STANFORD
GRADUATE SCHOOL OF BUSINESS
STANFORD SOCIAL INNOVATION *review*

The Funding Gap

By Michael Chertok, Jeff Hamaoui, and Eliot Jamison

Stanford Social Innovation Review
Spring 2008

the Funding GAP

Social enterprises combine the best of the nonprofit and for-profit worlds, but that very innovation has made it difficult for them to raise money. Philanthropists are reluctant to give grants to profit-making organizations, and commercial investors are wary of investing in organizations that are driven by a social mission. The authors explore the social enterprise capital market and offer short- and long-term solutions to this funding gap.

by MICHAEL CHERTOK, JEFF HAMAOUI, & ELIOT JAMISON

ILLUSTRATION BY MASTERFILE

On a trip to the ancient temples of Angkor Wat, Jeremy Hockenstein was struck by how many of the young Cambodians he met had worked hard to learn English and computer skills and yet were not able to find jobs that used their talents. In 2001, shortly after returning home to the United States, Hockenstein set out to help solve this problem by founding the nonprofit Digital Divide Data. Today, Digital Divide Data employs nearly 500 disadvantaged young people in Cambodia and Laos to perform a variety of IT services for the company's clients around the globe. In addition, more than 200 former Digital Divide Data employees now work in jobs in other organizations that pay an average of six times Cambodia's per capita income.

Not only has Digital Divide Data provided Cambodian and Laotian youth with jobs and training, but in 2005 the organization broke even financially. Having proven Digital Divide Data's business model, Hockenstein wanted to expand the organization, but he was unable to convince investors or donors to give him enough money to grow the operation at a fast pace. "After we proved that our business worked and could bridge the divide that separates young people from opportunity in poor countries, we thought we'd be able to raise

millions to expand this work," says Hockenstein. "Instead, we worked tirelessly over two more years to attract more modest financing."

Several social enterprise funders turned down Digital Divide Data because their criteria didn't accommodate the organization's business model or stage of development. A small group of institutional funders and individual donors did help the organization continue to grow, but at a slower pace than Hockenstein had envisioned.

Digital Data Divide is not the only social enterprise that has found itself up against this funding gap. Social entrepreneurs are often able to raise start-up capital ranging from $100,000 to $250,000 from foundations, business plan competitions, fellowships, friends and family, angel investors, or sometimes even small venture funds. But when it comes to raising money to grow the social enterprise – $250,000 to $2 million or more – social entrepreneurs have had less success.

At one level this is not surprising. Entrepreneurs starting social enterprises *should* find it difficult to raise capital – not every social enterprise deserves funding, and capital markets for socially oriented business ventures must be competitive. But the difficulties in this market go beyond what the ordinary and healthy competition for capital presents. The experience of the few funders in this space, as well as of seasoned social entrepreneurs, suggests that there is only a very limited capital market for investments of $250,000 or more. Indeed, even finding good funding data on this emerging sector is a challenge.

Heerad Sabeti, a co-founder of transForms and the Fourth Sector Network who has in partnership with the Aspen Institute studied the social capital marketplace, says it best: "A great deal of entrepreneurial energy is thwarted by a lack of mission-aligned early-stage capital for social ventures, and for the capital that exists, access is limited. Social purpose ventures that make it past this stage often do so by compromising their mission and values in order to satisfy investor demands."

MICHAEL CHERTOK *is a program officer at a large private foundation. Previously, Chertok served as managing director of Global Catalyst Foundation, board chair of Digital Divide Data, a partner at Origo Global Business Advisors, and a member of the United Nations Task Force on Financial Mechanisms for ICT for Development.*

JEFF HAMAOUI *is the founder and managing director of Origo Global Business Advisors. In the eight years since founding Origo, he has worked with private and public sector organizations in more than 30 countries, including the U.S. Agency for International Development, General Electric Co., GrupoNueva, Goodwill Industries, and the W.K. Kellogg Foundation.*

ELIOT JAMISON *works in the infrastructure investment group at Babcock & Brown, an investment and fund management group. Before joining Babcock & Brown, Jamison was a partner at Origo Global Business Advisors.*

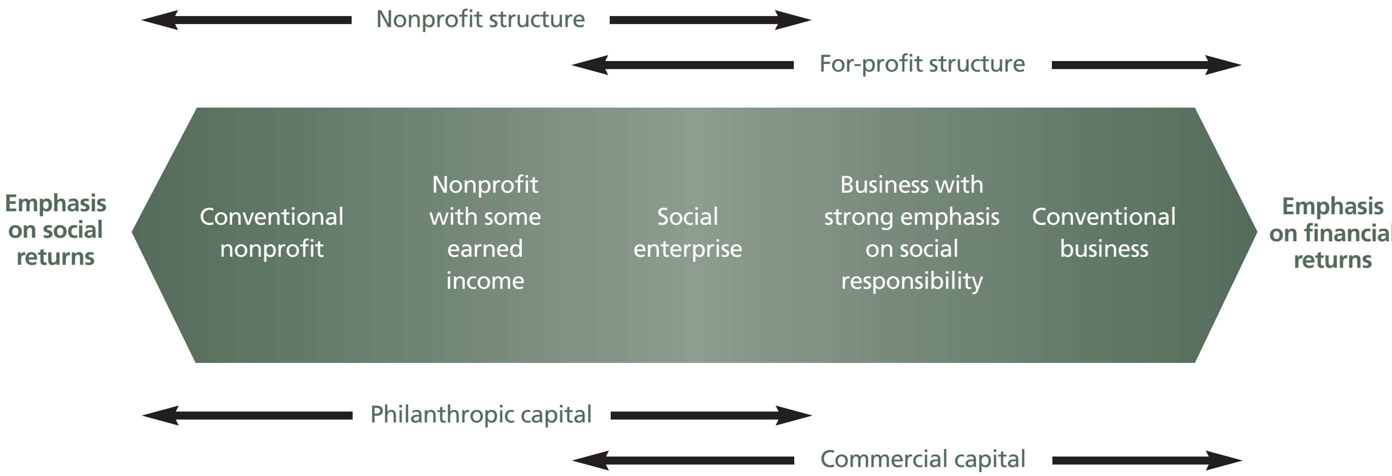
One of the reasons social enterprises have trouble raising money is that they do not fit neatly into either the traditional nonprofit or for-profit model. (See "Spectrum of Social and Financial Returns" at right to see how social enterprises fit between traditional nonprofit and for-profit organizations.) Foundations and other philanthropists are used to donating money to traditional nonprofits but are often uncomfortable donating money to an organization that generates a profit. Commercial investors, on the other hand, are used to investing in traditional for-profits but are often uncertain about investing in organizations with an explicit social mission.

Social enterprises sit at an intermediate point on the spectrum, because they have a joint emphasis on producing financial returns for investors and on producing positive outcomes in society. But the core idea behind a social enterprise goes beyond the trade-off or balancing act between social and financial returns. Instead, it relates to the ways in which innovation and an entrepreneurial approach can produce organizations that achieve an abundance of both social and financial returns. The pressure to consider financial, social, and environmental results forces managers to rethink long-standing business practices and imagine new ways of operating.

When it comes to financing, it's important to realize that a social enterprise can be incorporated as either a nonprofit or a for-profit and can seek financing from both commercial and philanthropic sources. A nonprofit social enterprise, however, is limited in the types of commercial capital it can raise. It cannot sell equity or make distributions of profit, but it can take out commercial loans. For-profit social enterprises do not face those same legal constraints. Nevertheless, potential philanthropic funders are likely to be more skeptical and ask a for-profit to prove how much social value it is creating and why it deserves philanthropic support.

Another reason that funders are uncertain about investing in social enterprises is the lack of agreement among social entrepreneurs and their supporters about what exactly a social enterprise is. For some it refers to a nonprofit organization that has started a commercial venture to raise extra funds. For others it refers to nonprofits that have adopted an entrepreneurial or businesslike approach to solving social problems. And for still others it refers to any organization, for-profit or nonprofit, that creates positive social impact and has some earned income, no matter how minor either of these components is. In this article we adopted the Social Enterprise Alliance's definition of a social enterprise as "an organization or venture that advances its social mission through entrepreneurial earned income strategies." The organization can be either a nonprofit or a for-profit.

SPECTRUM OF SOCIAL AND FINANCIAL RETURNS



A number of authors have described variations on this diagram and the concept of a spectrum of organizations from for-profit to nonprofit. For example, see Jed Emerson, "The Blended Value Proposition: Integrating Social and Financial Returns," California Management Review *(Summer 2003).*

Creating Hybrid Enterprises

Rather than choosing between a for-profit and a nonprofit structure, some social entrepreneurs do both, creating a hybrid structure consisting of two distinct but related organizations – one a for-profit and the other a nonprofit – with closely related missions and overlapping operations. One of the primary reasons entrepreneurs create hybrid organizations is that it allows them to approach philanthropic and commercial capital providers in ways that are familiar to each type of funder. The nonprofit can approach individual donors and foundations for a grant, and the for-profit can approach debt and equity investors on commercial terms.

Hybrid organizations need to pay particular attention to legal and tax issues. Safeguards must be put in place to ensure that the for-profit does not receive improper financial benefit from its affiliation with a tax-exempt nonprofit. The two organizations should be separate enough to function on their own and take full advantage of the different opportunities available to each organization.

All hybrids have separate for-profit and nonprofit entities, but the two organizations can be linked in many different ways. Sometimes the for-profit is partially owned by the nonprofit, and at other times there is no cross-ownership. The extent to which the two organizations share board members, staff, and offices can vary. And the way that the for-profit's earnings are shared with the nonprofit can take many forms, including dividends, royalties, license fees, or donations.

One example of a hybrid organization is World of Good, a Berkeley, Calif., for-profit company founded by Priya Haji and Siddharth Sanghvi, two friends who received MBAs from the University of California at Berkeley's Haas School of Business. After studying the fair trade movement in the United States, Haji realized that the lives of thousands of female artisans the world over could be improved by selling handcrafted products – which range from Indian silk scarves to Vietnamese serving plates – to socially conscious consumers.

In its first full year of business, World of Good sold more than 100,000 handmade items crafted by 133 artisan groups in 31 countries – all of which helped make concrete improvements in the lives of more than 2,500 artisans and their families. The organization created employment for the disabled in Cambodia and for HIV-positive women in Swaziland. It also promoted fair trade with its purchasing practices.

World of Good reinvests 10 percent of its profits into its affiliate 501(c)(3) nonprofit, World of Good Development Organization, which is committed to building a stronger fair trade crafts movement in the United States, to promoting transparent international fair trade standards, and to investing in economic and social development projects in craft-producer communities. Unlike some hybrids, there is no cross-ownership between these two organizations, but there is operational overlap. Each organization has a five-member board, with two members in common, and one of the co-founders and some of the staff help manage both organizations. The mainstream venture capital fund Draper Fisher Jurvetson has invested in World of Good.

Hybrid structures have some disadvantages. Establishing two separate organizations takes more time and money than does establishing just one. In addition, realizing synergies between the for-profit and nonprofit activities may be more difficult, given their organizational separation and the legal requirements that govern their interrelationship.

Investing in Social Enterprise

Despite the very real funding gap that exists in the social enterprise capital market, investors are getting interested. In recent years, for example, a new breed of venture capital fund invests in companies offering social and financial returns. Angel investors, who in the past were interested only in making the highest financial return possible, have begun to invest in mission-driven businesses as well. Foundations have also begun to invest some of their endowment funds in social enterprises. Despite their promises, these efforts remain highly fragmented.

To better understand the scope of the social enterprise capital market, we have divided it into two parts. The first source of capital is individuals and institutions that invest their own money directly in the social enterprises – what we call *direct investors*. The second source of capital (which we discuss in the next section) is intermediaries that invest other people's money in social enterprises – what we call *intermediary investors*.

There are five types of direct investors: angel investors, philanthropic foundations, endowed nonprofits, international development agencies, and pension funds. (See "Direct Investors" at right for a further discussion of each type of investor.) A growing number of people believe that their investment capital can be a force for positive change and so dedicate part or all of it to instruments that they have identified as having a positive social impact. Most make their investments through intermediaries such as mutual funds, but some invest directly in other enterprises.

The most common type of direct investor is the angel investor, who typically invests small amounts of money at an early stage when social enterprises are still small. Angel investors sometimes work in groups. One example is Investors' Circle, whose membership is primarily made up of individual investors but which also includes professional venture capitalists, foundation officers, and family office representatives. In aggregate, Investors' Circle members have invested more than $120 million in more than 190 social enterprises.

Although a small number of angel investors have begun to invest directly in social enterprises, they are not yet doing so on a wide scale. Today, it is more common for institutional investors, such as foundations, to invest directly in social enterprises. The W.K. Kellogg Foundation joined this movement most recently, and it has done so in a significant way – committing $100 million to mission-driven investing ($25 million in Southern Africa and $75 million in the United States). An explicit part of the foundation's objective is to experiment and learn.

Direct Investors

Angel investors are wealthy individuals who typically invest in early-stage businesses, taking a share of the company in exchange for their money. Recently, angel investors have also begun to invest in social enterprises. Investors' Circle, a network of angel investors who fund social enterprises, is one of the most prominent examples.

Philanthropic foundations are institutionally and legally committed to charitable purposes and have large pools of capital in their endowments. They would seem to be natural candidates for investing in social enterprise. In practice, however, foundations have done very little of this type of investing. A few philanthropic foundations, such as the F.B. Heron Foundation, the Ford Foundation, the W.K. Kellogg Foundation, and the Omidyar Network, have been relatively active in this area.

Endowed nonprofits, particularly universities and hospitals, have large endowments. Although these nonprofits pursue their charitable missions through direct programs rather than providing grants to other organizations, their endowments could be used to invest in social enterprises aligned with their mission. Currently, little such activity exists.

International development agencies provide financial support for economic development in low-income countries. Their largest programs tend to be government-to-government loans and grants, but many also support private enterprises through grants and direct investment. International development agencies are increasing their support for private enterprises and have begun to examine the role that social enterprise can play in economic development. For example, the U.K. Department for International Development has funded a series of "challenge grant" programs that have funded, on a competitive basis, private enterprises with development benefits.

Pension funds are responsible for providing financial benefits to retirees and so are primarily driven by financial returns. Therefore, pension funds are mostly interested in social enterprises whose for-profit businesses manage to make competitive financial returns. Some public employee pension funds, however, particularly state ones, are beginning to consider social returns alongside financial ones. Although some large pension funds invest money directly, most invest through intermediaries such as banks and mutual funds. CalPERS (the California Public Employees' Retirement System) is an example of a pension fund that has begun making socially driven investments (through both its Green Wave program and its California Initiative).

–M.C., J.H., & E.J.

The International Finance Corporation (IFC), the private sector arm of the World Bank, is another institutional investor that has begun to invest directly in social enterprises. The IFC has been actively exploring how to support social enterprises in developing countries – using both financing and technical assistance – through its Grassroots Business Initiative. The IFC believes that revenue-generating businesses can help reduce poverty by creating jobs and ensuring that critical goods and services are priced fairly.

One organization that the IFC has supported is Roundabout Outdoor, a socially responsible South African advertising company that developed PlayPumps, a merry-go-round that doubles as a community water pump. They have also invested in Honey Care Africa, a Kenyan social enterprise that helps subsistence farmers become profitable, honey-producing beekeepers.

Social enterprises are still a long way from the time when individuals and institutions will routinely consider investing in them directly. But even modest movements in this direction could unlock significant amounts of capital for positive social change.

Raising Money From Intermediaries

The second source of capital for social enterprises is intermediary investors who invest other people's money. We identify seven types of intermediary investors: social venture capital funds, community development financial institutions, social enterprise and nonprofit loan funds, international small- and medium-size enterprise development funds, venture philanthropists, specialized foundations, and socially responsible mutual funds. (See "Intermediary Investors" on p. 50 for further discussion of each type of investor.)

Because intermediary investors work on behalf of the ultimate owner of the money, they are often bound by explicit agreements with their investors or donors about how they can invest the funds. As a result, existing intermediary organizations are likely to be slow to adopt practices that are new and that may be perceived as risky or unproven. They are also cautious about using any considerations beyond the direct financial interests of their investors.

Both of these factors suggest that existing intermediary organizations may be slow to provide support for social enterprises. Nevertheless, newly formed intermediaries that were explicit with their investors about including social enterprises among their investments, such as socially responsible mutual funds, are more likely to be a source of investment capital for social enterprises.

One example of an intermediary investor is the NewSchools Venture Fund, a nonprofit venture philanthropy firm with a mission to improve K-12 education in the United States. The firm invests in both for-profit and nonprofit organizations. NewSchools Venture Fund's investment can take the form of a grant, loan, or equity investment, depending on which is best suited to the organization's needs. The financial returns from loans and equity investment are recycled back into the fund and invested in new organizations. Because NewSchools Venture Fund is a 501(c)(3) organization, it receives all of the capital that it raises in the form of gifts.

Another intermediary investor is SJF Ventures and the affiliated SJF Advisory Services, a community development venture capital firm that invests in growth-stage businesses in geographic areas or business sectors that are overlooked by traditional venture capitalists. SJF Ventures is a limited partnership with investors that include financial institutions, foundations, and individual investors; it intends to provide commercially competitive returns to these investors. SJF Advisory Services is an allied nonprofit that provides entrepreneurial, workforce, and sustainability assistance services to the organizations in which it invests. SJF Advisory Services is funded through grants from government and foundation sources. Although the companies have different funding sources, they work closely together and have complementary operations that support a common mission.

Leveraging Government Power

Government policy plays a significant role in influencing the decisions that philanthropists and commercial investors make. Two of the most powerful tools that government policymakers wield are tax policy and regulations, each of which is a point of leverage for spurring (or inhibiting) investment in social enterprises.

For example, in the United States the tax deductibility of charitable contributions creates an incentive for people to divide their money into two pools – one to invest and one to donate to charity. Under existing policies, investing in a social enterprise that produces below market rate returns does not qualify an investor for a partial tax deduction or similar credit, so it is less advantageous from a tax perspective.

Tax policy can, however, create incentives for investment in social enterprises. In 2005 the United Kingdom created a new type of organization – the community interest company (CIC) – which shares some characteristics of nonprofits and for-profit business. A CIC is legally obligated to operate for the benefit of the community, not just for its shareholders. It can be privately or publicly owned and can pay its board members. There are now 1,408 CICs in the United Kingdom, ranging from the Dartmoor Railway, a small passenger railroad in the

Intermediary Investors

Social venture capital funds focus on companies that meet various social and environmental criteria, such as clean technology, education, health, and community development. A recent survey found that social venture capital funds in the United States had approximately $3 billion in assets. One example of a social venture capital fund is Commons Capital.

Community development financial institutions make loans and equity investments in social enterprises that focus on low-income communities. They tend to focus on affordable housing and small business development. Examples of community development financial institutions include SJF Ventures and Pacific Community Ventures.

Social enterprise and nonprofit loan funds make loans at market rates or below and often explicitly target social enterprises. They are intended to fill some of the financing gaps discussed previously, but not many of these funds exist and they tend to be limited in scope. Two examples of social enterprise and nonprofit loan funds are the Nonprofit Finance Fund and Partners for the Common Good.

International small- and medium-size enterprise (SME) development funds support the small- and medium-size enterprise sector in developing countries. They are created by development agencies, foundations, and private investors. Although not all SMEs are social enterprises, many of these funds invest in SMEs because organizations of this size create many positive economic and social effects. E+Co, based in Bloomfield, N.J., is an example of such a fund; it has a track record of successful investing in clean energy enterprises in emerging markets – generating financial, social, and environmental returns.

Venture philanthropists are a diverse group with a common thread. They all apply some aspects of a venture capital approach to philanthropic giving. For example, venture philanthropists might provide advice on operations in addition to just lending money, measure performance intensively, and make explicit plans for "exiting" the investment when the enterprise becomes self-sustaining. One example of a venture philanthropist is NewSchools Venture Fund.

Specialized foundations are a small but growing group. They focus explicitly on giving individuals the tools to channel their investment and philanthropic dollars into social enterprise. One example of a specialized foundation is the Calvert Foundation.

Socially responsible (SR) mutual funds invest in publicly traded companies. They are most relevant for established, for-profit social enterprises that are already publicly held or are considering an initial public offering. Some of these funds also invest a small percentage of their capital in community development projects and social venture capital. Portfolio 21 and Domini Social Equity Fund are two examples of SR mutual funds.

–M.C., J.H., & E.J.

Devon countryside, to Radio Asian Fever, a radio station targeting the Asian community in Leeds.

Another tool government policymakers can use is tax credits. For example, in 2005 Congress passed the Renewable Electricity Production Tax Credit, which provides a 1.9 cent per kilowatt-hour credit during the first 10 years of a renewable energy facilities operation. These credits make it less expensive for new companies to produce wind and solar power systems and have allowed them the opportunity to compete for commercial sources of capital.

National governments and international institutions such as the World Bank have, at times, provided businesses investing overseas with risk insurance or loan guarantees to partially mitigate the risk. For example, the Overseas Private Investment Corporation, an agency of the U.S. government established in 2001, has provided crucial financial guarantees for the securitization of microenterprise loans, low-income housing financing, and clean energy projects around the world.

In the United States, the federal government has made interest on bonds issued by state and local governments free from federal income tax, and it extends the same benefit to certain bonds issued by nonprofit organizations. This allows these organizations to raise capital from the mainstream financial markets on more favorable terms.

These examples are just a few of the government-initiated programs and regulations that are in place around the world to encourage investment in areas that otherwise might not attract funding from commercial sources. These examples do not all relate directly to social enterprise, but they do demonstrate the tools and techniques that could be used to further the growth of social enterprise or to remove barriers that might be preventing such growth.

Taking on New Tasks

Creative entrepreneurs have found new sources of investment capital to fund their social enterprises. And bold investors have pioneered new types of investment vehicles to fill the funding gap. Still, the amount of growth capital for social enterprises remains inadequate.

We have identified a number of short-term actions and long-term research projects that can help organizations increase the flow of capital to social enterprises, particularly to increase access to growth capital. Some of these actions require many organizations to coordinate their efforts, but others require just a few players.

Short-Term Actions

Tool kits. A consortium of entrepreneurs and professionals (lawyers, accountants, and strategy consultants) should create a tool kit of basic resources that would make it easier for entrepreneurs who are starting social enterprises to choose and implement an appropriate organizational form. The tool kit would provide templates of organizational documents and checklists of required approvals.

Incubators. A leading foundation should create and fund an incubator where entrepreneurs would have the space, time, and money to experiment with different funding mechanisms and develop new financial tools. Many entrepreneurs, often with top-notch experience in the for-profit and nonprofit funding worlds, have creative ideas for new funds and tools to address some of the capital challenges identified in this article.

Education and Training. Academic institutions, think tanks, and consulting firms should develop education and training programs on social enterprise. These would include awareness-raising events, conferences, publications in trade journals, a general media strategy, and partnerships with university programs. For example, these leaders could develop new curricula to train money managers in how to incorporate environmental and social factors into their investment analyses and strategies.

Long-Term Research

Fiduciary Duty. There is a wide variety of opinions on the extent to which pension fund managers and other fiduciaries can legally take into account nonfinancial considerations when making investment decisions. Further clarification of this issue will help existing investors make better decisions and help policymakers understand whether they need to make further changes in the appropriate regulations.

Financial Returns. Researchers should investigate what types of financial returns investors can reasonably expect from social enterprise investments. They now have enough evidence from certain fields of social enterprise, such as community development, to assemble good information on this question.

Investment Trade-offs. There has been a great deal of discussion and some surveys about the trade-offs that investors make between financial and social returns, but little empirical research on the subject has been done. Economists and other social scientists have developed sophisticated methods for understanding people's true preferences, and these should be applied to determine the extent to which investors and donors might choose various social enterprise investment options.

Government Policy. Researchers need to undertake a detailed study of the ways in which government policy affects the social enterprise capital market and the ways that it might affect the market in the future. The study should go beyond obvious policies like tax-exempt status, and look at other policies like loan guarantees, enforcement of nonprofit regulations, and government purchasing decisions.

Economic Efficiency. Social enterprise leaders need better answers to the question whether social enterprise is truly a more efficient way to achieve social and economic goals or if it just reshuffles existing activities without actually making them better. Answering this question requires detailed studies of the economic efficiency of social enterprise and its role within the broader economic system.

Sometimes Success Breeds Success

Despite the challenges that Hockenstein faced when he was trying to raise money for Digital Divide Data, his organization is now seeing success. In 2006 the organization achieved profitability in its business-related activities, and in early 2007 the organization received a commitment from the Swiss Agency for Development and Cooperation for a total investment of $910,000 over three years. In part because of this grant-based financing, Digital Divide Data's staff and revenue doubled over the past year.

Even this financing package – generous in the realm of social entrepreneurship – is modest when compared to the tens of millions of dollars that people regularly invest in for-profit ventures. Digital Divide Data continues to look for other sources of philanthropic and patient capital financing. Hockenstein, ever the entrepreneur, boasts that Digital Divide Data has increased its margins from 21 percent to 34 percent over the past year, and asks, "Who wouldn't want to invest in this business?"

Nevertheless, social enterprises still need more capital, particularly at the earlier and riskier stages of the social investment spectrum. As Tom Reis, a long-term investor with the Kellogg Foundation, puts it: "Everyone is willing to back the already proven horse, but very few are stepping up and taking the early-stage risks that not only would really help these social entrepreneurs, but also are part and parcel for investors who truly want high social and financial returns. High risk, high rewards – isn't this the game we are supposed to be playing?" □

A grant from Applied Materials Inc. supported the research and writing of this paper and Social Fusion partnered with us to produce it. We have benefited from the input and commentary of numerous colleagues in the writing of this paper.

The opinions expressed in this article are those of the authors and do not necessarily reflect those of their employers.