Riding on the Bleeding Edge: A Framework for Tracking Equity in the Social Sector and The Creation of a Nonprofit Stock Market

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Based upon either the creation of an SROI framework or other greater ability to measure the creation of socio-economic value in the nonprofit sector, we now present a vision of our future that some might view as radical or bleeding edge:[1]

We propose that a number of forces are moving which make it possible to envision a time when the nonprofit sector organizes itself to support a Nonprofit Stock Market.

This idea, while obviously entailing a number of significant challenges, will become increasingly viable due to the following factors, each of which builds upon the other:

First, with the significant transfer of wealth from Baby-Boomer parents to their children over coming decades, it is estimated that over $4 trillion will change hands between generations. These funds will be controlled by individuals who have benefited greatly from the rise in the stock market of past years. They understand investing and demand accountability. They have the ability to contribute significant amounts of new capital to the nonprofit market; however, they distrust much of the existing system available to them to guide their giving.

Second, these new donors will demand new forms of information to steer their investments in the nonprofit sector, in the same way they demand information regarding their for-profit investments. The reality is that the nonprofit sector in many ways represents an illiquid capital market where a lack of objective information prevents the market place from attracting new and possibly larger amounts of capital. In the absence of such objective information, those who seek funding are forced to compete by means of pleas and pitches—not by the presentation of a rational explanation of why their particular strategy has been most effective or should receive increased financial support.

Third, the information and analysis increasingly demanded by potential donors will become readily available in credible forms not available in the past. GuideStar and related efforts will become more refined and through their efforts "raw"financial information regarding individual nonprofits—in the form of on-line access to IRS-990 forms and other data—will become readily available to donors in search of "objective" information. While GuideStar is working to assure that information they provide donors about nonprofits is well organized and has integrity, the raw data will be available to any who would download it, thereby making it susceptible to misuse and misinterpretation.

Fourth, the nonprofit sector will therefore increasingly need a process whereby organizations sharing similar areas of interest and strategies will be drawn into a discussion of standards, measures and analytic frameworks by which this new information will be weighed and assessed. The nonprofit capital market is already showing signs of this shift from charitable giving to a demand for philanthropic investing in social change strategies with a demonstrated track record of success—this trend will only continue and those managing nonprofit organizations will have to create a coordinated response.

Fifth, in future years the combination of available raw financial data and the efforts to establish performance standards will lay the foundation for the creation of organizations (both for-profit and nonprofit) that may operate in the manner of "nonprofit rating services." These entities will analyze data, assess industry standards and then "rate" the performance of nonprofit organizations competing for funds in the capital market.[2] There are increasing numbers of consultant organizations conducting "social audits" of for-profit corporations in order to inform both managers and shareholders about the performance of the corporation, and the same approach will evolve in the nonprofit sector.

Sixth, over the next decade, with these forces in motion,nonprofit organizations and those supporting their work will be forced to increase the capacity of the sector to create information management systems that can track social impact and performance measures embraced by the sector. As is the case with the REDF WebTrack System,these information and data tracking infrastructures will become increasingly viable as one way to measure both performance and the social return on investment generated by philanthropic and public sector funding. This "objective" data will be complemented with more qualitative, social impact reporting to form a baseline against which others will have to compare their own efforts.

Seventh, for the first time we will have the ability to describe an Industry Index for a given area of nonprofit activity. For example, there could be a performance index for youth programs serving different youth with varying presenting issues. Namely, we will be able to tie investments to results and compare organizations within a given market segment or cohort.

Eighth, we will come closer to understanding what elements of Social Value truly are beyond measurement. These areas will be vetted and supported on the basis of their uniqueness and intrinsic worth. Within a given organization or segment, we may be able to isolate elements that are immeasurable and value them for what they are. We will understand that it is the combination of both Socio-Economic and Social Values that creates the rationale for the sector as a whole and the legitimacy of supporting its development and work.

Finally, we will be able to more directly link documentation of social impact with grant making, individual donations and other funding decisions. But that is not all. We will build more rational arguments for increasing the availability of funds to various programs and under-capitalized areas of the nonprofit sector based on the social share earnings. In the future, we will be able to create systems that may more fully compensate nonprofit managers and service providers for actual demonstrated increases in the Socio-Economic Value they help create. Some may think it a terrifying concept to pay social workers based on the amount of Social or Socio-Economic Value they create. But increasingly we may be able to, based on this Socio-Economic Value created, track the social equity being generated in the sector through the shifting worth of any given organization's social share value—set by its generation of social earnings in the nonprofit market place.

With these metrics in place, individual charitable "investors" will be able to track the performance of their investments and even engage in trading shares at various class levels or leaving shares to heirs who would inherit a legacy of philanthropy. By extension, donors sharing similar interests might organize themselves into groups, similar to donor advised funds operated by many community foundations. These groups could organize their philanthropic gifts or investments into pools of similar nonprofits, each of which would meet baseline performance and social return criteria. These groups would then become the equivalent of charitable mutual funds—receiving investments, tracking social, socio-economic and economic "returns" to the investors. In this way, we have the potential to create a Nonprofit Stock Market wherein organizations receive annual performance reports tracking the activities of the sector over each quarter, year and decade.

In such a market, donors may purchase equity "ownership" in nonprofit organizations, tracking the social earnings and SROI of their charitable portfolio in the same way they would any other investment of capital. Through a variety of offerings, we could for the first time define the various returns and instruments lying along the continuum moving from socially responsible, for-profit investing to charitable giving. In so doing we will create an expanded capital market with new players bringing greater and greater amounts of capital into the nonprofit sector as they buy and sell "shares" in "community futures" and related commodities.

Other chapters in this book have addressed the challenge and opportunities of building management information systems to track social impact and value creation. With these systems in place, we may then pursue a shift to performance and outcome funding based upon the sector's true SROI. As performance comes to be tied directly to funding, moving funding decisions away from "grants" and toward "reimbursement for social value generated," it may even be possible to create actual financial cash flows to convert the projected socio-economic value of social programs to real economic value in the market place. Such a process would convert the imputed value of an SROI analysis into true,financial value that may then be tied back to the original investment that made that value possible.

As the balance of this chapter describes, how value creation is assigned—whether to investor, community, program participant or nonprofit in the form of organizational equity—will need to be determined.

Regardless, there is now the potential to:

a) quantify the economic value generated by nonprofit organizations,

b) return that economic value to those that created it (e.g. nonprofit organizations and their various community investors/ stakeholders) and

c) create a system by which nonprofits could be capitalized today based upon their projected future “social earnings” in years to come.

Now, for some the notion of a Nonprofit Stock Market may be the ultimate incarnation of a social nightmare whereby the effort to quantify value creation in the nonprofit sector has run fully amok. And, to be sure, there are certainly many challenges to be overcome if we are to achieve the ultimate potential represented by such an initiative. However, the fact that a goal carries some degree of risk does not mean we should not attempt to attain it. In the end, we will not be able to quantify everything. And there are certain efforts that should receive our charitable support simply because it is the “right” thing to do. However, the more we are able to quantify and track the social return on investment of those efforts that are quantifiable, the more we will appreciate and treasure the value of those things which are not.

Social Share Value, Social Earnings and Equity Ownership

How would this system of “investing” in nonprofits operate? How would a donor (whether individual, foundation or government) be credited for the value the investment makes possible? To begin addressing these questions, we must first understand how the current nonprofit capital market operates.

In traditional forms of philanthropy, a variety of funders might support various components of a nonprofit’s operations. If a single foundation is fully underwriting the cost of an organization’s development or a given program, that foundation will document the work of the program, taking “credit” for the effect of its grant in its annual report or similar documents. In essence, the foundation is reporting on its social return on investment.

In those cases where multiple foundations are supporting the same program, all funders report the total numbers generated by the program as being the “return” on their grant. Therefore, three funders providing $25,000, $50,000 and $100,000 grants to the same job-training program making 230 placements would all report that their grant support helped make 230 placements possible. This approach makes no allowance for assigning appropriate returns to funders taking greater risk or investing significantly greater resources in a given organization or strategy. Nor does it reward “social investors” for investing greater amounts in a given organization, save for possible “naming opportunities” or the generation of a modest side-bar in a local newspaper acknowledging a large grant.

While it is important for individual foundations to track the specific returns generated by their charitable investments,it must also be acknowledged that no single investment generates the total return. For example, a nonprofit may provide job-training, counseling and child-care services to its client customers. These services are all administered by the organization’s managers, and while each program participant may access services differently, it is the composite impact of the organization’s work that makes for the success both of individual participants and the organization as a whole.

Therefore, rather than simply attempting to calculate a return on the individual grant made by an outside foundation, it is more useful for funders to understand their investment as contributing to a total return that is, in effect, leveraged against other investments made in that same time period. What any foundation grant “buys” is not simply the single program funded by that foundation. The funder is also “buying” the added value of the organization’s administration (which may or may not be covered by the grant), other programs from which the funded program benefits, and other elements that make for the success of a given nonprofit organization.

In addition, it should also be understood that there is a residual value of all prior investments—what we call "organizational equity"—which constitutes the social value of the nonprofit organization and, collectively, the sector as a whole. While all philanthropic investments (e.g. grants) come into the organization in the form of cash assets and these assets may be spent down, over time they also build intellectual capital within the organization itself (i.e. "We know how to work with this population" or "We know how to build this type of affordable housing"). In our framework, during the investment period, the value generated accrues to the investor, but at the end of the investment period (e.g. when a grant is not renewed) the value created is retained by the nonprofit itself. In this way the organization builds not only "hard" assets in the form of buildings and equipment, but "soft" assets in the form of goodwill, intellectual capital and staff expertise.

As stated above, several dilemmas surface in attempting to structure this analysis:

How does one assign equity value for each investor in a given year?

How does one account for a prior year's philanthropic investments?

Is it possible to calculate the residual value of such investments as the organizational equity any nonprofit brings to the table?

If so, how does one then track additional investments in future periods?

In an effort to begin to address these questions, the following section of this chapter presents a framework by which philanthropic "equity" investments may be viewed, measured and valued relative to a variety of shareholders and the nonprofit "owner" (e.g. the nonprofit organization itself).

The Fundamentals of For-Profit Equity Structures

We must first understand how equity and investments are treated in the for-profit sector. A sample scenario for the assignment of equity in a for-profit start-up is presented as follows:

An entrepreneur starts a business with an initial investment of $1,000,000. Over the course of that year, the assets of the business are applied in the market place and the value of those assets increases by $200,000, providing for a year-end total value of $1,200,000 for the business, with no change in ownership position.

Beginning Year 1	Total Value	Percent Ownership
Owner 1	$1,000,000	100%
Asset Value Increase	$ 200,000	
End Year 1	$1,200,000	

At the beginning of Year 2 a partner is introduced who brings an additional $1,000,000 to the table. Owner 1 retains the increase in value from Year 1, but her equity position is decreased to accommodate the presence of the new partner. The business value increases by $800,000, for an End of Year 2 value of $3,000,000.

Beginning Year 2	Total Value	Percent Ownership
Owner 1	$1,200,000	54.55%
Investor 1	$1,000,000	45.45%
Total	$2,200,000	100.00%
Asset Value Increase	$ 800,000	
End of Year 2	$3,000,000	

At the beginning of Year 3 another investor is introduced who also brings an additional $1,000,000 to the table. Owner 1 and Investor 1 share the $800,000 increase in value from Year 2 in accordance with their equity positions in the enterprise.

Beginning Year 3	Total Value	Percent Ownership
Owner 1	$1,636,400	40.91%
Investor 1	$1,363,600	34.09%
Investor 2	$1,000,000	25.00%
Total	$4,000,000	100.00%
Asset Value Increase	$1,000,000	
End of Year 3	$5,000,000	

During Year 3, the value of the assets increases by $1,000,000. At the end of Year 3 the trio share the increase in value of $1,000,000 based upon their percentage ownership position:

End of Year 3	Total Value	Percent Ownership
Owner 1	$2,045,500	40.91%
Investor 1	$1,704,500	34.09%
Investor 2	$1,250,000	25.00%
Total	$5,000,000	100.00%

At this juncture, the return on investment is calculated as:

End of Year 3	Calculation	Return on Investment
Owner 1	($2,045,500-$1,000,000)/$1,000,000	104.50%
Investor 1	($1,704,500-$1,000,000)/$1,000,000	70.45%
Investor 2	($1,250,000-$1,000,000)/$1,000,000	25.00%

The REDF Nonprofit Equity Framework:

Application of Social Earnings to Nonprofit Calculations of Equity and Social Return on Investment

This for-profit framework is similarly invoked for the assignment of nonprofit share value. At Time Zero, Owner 1 is understood to be the nonprofit organization itself, with subsequent "owners" including foundations, donors, community residents or other philanthropic investors. The investments made in this enterprise generate not only a financial return on investment, but also create net social cost savings for society. As demonstrated in other chapters of this book, those savings then constitute the basis for calculating the social return on investment to all shareholders—both community and investors (foundation, governmental, etc.).

Our first step in the nonprofit application of a share value framework is to recalculate the equity ownership position as presented above. Let us assume in our example that at Time Zero we have two equity owners: the nonprofit corporate owners and a single foundation investor. The total value of the organization is estimated at $5,554,654 which is the example used in the social return on investment framework presented earlier.

How does one account for prior year investments, such as grants made in 1994? Is it acceptable to calculate the residual value of such investments as the organizational equity any nonprofit brings to the table? For the purpose of our present analysis, we have decided to "freeze" the assets of the organization at Time Zero and equate any residual value of prior grants as being "gifts" to the organization and have labeled them as "organizational equity." Any grants received in Time Zero may be thought of as current year investments in order to assign share value at the first point of analysis.[3] As additional grants are received, they are viewed as assets of the organization and assigned a "balanced" value of a given number of shares.

At the close of Year 1, the owners want to raise additional capital to support the pursuit of their social mission. They understand that if they do so, they will have to reduce their ownership position by a certain amount—in our example,25%.

If this were a for-profit capital raising effort,upon issuance of the shares to the market (what is known as an "initial public offering") and assuming the investment bankers priced the issue perfectly, one million shares would be issued at $5.554 each. Because the two owners will maintain 50% ownership, each will be assigned ownership of 250,000 shares at $5.554. This amount is equal to 50% of the total estimated value of the nonprofit organization. The publicly issued shares and the privately held shares sum to equal the estimation of the firm value: $5,554,654.

In this sample calculation, we will assume there is "perfect" market information, such that all known information is disseminated throughout the investment community. For purposes of demonstration, we are assuming no insider information exists which might have an effect on share value beyond that of the underlying assets.[4]

Therefore, in this example, the only factors that affect the share price are the actual performance of the business operations and the net social benefit to society. As presented in the previous section, at Time Zero there are projections made regarding the future economic and social returns in subsequent years. These projections, together with the actual asset base of the nonprofit at Time Zero, form the basis for calculating share value of the organization as a whole. Going forward, the organization's overall assets and value will change as new investments are made, retained earnings are generated by the business and social impacts created through the operation of its programs. Any increase or decrease in these values will affect the share price accordingly.

This is best illustrated with the following example:

Total Number of Shares	**1,000,000**
Original Price/Share	**$ 5.55**
Value Business Operations	**$3,182,056**
Net Social Value	**$2,372,599**
Total Market Capitalization	**$5,554,654**

Time 1

Beginning Value	**$5,554,654**
End of Year Value	
Business Operations	$3,684,930
Net Social Benefit	$3,469,321
Total	$7,154,251
Change in Value from Time1 to Time 2	
Change in Business Operations	$ 502,874
Change in Net Social Benefit	$1,096,722
Change in Total Value	$1,599,597
Change in Share Price	
Inc/Dec Price Per Share *(Change in Total Value/# of Shares Outstanding)*	1.600
New Share *(Old Share Price + Inc/Dec Price Per Share)*	7.154
Change in Share Return	
Total Percentage Change	28.80%
Business Return	9.05%
Social Return	19.75%

The REDF Nonprofit Equity Framework has been designed to replicate a quasi-stock market such that only two pieces of information affect the share value: profits and net social benefit to society. Any increase or decrease in value between the two will affect the price per share.

In this example, we started with 1,000,000 shares outstanding at a price of $5.554. The total market capitalization or value of the outstanding shares is $5,554,654. After the first time period the business produced an increase in operating profits of $502,874 and an increase in social benefits of $1,096,722. Thus the value of the organization has increased by $1,599,597. Interpreting these results, shareholders would increase their selling price in the market place to reflect the increase in firm value. Because 1,000,000 shares are outstanding each share would rise in price by $1.60 resulting in a new share price of $7.154, calculated by dividing the rise in value by the number of shares outstanding.

In applying this for-profit scenario to the nonprofit sector, at least two significant issues need to be addressed:

First, ***how does one allow for prior year investments?***

The example assumes one can "freeze" values at Time Zero[5] in order to create a baseline against which future valuation may be calculated. This assumes, therefore, that all prior grant and other investments made in the organization remain with that organization in the form of organizational equity. In the for-profit example, this is best thought of as the owner's initial investment. In Time One (when new, outside philanthropic investments are received), the equity structure is revised to reflect both the new investment and the presence of a new shareholder.

An additional reason to set Time Zero as a baseline for nonprofit equity assignments is that the vast majority of nonprofit organizations have no management information system in place to track social impacts or the leverage of prior investments. Therefore, most estimations of value are inherently flawed and unreliable. The authors assume that, similar to REDF's investment in developing an accurate management information system for its investee organizations, those attempting to implement this approach to share valuation will have similar systems available to generate future data with the integrity to calculate business and social return.

A second significant issue is ***how to create a nonprofit "anti-dilution" clause to protect the community organization from losing equity control of its activities.***

For example, over a 10-year period the organization will receive more and more grant and other funds to support its work. While the initial position of the organization as controlling 100% ownership at Time Zero may be initially acceptable, over time that position will decrease with the addition of each new philanthropic investor. This creates a possible scenario where the organization may ultimately have virtually no claim on the social and other returns generated through its own work.

At this time our framework is simply a tool for financial analysis of social return on investment and does not translate to true "equity ownership" of the nonprofit involved, but the intellectual challenge remains:

How do we create a framework to assure the investors do not end up in control of the organization as opposed to the community of which it is a part?

The following illustrates the nonprofit dilemma of equity ownership dilution as a result of obtaining outside financing.

The nonprofit is incorporated with $1,000,000 of organizational equity financing.

Time Zero	Total Value	Percent Ownership
Nonprofit	$1,000,000	100%
Asset Value Increase	$ 200,000	
End of Year	$1,200,000	

Upon the initial success of the organization a foundation or other entity decides to contribute $1,000,000 to the nonprofit. The nonprofit retains the $200,000 increase in value from the beginning of the year to the end.

Beginning Time 1	Total Value	Percent Ownership
Owner 1	$1,200,000	54.55%
Funder 1	$1,000,000	45.45%
Total	$2,200,000	100.00%
Asset Value Increase	$ 800,000	
End of Time 1	$3,000,000	

At the beginning of Year 1, the nonprofit is valued at $2,200,000. By the end of Year 1, its value has increased by $800,000 to $3,000,000. The nonprofit and Funder 1 share the increased value based upon their equity ownership percentage. In addition, at the start of Year 2 a new funder contributes $2,000,000 to the nonprofit.

Beginning Time 2	Total Value	Percent Ownership
Nonprofit	$1,636,400	32.73%
Funder 1	$1,363,600	27.27%
Funder 2	$2,000,000	40.00%
Total	$5,000,000	100.00%
Asset Value Increase	$1,200,000	
End of Time 2	$6,200,000	

Again the increased value of $1,200,000 is distributed based upon the equity percentages. The Year 3 equity position is described below.

Beginning Time 3	Total Value	Percent Ownership
Nonprofit	$2,029,160	32.73%
Funder 1	$1,690,840	27.27%
Funder 2	$2,480,000	40.00%
Total	$6,200,000	100.00%

Funder 2 now retains the majority equity position. The nonprofit no longer maintains the majority interest and control.

While a potential challenge, ownership dilution may be addressed in the following three ways:

First, we do not expect the funder will continue its commitment to the organization indefinitely. Many foundations make one-time grants or will only commit support for up to three years. REDF, engaging in a venture capital approach to social purpose enterprises, incorporates a much longer time horizon for capital support and technical assistance, up to seven years or more. Throughout this time period the funders may obtain a substantial portion of the equity ownership. However, upon completion of the relationship and assistance, the nonprofit could assume the equity position of the individual funder.

For example, Funder 1 decides to end the funding relationship with the nonprofit. Therefore, the 27.27% equity ownership formerly held by the funder is passed to the nonprofit.

Beginning Time 3	Total Value	Percent Ownership
Nonprofit	$3,720,000	60.00%
Funder 2	$2,480,000	40.00%
Total	$6,200,000	100.00%

In this way, ***the REDF framework conceptually assigns equity ownership to funders as a means of quantifying the social return on philanthropic dollars, not as a means of thwarting the control, direction, makeup of management or the pursuit of social mission.***

A second approach to the ownership issue might be the conversion of individual donors (those providing annual contributions in support of a nonprofit) to nonprofit shareholders who would, in effect, "own" the nonprofit. Presently, many nonprofits claim to be community-based, but in reality are governed by boards of directors who often have little direct connection to the affected community. A "community nonprofit shareholder" approach could both broaden true community ownership and act as a vehicle for nonprofits to raise additional capital.

Finally, nonprofits could issue various classes of stock (Senior, Preferred, etc.) which could have voting or non-voting status depending upon financial and other factors, such as residency. In these ways the "ownership" could remain with the community in question.

Conclusion

Clearly, the vision and ability to create an operating Nonprofit Stock Market that trades nonprofit shares is many years off and, perhaps,unattainable. There are many significant challenges to the creation of a Nonprofit Stock Market, ranging from the formidable task of creating information systems with adequate integrity to track real social value to issues of how to assign appropriate "ownership" positions to various financial and nonfinancial stakeholders. Indeed, it is most likely that the idea may simply remain that—an idea for what a nonprofit future could hold.

Regardless, nonprofit organizations are seeking new sources of capital, working to create secondary markets for the loan portfolios of community development/finance institutions and pursuing evolving relationships with for-profit and other partners. A vision of our future that includes social mutual funds, nonprofit bond markets, and, yes, a Nonprofit Stock Market may have the long-term effect of helping us step out of our present paradigms. These visions of our future may help us to understand new relationships, funding opportunities and ways of advancing our progress toward the achievement of greater social and economic justice. We offer these thoughts as part of our effort to advance new ideas to help inform our work in coming decades.

Footnotes

1 Indeed, one reviewer concluded that our vision was downright wacky! It is, of course, good to know we've still got it!

2 We first raised this idea in the chapter entitled, "Grants, Debt and Equity: The Nonprofit Capital Market and Its Malcontents," found in *New Social Entrepreneurs* at www.redf.org.

3 It should be acknowledged that not all grants should be viewed as investments in that some grants may be made in support of or reimbursement for the provision of services and are a form of "third-party payment" more than they are an "investment." This distinction will be explored in future documents.

4 The reader should recall, however, that without commonly endorsed standards, there is no present liquidity and no perfect market information upon which potential nonprofit "investors" may rely.

5 In investor parlance, Time Zero represents today, Time One is a year from today and so forth, going forward to the end of the investment period.

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