Social Investors on the Sidelines

A new study finds socially responsible investors interested in MSEs but wary.

As much as US$24 billion in socially responsible investments (SRIs) is waiting in the wings for micro and small enterprise (MSE) investments in emerging markets—with US$15 billion of it eyeing Latin America.

According to a recent survey by Enterprising Solutions Global Consulting, an international development firm specializing in enterprise-led strategies for sustainable development, as much as 4 percent of U.S. socially responsible investments could be available for MSE investments. Surveyed were 25 leading SRI professionals who directly manage just under US$4 billion. Their companies control more than US$400 billion, invested primarily in large capital stocks screened for a variety of social issues.

Socially responsible investments for MSEs employ two specific criteria in addition to the financial results all investors seek: MSEs must (1) comply with all domestic labor, environmental, and other relevant laws and (2) have at least one strong measurable social impact, such as poverty relief or the environment.

Some industry experts such as Amy Domini of Domini Social Investments, with US$1.9 billion under management, feel that 1 percent of U.S. social investment is a more realistic expectation. In its report, Enterprising Solutions states: "This small survey was not meant to be representative, and if we control for two large estimates, the potential falls to 1 percent, but this is still significant." At a level of 1 percent, Latin American MSE investments could expect to see an inflow of US$3.7 billion.

By either estimate, SRI demand for MSE emerging market investment is significant. So what is holding it back?

Development finance experts have long held that MSE funds can be profitable. This led to the creation of a range of development agency–financed "model" funds—the vanguard of emerging market MSE investment—on the premise that private sector investment would follow if shown the way. During the 1990s more than 200 funds were established in developing countries, according to the Washington-based Institute for Small and Medium Enterprise Finance, including Small Enterprise Assistance Fund's Andean Fund and the Latin American microfinance institution equity fund ProFund, financed largely by multilateral banks. But private sector investment in MSE development remains disappointing.

Erik Geurts of Triodos, a private socially responsible bank based in Holland, says: "It seems we haven't found the magic formula yet. Fund management costs are too high and capital bases are too small." Moreover, MSE funds are not well known as an asset class, nor are they well benchmarked for investment managers.

The funds' small size and fixed management costs have been problematic, even for the model funds. Bert van der Vaart, president of Small Enterprise Assistance Funds (SEAF) notes: "Few MSE funds achieve market returns partly because management fees can reach 6 percent or 7 percent of committed capital, compared with 2 percent to 2.5 percent for larger funds. SEAF spreads back office functions and exit costs over 12 funds, reducing its fees to 3.5 percent—a challenging task for funds of less than $15 million."

Returns have also been a question mark, but not where SRI investors are

ILLUSTRATION BY BRAD YEO

> **“Finding the right investment vehicle is the challenge.”**
>
> —Michael Lent
> Progressive Asset Management

concerned. The survey indicates that more than 60 percent of SRI professionals would be satisfied with a 5 percent to 15 percent annual return, something that Gijs Boot, CEO of K+ Venture Partners, a private MSE funds advisor in the former Eastern Bloc, says is “well within the realm of the possible for small enterprise funds.” A focus group of 15 microfinance investors, organized by Enterprising Solutions to coincide with the Inter-American Development Bank’s microfinance conference in Santo Domingo last year, suggested that potential return on equity for MFIs ranges from 10 percent to 12 percent.

Estimated Emerging Market MSE Investment Demand from U.S. SRI (US$)

Total SRI screened investments*	$610 billion
4% of SRI investments for MSEs	$24 billion
1% of SRI investments for MSEs	$6 billion
Share of capital for Latin American MSEs (61%)	
At 4%	$15 billion
At 1%	$3.7 billion

*Funds actively managed with multiple social screens.

Even with the maturation of numerous information sources on emerging market investment environments, access to reliable information still looms as a barrier to MSE investing. Michael Lent, of Progressive Asset Management in New York, says that “knowing what goes on within and around emerging market MSE investments is a big challenge for the deskbound financial advisor in New York. That’s why credible and accessible fund intermediation is badly needed.”

Not surprisingly, another major barrier has been the relative abundance of development agency finance for model funds. According to an Enterprising Solutions MSE fund study, “Soft finance, or below market rates or terms, offered by development agencies to model funds seems to deflect interest from developing private capital market linkages.”

In fact, of the 27 funds serving microfinance institutions and small business surveyed by Enterprising Solutions in late 2001, only nine had any private sector investment. Several funds began life with the intention of raising SRI capital but eventually found soft finance more convenient. Fund managers apparently are asking themselves why they should bother developing private sector capital market links when soft money is abundant.

Many model funds also have overly aggressive social objectives—often linked to development agency funding compliance—that can adversely affect fund management. The Solar Development Fund, for example, is mandated to invest in alternative energy companies that alleviate poverty while advancing rural economic development through electrification and making money—not a simple challenge.

The results almost always are confused management objectives and inconsistent social and financial performance. But according to Peter Kinder, president of KLD, a leading SRI information research firm in the United States, this does not have to be the case: “With the right research tools and the right techniques, achieving competitive results does not appear to be an overly difficult task and social objectives do not have to have negative effects on returns.”

Clearly, the 30-plus years of SRI management best practice has yet to be widely applied in emerging market MSE investment. As Kinder notes, “Social investors have repeatedly expressed a willingness to forgo some portion of return in order to achieve social objectives *consistently*. That they’ve had to give up little is a pleasant, unexpected surprise to them.”

If the challenges facing emerging market MSE investments are tough but manageable, why has development agency financing not catalyzed significant private capital interest in MSEs? It may be a matter of market segmentation. Perhaps the SRI market will be the next vanguard for MSE investment, moving later to more rigid conventional markets.

Sound far-fetched? Social investors are a courageous bunch; they have taken on, and seem to be conquering, a host of tough investment challenges, from inner-city redevelopment to rural enterprise and low-income housing. As a pioneer of Central American agricultural cooperative investments in the early 1990s, Lent contends that the social investment money is there, but “finding the right investment vehicle is the challenge.”

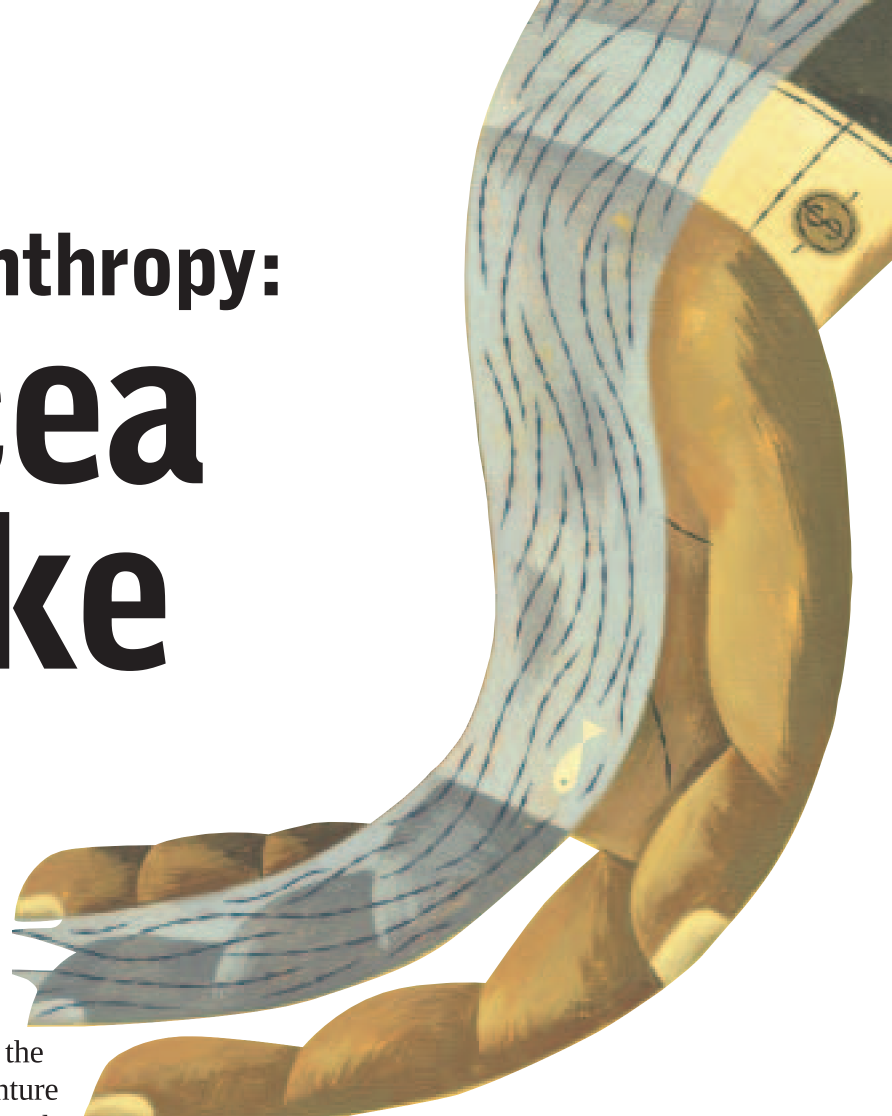
According to Enterprising Solutions’ survey and research, an investment company model is preferred by 75 percent of respondents, closely followed by a specialty mutual fund, at 67 percent. Investments need to be publicly and widely available. Funds must manage at least US$30 million nationally, with up to 20 percent of the portfolio in MFIs, and the balance can be in MSEs.

The potential interest of 1–4 percent of actively managed U.S. social investment in emerging market MSEs should turn a few heads. But without the means to intermediate it, it remains just that: potential.

—MARC DE SOUSA-SHIELDS

For additional information, please visit the website: **www.socialinvest.org**

Venture Philanthropy: Panacea or Snake Oil?



The already heated debate in the non-profit sector about “venture philanthropy” is getting hotter by the day. Anyone who has not yet voiced an opinion on the subject is no doubt preparing to do so.

How has this fledgling field caused such a furor? Venture philanthropy has been both vilified as a perversion of charity and touted as the solution to the perceived limitations of traditional beneficence. Is it the hard-to-swallow but effective medicine the world of philanthropy needs? Or is it snake oil, an ineffective gimmick that will drag down the whole sector?

Defining Venture Philanthropy

The term “venture philanthropy” is used by different people to mean very different things. (See page 61) It can be broadly described as an emerging field of “engaged philanthropy” that combines the policies and practices of long-term investment and venture capital models of the for-profit sector with the principles and public-benefit missions of the non-profit sector. Its strategies involve both capital investments in non-profit organizations or social enterprises and some form of technical or capacity-building assistance.

While traditional philanthropists usually award grants and subsidies, venture philanthropists offer their beneficiaries an array of financing options. Instead of one-year grants, they tend to provide longer-term (and perhaps larger-scale) investments. They may also take a position on a non-profit’s board to assist with organizational development and provide other types of capacity-building, coaching, mentoring or technical assistance.

Venture philanthropists focus their support on the organization as a whole rather than on individual projects or programs. They also encourage innovation by sharing the risk of failure, rather than placing the burden solely on the non-profit.

Measurable results are important for venture philanthropists, who usually expect their beneficiaries to meet agreed benchmarks for success. They require regular progress reports, as opposed to a narrative with a financial report at the end of a grant term.

Exit strategies are also a part of life for venture philanthropists. These may be triggered once their goals are achieved; when they can no longer add value—for instance, when a non-profit outgrows the type of support provided; or when a beneficiary falls short of expectations.

Dorothy Ridings of the Council of Foundations in the United States thinks that venture philanthropy is hardly a new concept. Indeed, donors and philanthropists have grappled with some of the issues for decades. The Peninsula Community Foundation in San Mateo, California, claims to be the "birthplace of venture philanthropy." Its Center for Venture Philanthropy claims that the foundation coined the term in 1984, although it was popularized later in the *Harvard Business Review*. What is new is the unique application of venture philanthropy during the past few years. Venture philanthropy funds have surfaced only recently, putting long-debated principles into practice.

Venture philanthropy has been around in North America and Europe for more than a decade, but is relatively new in Latin America. NESsT, an international non-profit organization operating in Central Europe and in the Andean region and Southern Cone of Latin America, promotes venture philanthropy in developing countries through public education and investment. Through its NESsT Venture Fund (Fondo Nido), it invests in a portfolio of social enterprises, providing both financial and technical assistance to help the enterprises grow, evolve and become profitable. (See box below)

Skeptics of Venture Philanthropy

Venture philanthropy does not lack critics. According to Neil Carson of Responsive Philanthropy, venture philanthropy is something of a Rorschach test. "Depending on whom you ask, it

Venture Philanthropy in Latin America: The NESsT Venture Fund (Fondo Nido)

Feasibility studies help enterprising non-profits make good business decisions.

Organization	Location	Mission	Social Enterprise
Comité para la Democratización de la Informática — CDI Chile	Santiago, Chile (programs throughout Chile)	Use technology as a tool to promote citizen education, health, non-violence, human rights, literacy and other concepts in the poorest communities of Chile through participation in Schools of Information Technology and Citizenship.	Create a computer-training center transferring the methodology used in mission programs to paying customers.

Cristina de Molina, CDI Chile's co-director, approached NESsT in mid-2000 with the idea of founding an income-generating training enterprise to support her organization's mission. Cristina had lofty goals: she wanted to start and organize this business venture and generate income to finance other activities. Using CDI's proven methodology, the new enterprise would cater to for-profit firms and NGOs. The plan was to make use of the SENCE, a tax deduction that companies can take for the cost of training their staff. Companies can either use this benefit themselves or transfer it to NGOs. However, de Molina had scant knowledge of the size of the market, possible competitors or the potential yield of this enterprise. With NESsT's support, CDI prepared a comprehensive feasibility study that helped clear these questions and aided her in drafting a more realistic business plan. As a consequence of this study, CDI decided to invest in a training center that could be used for its programs as well as other commercial activities, allowing the organization to achieve considerable savings.

Organization	Location	Mission	Social Enterprise
Corporación CIEM	San Felipe, Chile	Preservation and promotion of indigenous culture and local sustainable development in the Aconcagua region through the *Centro de Artes y Oficios El Almendral*, an arts and trades center, to teach local handicrafts, environmental conservation, etc.	Sale of printing services using donated equipment. Sale of local handicrafts and coffee shop for visitors.

Jorge Razeto, director of CIEM, requested help with three business activities: a small printing shop, a coffee shop and a handicrafts store. These businesses had already been launched, but neither the coffee shop nor the store had managed to cover its costs or generate income for CIEM. Only the printing shop seemed to be breaking even, and Razeto and his team did not have a clear idea of future earning potential of the businesses or how to make them grow. With NESsT's support, CIEM is finishing a feasibility study that will help them decide the future of the businesses and seek financing for their expansion.

is the future of philanthropy, a passing fad, good grant making or misguided hubris," he says.

Some critics believe that venture philanthropists are promoting an investment-like strategy that fails to recognize the unique needs and culture of non-profit organizations. Their interventions force non-profits to reengineer themselves in a way that many are unprepared to attempt. But although some philanthropists may have little knowledge about or experience with non-profits, there is indeed a high demand for investments in the sector. A large, untapped market of social entrepreneurs can benefit from the venture philanthropy approach to financing and technical support.

Others view venture philanthropy as a fleeting fashion that derived its cachet from entrepreneurs who became immensely rich thanks to the technology revolution. Certainly, many U.S. venture philanthropy funds depend on the energy, drive and wealth of founders from the high-tech sector. However, the principles and practices of venture philanthropy are now an integral part of the philanthropy sector.

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> —Neil Carson, Responsive Philanthropy

The field is becoming a mainstream financial source, attracting a wider body of proponents and investors and weaving itself into the fabric of the non-profit sector.

Some skeptics cite the high risks and uncertain returns in the venture philanthropy approach, even though the high rates of failure among start-ups in the for-profit sector have not dissuaded investors. Additionally, the high level of risk in the non-profit sector is balanced by a high potential for social returns. The non-profit ventures of the world may be pretty safe long-term investments if one is willing to trade a purely financial return for a social return on investment.

Much of the criticism of venture philanthropy is aimed at the demand side of non-profit enterprise development, the obstacles and challenges non-profit entrepreneurs face and their capacity-building needs. Less thought is given to the supply side, the models and strategies for "investing" in entrepreneurial activities of non-profit organizations and strengthening these social-purpose enterprises. Venture philanthropy is largely regarded as unproven, much as microlending was viewed just a decade ago.

Three Faces of Venture Philanthropy

Venture philanthropy approaches help achieve a variety of different, though interrelated, ends.

1. Investing in Individual Social Innovators: Some venture philanthropists provide targeted financial and capacity-building support to individuals they refer to as "social entrepreneurs"—individual leaders who address a critical social problem in a unique or particularly effective way.

2. Investing in Social Purpose Enterprises: Other venture philanthropists provide capital, technical assistance and access to other support networks to for-profit enterprises owned and operated by non-profit parent organizations to generate income and provide employment opportunities for poor or marginalized constituencies.

3. Investing in Non-Profit Organizational Development: Still other venture philanthropists provide financial and capacity-building support to non-profit organizations in an effort to "bring to scale" their successful activities.

Bottom Line

While most venture philanthropists are somewhat critical of the traditional approach to grant making, few question the fundamental importance of charitable giving. Venture philanthropy is intended to complement, not replace, beneficence. The field has attracted fresh resources to the non-profit sector by reaching out and engaging a new type of philanthropist. As long as these enterprising donors help expand the array of philanthropic investment tools, current charitable giving should not be threatened.

Venture philanthropy may be in its infancy, but it holds great promise for the diverse organizations of civil society, including those involved in microenterprise development. Just as venture capitalists once were an avant-garde and now are mainstream members of the for-profit financial world, venture philanthropists will soon be accepted by the rest of the non-profit sector.

—LEE DAVIS AND NICOLE ETCHART

Adapted from "Venture Philanthropy: The Rise of New Philanthropy in the Old World," an article published in Philanthropy in Europe *(Paris, Spring 2001).*

For additional information, please visit the website: **www.nesst.hu/venture.asp**

SOCIAL INVESTMENTS

When Donors Invest

Program-Related Investments

There's no doubt that making a grant to an organization involves betting on its staff, its program and its beneficiaries, but it is still a far cry from making an investment and expecting to get the money back—with interest.

Yet that is exactly what two of the leading foundations in the United States are doing: investing in the programs of non-profit institutions and being repaid in full with interest. The Ford Foundation, which pioneered program-related investments (PRIs), dedicates some $17 million to them each year. The MacArthur Foundation is doubling the amount it invests annually, from $10 million to about $20 million.

Program-related investments generally are used to fund business strategies that achieve a social benefit. Typical investments by Ford and MacArthur involve capitalizing business development in an industry cluster to create jobs for low-income workers; capitalizing revolving loan funds for homeownership and small-business development; providing working capital for a non-profit builder of affordable housing; and putting funds into a credit union to support coffee processing by coffee cooperatives. Since many donors don't easily grasp the business orientation of such organizations, the PRI as a funding mechanism has not spread to other funding institutions.

For experienced donors like the Ford Foundation, program-related investments offer many advantages. "We can get more bang for the buck [because] we put money out and it comes back," says Frank DeGiovanni, director of economic development at the foundation. PRIs, of course, can be used for activities in which funds are recycled—such as revolving funds—and are especially useful for programs that need a large amount of capital. Ford typically makes loans of around $2 million through its PRIs; it would be hard to make a grant that large, DeGiovanni notes.

The PRIs are an effective tool for coaxing the development of the organization that receives the financing, since the Ford Foundation rigorously analyzes the funding request and the organization. "There is a business discipline it [the investment] reinforces," says DeGiovanni. "It helps organizations think. If they are doing a 10-year loan, we [Ford] ask for a 10-year plan; we engage the organization on their assumptions about growth management." Over the longer term, PRIs help organizations become self-financing and allow the foundation to leverage its resources.

Program-related investments are versatile. They usually take the form of loans, but they also may be transferred as loan guarantees or equity investments. The loans can be structured as short or long term, and the investment may also provide bridge financing for an organization or financial intermediary. The interest rates charged on recovery are typically very low, around 3 percent, although "depending on the business model and the investment structure, higher rates may be earned so long as they are below what the market demands for that type of risk," says Karen Seabury, program officer for PRIs at the MacArthur Foundation, based in Chicago.

In the United States, the leading thrust of program-related investments has been to help stimulate development finance. Community development financial institutions provide financial services that commercial banks don't offer. Over the years, PRIs have funded some of the few community-oriented regulated banks—such as Shore Bank in Chicago—as well as credit unions and revolving funds that support community development in low-income areas. The impact of PRIs "has been huge for developing this field by creating a new source for equity capital as well as debt capital," Seabury says.

Since donors are cautious about investing abroad, there are fewer PRIs overseas; Ford Foundation has fewer than 10. But the number of PRIs is

growing. "We use PRIs as tools to help build the capacity or capital of foundation grantees," says DeGiovanni. Representative PRIs include Ford's support to financing institutions that lend to small businesses in Mexico and Kenya, and the MacArthur Foundation's investment in the Terra Capital Fund, which makes equity investments in Latin American businesses that use natural resources in a sustainable way.

Special risks—particularly currency risk and hyperinflation—come with investing overseas. Devaluation can double a borrower's debt overnight as the local currency loses value against the dollar. "Ford's policy is that it is not appropriate for a nonprofit organization in a developing country to take currency risk; [it should only] take the credit risk," DeGiovanni says. Thus Ford tends to provide dollar-denominated loans but expects to be repaid in local currency at the exchange rate in effect when the loan is disbursed.

To avoid suffering capital losses from devaluations, the Ford Foundation asks the institutions it invests in to set up sinking funds. These require making regular deposits to an investment account that, over time, will offset some or all of the losses that might be incurred if the local currency erodes. The sinking funds are financed out of the spread earned between the interest rate charged by Ford and the rate charged by the local institution. In countries suffering from hyperinflation, which creates distortions in the economy, Ford avoids investing altogether or makes a recoverable grant.

The average return on PRIs has been around 3 percent for MacArthur and 1 percent for Ford. MacArthur uses the interest to fund field work in the United States, including operating support for trade associations, policy development and research on the impact of development finance.

Losses on PRIs have been low, averaging 3 to 4 percent of the capital invested by MacArthur. Losses in direct investments to operating businesses are much higher, about 20 percent. This has created a bias toward investing in financial intermediaries, which has generated better results, Seabury says. The Ford Foundation has experienced losses of approximately 10 percent since it began making PRIs in 1968. The majority of these losses occurred in the first five years, when Ford directly invested in small businesses and real estate projects. Since Ford, too, began to focus on investing in financial intermediaries, its losses have been much lower, DeGiovanni says.

Program-related investments were born in the United States in 1969, when special tax laws were created to permit foundations to make such investments. According to the law, even though the funds loaned through PRIs are returned to the donor institution, they are channeled into the donor's capital base and enter into the calculation of how much money it must give away the following year.

So far, no overall evaluations have been conducted to determine the impact of PRIs. A collaborative project with the development finance trade associations is under way that will measure the impact of development finance through an annual survey. The Ford Foundation is currently conducting a large study with Coastal Enterprises in the state of Maine to see whether Ford's loans to small and medium enterprises have created stable jobs that have lasted over time.

—LUCY CONGER

For additional information, please visit the website: **www.foundationnews.org**