge for most nonprofits attempting to pursue their social mission whether through traditional means or non-traditional strategies, such as the creation of market-based, social purpose business ventures.

In addition to these core challenges, the Nonprofit Capital Market itself is further hobbled by the following:

- Absence of market standards
- Lack of proven "Return on Investment"
- Market fragmentation
- Grant making in isolation
- Insufficient resources and capital market imbalance
- Various investors, various instruments
- Development of an emerging knowledge base
- Need for additional Nonprofit Capital Market research
- Learning versus funding
- Teaching funders to learn
- The tension between market cost capital and community-based need
- Market "insiders" versus market "outsiders"
- Market hype versus vision grounded in practice
- Atrophied investor relations
- Going to scale

We will briefly address each of these issues in turn:

Absence of Market Standards

One reason the for-profit capital market works as it does is that there are baseline standards for accounting, valuation of businesses and overall measurement of success. The nonprofit sector's lack of these is perhaps the single most detrimental factor preventing the expansion of philanthropic investments in the nonprofit sector. While there are emergent efforts to engage in "outcome funding" and the creation of standards by which to track "social return on investment" or SROI,[17] for the most part the nonprofit sector is driven more by politics, persuasion and perception than by any objective measure of success or capacity.

Examples of efforts to create standards by which comparative philanthropic investments may be weighed are seen in the work of the National Charities Information Bureau, the development and use of a "balanced score card"approach to standards and,more specifically, the work of GuideStar.[18] NCIB promotes standards for reporting and GuideStar posts not only the 990s of many nonprofit organizations, but also a number of "nonprofit ratios" by which the performance and resource allocation of organizations may be compared. These admittedly modest beginnings are a good start and must be taken even further. If the sector is to create a more effective capital market,the challenge of standards

will have to be addressed successfully and used to the advantage of quality programs in order to minimize the presence and financial support of poor programs.

Lack of Operating MIS to Track and Analyze "Social Return on Investment"

In addition to a lack of broadly embraced operating standards for the field, the nonprofit sector as a whole lacks management information systems with the ability to link the work of individual actors in the sector accurately with the impacts to which they lay claim. Many organizations operate programs and claim success of program designs based largely upon anecdotal information as opposed to having adequate information systems in place to track outcomes and draw connections between a given intervention or program and the social impact sought. With the rise in "effective grant making" and other funder interest in assessing the true impact of charitable funds, the Nonprofit Capital Market may be shifting toward a market that demands accountability. However, in order for the nonprofit players in this market place to make such a shift in operating systems and approach, significant investments in the design and installation of appropriate management information systems and evaluation methods will be required. Otherwise the "impacts" reported by most groups to outside funders would be simply estimates or projections as opposed to true measures of success.

Coupled with the inability to track SROI is the present inability to accurately analyze and attach investor value to social returns. Evolving frameworks for tracking SROI do attempt to assign "share value" to such returns, which may then be tied to the actual philanthropic investments made by individual investing agents. However, the challenge of rewarding added risk or proportional contribution remains significant. At present,a funder who makes a grant of $150,000 at the beginning of Year 1 is forced to "value" the impact of their grant on the same relative basis as one who makes a $5,000 grant in month 11 of Year 1. Without the capacity to assign relative risk and reward,the full potential of calculating SROI may be limited in its application.

While it would be easy to embrace SROI and other quantitative frameworks as "the" way to measure the impact of philanthropic dollars, such tools are only part of the process of accessing the true value presently being created in the nonprofit sector. Other approaches that build upon more traditional program evaluation and assessment tools also have their place in efforts to gauge impact and the added value created by nonprofit organizations. These, perhaps more qualitative, approaches must be further developed and refined in concert with evolving SROI and other approaches in order for the informed grant maker to fully appreciate the total impact of their grant making. Clearly, such approaches to evaluation are grounded in sound analysis and measurement; however, even something as basic as the personal story of a client or a hike through a wilderness area can expand upon and more fully reflect the actual effectiveness of strategic philanthropy. The advocacy of MIS/SROI approaches to measuring impact should not be to the exclusion of other evaluation strategies, but should augment and provide greater support for existing approaches in which the philanthropic community has already invested.

Market Fragmentation

While the for-profit capital market should certainly not be thought of as some well-oiled, smoothly running machine, it does operate with greater efficiency than its nonprofit counterpart. It must be acknowledged that fragmentation and inefficiencies significantly hinder the Nonprofit Capital Market. Those seeking resources must pass through a labyrinth of organizations, foundations and intermediaries, attempting to cobble together funds from a variety of sources with often competing priorities. One foundation supports endowments, while another won't make grants to organizations with "too many assets." Diversity is a healthy aspect of any system, but systems that are not able to build upon and coordinate their diverse elements soon break down into entropy. Despite efforts by the Council on Foundations (through the creation of a small number of foundation libraries) and some regional associations of grant makers who have helped present general information to assist those seeking funding, the Nonprofit Capital Market

remains an extremely challenging market to access for those smaller nonprofits already hindered by limited staffing capacity.

While there are those who celebrate the fragmentation of the market as a good and natural by-product of "the destructive creativity of capitalism," many players on both sides of the nonprofit capital table view such fragmentation as creating significant inefficiencies in the nonprofit market that force resources to be spent on activities that do not contribute either social or economic value to the nonprofit sector. Many of those involved in funding the nonprofit sector feel that a major challenge confronting the Nonprofit Capital Market is that of how to organize itself more effectively so that one investment may build upon the next to maximize both the efficient use of charitable resources and the added value of various charitable investments.

Grant Making in Isolation

A counterpart to the overall fragmentation of the Nonprofit Capital Market is the fact that a single grant maker can make a grant which launches a new initiative or program that may quickly take on its own life,usually attracting enough funds to stay alive if only for the short term, yet not enough to achieve real scale or sustainability. Grant makers, driven by their own vision and needs for market recognition, often neglect such basics as communicating with other funders and practitioners. Such practices may make for limited success, but in a sector with many linked players and relatively scarce resources overall, grant making in isolation can restrict the potential for strategic development of both individual organizations and the field as a whole.

Of equal concern are occasions in which one funder has seeded an initiative and seen it through its early years only to conclude that the effort was not as successful as had been hoped. Rather than publicly acknowledging that fact and sharing its lessons with the larger market place, a funder may exit a funding relationship with an organization, only to have that same organization then use its prior funding relationship to promote and secure new funding from another agent in the market, a funder who may be unaware of the initial foundation's dissatisfaction with the outcomes of its investments. While this may simply be an example of "buyer beware," much of what is supported in the market receives grants by way of reputation and perceived value.

At this time, in the absence of any broad standards or metrics by which funders may assess various grant making opportunities, each funder must engage in significant due diligence prior to awarding support. This fact makes it especially difficult for individual donors lacking in full-time staff to understand the full risk and potential of their individual donations. While in some ways this is simply reflective of the spirited independence of individual foundations and donors, the process of due diligence would be greatly facilitated by greater information-sharing and networking among those in the funding community in order to assure resources are directed to more effective organizations, while helping to prevent those with the best "spin" and grant writers from continuing to receive support.

Insufficient Resources and Capital Market Imbalance

In part as a result of the lack of standardization by which to evaluate the various investment opportunities present within the market, the majority of resources within the Nonprofit Capital Market tend to aggregate at one end of the sector—grants targeting support of Early and Intermediate Stage organizations. In addition to the imbalance created by this focus on grant making as the primary capital instrument,the foundation community's emphasis on "new" approaches and "innovation" in the nonprofit sector also creates a market "pull" toward Start-Up and Primary Stage organizations as opposed to those requiring Mezzanine or Mainstream support for the expansion of proven strategies and program initiatives. In addition, adequate resources may be lacking in both areas of development as a result of nonprofit leaders' limited access to the funding process or other factors effecting access to the market. There may be an overall tendency for the market place to move toward start-up and "new"initiatives; at the same time, there may also be segments of the nonprofit sector that for a variety of reasons will never be able to fully access opportunities to secure funding which might otherwise be available. In this sense, there may be questions of both a market imbalance and resource insufficiency.

Various Investors, Various Instruments

The capital market imbalance described above is further complicated by the fact that no single investor is limited to any single range of investment instruments. While it is true that foundations tend to make grants and lending institutions make loans, individual investors may make grants, loans or equity investments in any given nonprofit actor. Community foundations may make Program-Related Investments and grants. Indeed, any funding agent may make a grant of $5,000 or $500,000, and may also make a loan, recoverable grant or program-related investment.

While it would be helpful to have clear definitions of what types of instruments may be used by which investors, of greater value to the overall operation of the market would be more clearly delineated avenues by which the charitable investments (grants, loans and equity) of all actors in the market would be moved from one level of development to another. Regardless of which investors are active at which levels of the Nonprofit Capital Market, organizations moving from Start-Up to Primary to Mezzanine stages should be provided with more strategic access to those capital investors necessary for their long-term success and sustainability.

Development of an Emerging Knowledge Base

Those interested in understanding more about the Nonprofit Capital Market and how to be active within it must network through a variety of individual players, accessing a document here and a book there. The field is only now beginning to develop a formal knowledge base to inform those who would like to become more active as funders and to guide those seeking resources. There is no single model or approach to use in pursuing this practice and our understanding of the field is itself evolving. If we are to increase the number of investors active in the Nonprofit Capital Market, greater effort will need to be made among all those involved to document the process (both success and failure) and share information more widely than we have before.

One significant obstacle to creating this knowledge base is the tension between a funder's interest in funding an outcome versus openness to learning from an attempt to pursue a given outcome. If the Nonprofit Capital Market moves in the direction of demanding outcome measures and the overall quantification of impacts there is the very real danger that the field will lose any ability to support the creation of a learning environment wherein various experiences may be openly discussed and lessons shared. If the funder approaches the process in the role of customer ("purchasing" an activity that will have a certain outcome),the nonprofit will be positioned to document the fact that the "service" and its intended benefit were indeed achieved. What happens if the nonprofit's original strategy needs to be revised? What if the outcome is different from what was funded? There are many challenges to the creation of a learning process that will be of greatest benefit to both funder and practitioner. The sector will need to build in provisions to assure that learnings are documented and shared, as not hidden and viewed as failures.

An emerging impediment to the creation of a shared knowledge base in the field is the growing presence of fee-for-service consultants (nonprofit and for-profit). This pool of consultants is drawn from a number of disciplines, including nonprofit organizational development, small business development, philanthropic advisors and many other areas of practice. While there are some efforts to gather case studies and share information, as the intellectual capital of the field expands that knowledge could be controlled less by the sector or those who have funded these "learning opportunities" than by consultants who move from client to client—in essence selling the learning they have gathered from working with one nonprofit to their next client in need of such knowledge. Care will need to be taken to assure that as funders, practitioners and consultants work together the greater benefit of such partnerships accrues to the field and not consultant organizations.

Need for Additional Nonprofit Capital Market Research

Important as the "action research" represented by case studies and the gathering of lessons from the field of practice may be, there is also the need for additional basic research into the general field of philanthropy as it relates to "investing" in the nonprofit sector and the

various techniques for doing so. For example, understanding more about how charitable use assets may be used by foundations to support the work of practitioners and fulfill their social mission is an important and emerging area of both tax and practical research.

Many are familiar with the creation of charitable use assets—for example, houses donated for use as museums (engaging assets in the pursuit of a given mission) or ownership of the Kansas City Royals by a community foundation (engaging in the creative assignment of assets). But one wonders about other ways foundations could engage in more aggressive use of functionally related businesses such as credit unions or even manufacturing plants located in low-income neighborhoods. The fact is there are a variety of ways one may engage in both mission-directed assets and creative asset assignment. Such strategies could provide opportunities for joint ventures, the creation of community wealth and the charitable investment of foundation funds in vehicles that would provide some degree of financial return together with a direct social impact and return on investment. Additional research is necessary to assess not only what the possibilities of such uses of charitable capital might be, but also to support the wider dissemination of these possibilities to others in the Nonprofit Capital Market. What needs to be researched is how viable such options are and what legal,tax and other hurdles need to be overcome in order to make the best use of them.

Learning Versus Funding

As more foundations attempt to become more "engaged" in their philanthropy, new questions are being raised with regard to how a foundation may on the one hand seek to learn and grow from its relationship with a grantee, while on the other hand, remain in a decision-making role with regard to whether to continue funding the grantee. In the pursuit of closer relations between funders and grantees, there is a fundamental conflict between encouraging an open, honest relationship with a grantee portfolio and grantee fears of losing funding if they are truly open about their challenges and shortcomings. While this is true in many areas of grant making, it is especially true for those pursuing a Venture Philanthropy approach to the use of charitable dollars. How to build a learning culture to support the growth and development of the field, while also acknowledging that funding decisions are made based on the perceived and actual capacities of a given grantee to achieve its goals, is an ongoing challenge for both grantees and those who would support their work.

Teaching Funders to Learn

The foundation community of the United States invests billions of dollars in an array of community strategies targeting any number of issues of community concern. This is a significant responsibility and it is no wonder funders strive to involve some of the "best and the brightest" in the process of allocating charitable dollars. Unfortunately, this can often lead to an expectation of success that may have the unintended consequence of stifling opportunities for true learning between and among funders. Seldom does one hear a funder discuss problems of a given strategy or funding experiences wherein the foundation made a series of fatal errors in a "bad" grant process. Without greater openness to and support for the creation of a true learning environment, the funding community will never capture the full value of many of the experiences it makes possible through its financial support. Cultivation of the learning environment is necessary for change to take place and practices to improve. Foundations need to embrace the concept of learning for themselves as much as they promote it for their grantees.

The Tension Between Market Cost Capital and Community Needs

At its core, the fundamental challenge confronting the nonprofit market place is the reality that the return on investment is both social and economic. Understanding more about this tension and how it may be overcome is an important challenge. In many ways, the nonprofit sector evolved in response to the deficiencies of market-based capitalism. There are very sound and understandable reasons why investors don't place their capital with nonprofit organizations. Some of these reasons are definitive and grounded in the basics of economics, but others simply require greater investments of intellectual capital to overcome

perceived limitations. Through committing ourselves to thinking more creatively about historic problems, we have the potential for overcoming at least some of those problems. For example, Caroline Williams, in a recent paper entitled "Financing Techniques for Nonprofit Organizations: Borrowing From the For-Profit Sector,"[19] presents a number of creative and innovative ideas that should be considered. In addition, understanding how to factor in "community value" as a part of the investor definition of return and measure of return is an important challenge that needs to be a part of this discussion. This issue merits more attention from both the for-profit and nonprofit communities.

Market "Insiders" Versus Market "Outsiders"

The saying is well known: "Foundations fund people, not paper." The Nonprofit Capital Market is in many ways driven by personal relationships. Funders who have confidence in certain grantees promote those grantees to other actors in the market. Individuals without connections or access submit "over the transom" proposals. As we move toward efforts to formalize the Nonprofit Capital Market, it is imperative we assure full and broad participation by a wide range of practitioners in order to assure healthy diversity in the market place. Presently, those who know how to "work the system" have the greatest success and little strategic effort is made to aggressively bring communities of color and those who "don't fit the mold" into the mix. We should view this period of growth as an opportunity to bring more and diverse players to the table as a way of teaching others how to leverage greater resources through a more attuned understanding of the nonprofit capital investment game. In addition to teaching others how to more effectively operate within the market, such efforts would have the added benefit of allowing those making grant making decisions to become better informed of the many options and strategies being pursued outside the mainstream network of more easily identifiable players. Greater effort in this area would be of benefit to both funder and grant seeker.

Market Hype Versus Vision Grounded in Practice

While vision is what sustains a people in times of need, vision alone is not adequate for achieving our goals. Vision must be grounded in the realities of practice, experience and history. In the aftermath of The New Era Foundation, the United Way scandal and a history of funding experiences where nonprofit organizations were perceived as not having achieved their stated missions,[20] the potential is great for "over-hyping" both the Nonprofit Capital Market and the players active within it. Some might say that a degree of "promotion" is good for the sector and just a part of how any marketplace of ideas should function. However, in the nonprofit sector, where charitable funds are precious and many donors and practitioners are sincerely searching for "a better way," the risk of losing funds on ill-conceived or overly risky ventures is great.

While there are certainly many creative and talented actors in the nonprofit sector in roles as funders and practitioners, there is a danger in our forgetting that ours is an emerging practice. In our rush to raise new funds, advocate new approaches to "old" problems and enlist others in our efforts, we should not forget to provide ourselves both a margin for learning and a commitment to building upon the actual experience of practitioners. If we neglect to do so, we will raise expectations beyond what we may be able to deliver and may well miss out on the potential for creating a learning community from which we can all benefit. It is a given in the for-profit market that there will be winners and losers. In the nonprofit market we have an ethical responsibility to help assure the responsible use of funds and pursuit of innovation.

Atrophied Investor Relations

The for-profit market is controlled to some degree by clearly enunciated, legally grounded terms that govern relations between investors and invested organizations. By contrast, grant proposals and personal relationships guide the Nonprofit Capital Market. This has led to the evolution of relationships between funder and fund seeker which are burdened with "spin," increasing the distance between those with the resources and those who require them. The development of honest, open investor relationships is difficult, yet critical to

the success of our efforts to both formalize and expand the Nonprofit Capital Market. And although understanding how to cultivate and manage such relations will take time, the benefits to be gained by both nonprofit organizations and funding institutions cannot be underestimated.

Going to Scale

As various players compete for funding in the Nonprofit Capital Market there is an emerging tension between the commitment to taking successful programs "to scale" and that of supporting a diverse range of strategies at various sizes. While it may be clearly of value to build upon success, a drive to go to scale may be motivated solely by the notion that "bigger is better." This tension between growth and stasis involves values related to our definitions of success, impact and worth in the sector. Perhaps "going to scale" is less important than an organization's achieving "appropriate scale"—and having access to the appropriate resources to do so. In some cases, this may mean an organization with demonstrated success receiving adequate funds to expand its work to other communities across the country and perhaps internationally. For others, scale may be a question of the organization's sustainability; funding may instead be targeted at enhancing the management and funding capacity of the nonprofit. This issue deserves greater attention in the near term, lest we risk losing opportunities to support community-based solutions in our drive to replicate proven successes of the field.

Conclusion

This chapter has presented a basic introduction to the Nonprofit Capital Market, its players and investment instruments. As our nation anticipates such substantial shifts as governmental devolution of funding and authority, the generational transfer of billions of dollars from parents to children and the critical needs of communities left behind in past decades of historic economic expansion, it is imperative those active in the nonprofit sector move to achieve greater, demonstrated success in our field.

The fundamental challenge of the Nonprofit Capital Market is not simply a function of applying more resources to problems, but of applying appropriate resources in strategic ways that will provide us with the return sought by all: funder, practitioner and community representative. Building upon the success of the past and the innovation of the present, we can only anticipate increased social return on the investment of charitable dollars in our future.

Footnotes

1 Excellent resources for understanding the sector include "America's Nonprofit Sector: A Primer" by Lester Salamon and "The Nonprofit Almanac" published by The Foundation Center.

2 This information is taken from the Independent Sector's Web Page,www.independentsector.org.

3 See chart of page 193.

4 This document, while written for and with the Nonprofit Capital Market Working Group, draws in part upon concepts and language presented in other documents published by The Roberts Foundation: specifically, the Foundation's work in the area of Social Return on Investment and its book, *New Social Entrepreneurs*. Copies of these documents are available at www.redf.org.

5 For additional information on socially responsible business activities, please contact Business For Social Responsibility or the Social Venture Network, both located in San Francisco, CA.

6 "A Study of the Availability and Sources of Venture Capital in Maine," produced by the Finance Authority of Maine, published in March 1995.

7 Community Wealth Creation Forum, October 1996, Washington, D.C.

8 For those interested in understanding the full breadth of the Nonprofit Sector, a good initial resource is the Independent Sector Web Page (www.independentsector.org).

9 It should be understood that the focus of this document is on those entities organized and operated exclusively for "religious, charitable, scientific, testing for public safety, literary, or educational purposes" or for other purposes as described within section 501(c)(3) of the Internal Revenue Code. Such entities are further categorized as "public charities" (generally thought of as the organizations that do good works and to which you and I may give tax-deductible contributions),and "private foundations," which are the organizations that generally fund public charities. Therefore, this document will not address organizations such as trade unions, mutual insurance companies, country clubs and some types of cooperatives. Even with this restriction, the focus of our discussion addresses thousands of nonprofits working in the areas of education, social services,the environment and so forth.

10 Also referred to as operational philanthropy.

11 Mr. Rosenberg, a well-respected investor and philanthropist, is the author of *Wealthy and Wise*, a book providing guidance to individual donors considering both the amount of and strategy most appropriate for their philanthropy.

12 This fact speaks directly to the "operating revenue" versus "capital investment" issue discussed above.

13 For a discussion of the "liquid" versus "dedicated" attributes of the Nonprofit Capital Market, please see "Grants, Debt and Equity: The Non-Profit Capital Market and Its Malcontents," found in the book, *New Social Entrepreneurs*, ordering information for which may be found at www.redf.org.

14 A distinction should be made here between providing a "direct financial return" and distribution of surplus funds. Technically speaking, nonprofits may provide a direct return to investors, as long as it is fixed interest at or below market-rate and is the result of an "arms-length" transaction. As discussed elsewhere, while nonprofits may issue bonds and borrow, they may not distribute or promise to distribute net surplus (net income) or their net assets to "investors" or others who control the nonprofit. However, when in line with their mission,nonprofits may provide funds directly to outside individuals (such as in the form of scholarships or other financial awards).

15 In the January/February 1997 issue of the Harvard Business Review, Chris Letts, et al,published *"Virtuous Capital,"* an article comparing the strategies of venture capitalists with those of foundation programs. In 1998, Stanford University's Graduate School of Business released *"The Roberts Enterprise Development Fund: Implementing A SocialVenture Capital Approach to Philanthropy,"* a case analysis of how one foundation has executed a focused strategy of venture philanthropy. Copies of the case are available through the REDF office and the Stanford University Graduate School of Business. And "When Pigs Fly," an article by Bruce Sievers, Executive Director of the Walter and Elise Haas,Jr. Fund, which critiques venture philanthropy as an approach for charitable support of nonprofit organizations,is also an interesting read.

16 Stanford University's Graduate School of Business has recently released a case study of the Roberts Enterprise Development Fund, analyzing both venture philanthropy and the issues raised by foundations' pursuit of such an approach. Ordering information is available through Stanford University and the offices of REDF:www.redf.org.

17 The Corporation for Enterprise Development (with the support of the Annie Casey Foundation), the Roberts Enterprise Development

Fund (of The Roberts Foundation) and other players are moving to promote frameworks to measure and quantify social return on investment. As these and other frameworks are formed and endorsed by the sector as a whole, the "metrics" by which standards may be created will evolve, moving toward the creation of standards and benchmarks against which competing investment opportunities may be measured. The REDF SROI framework is presented in a companion chapter of this book and the CFED document is available through their office (Washington, DC).

18 See www.ncib.org and www.guidestar.org for additional information on each of these organizations and their approach to establishing standards for the nonprofit sector.

19 "Financing Techniques for Nonprofit Organizations: Borrowing from the For-Profit Sector," was written by Caroline Williams for Creative America, a report by the President's Committee on the Arts and Humanities, Washington, D.C.

20 Recent polls have listed "nonprofit organizations" as close to used car salesmen in the degree of trust the American public has for their statements and actions.

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