Full spectrum finance:
how philanthropy discovers impact beyond donation and investments

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Thinking of ourselves as the centre of the universe is a mistake we all make sometimes. We correct it when new phenomena cannot be explained using our old model. The social sector may experience such a moment with the rise of social innovations that clash with both the expectations of philanthropy on the one hand and business on the other.

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According to research by Ashoka and McKinsey&Company published recently (Harvard Business Manager 6/2015), several recent billion dollar markets have been pioneered by social entrepreneurs – who never had profitable markets as their primary goal. And neither did the philanthropists who backed their ideas early in their journey such as open education, private hospitality, organic agriculture and peer-to-peer loans. Today, many of these markets are in the crosshairs of venture capitalists.

The findings illustrate an increasingly confusing world, with social entrepreneurs creating communities with huge economic potential, with businesses engaging in venture philanthropy for long-term market gains, with foundations testing the waters of mission investing and governments creating (misnamed) bonds to generate social impact.

‘For profit or not for profit?’, though, is still the simple question that frames our thinking as well as the reality of pretty much every social entrepreneur. It suggests that business models either return at -100%, and thus require donations or subsidies, or return well above inflation rate, and thus attract loans or equity. Pretty much all financial instruments currently in broad use correspond to one of these two ends of the spectrum.

Yet the most interesting ideas live between these extremes, and clash with the expectations of traditional donors and investors alike.

Let us play a simple game of three questions. The first two are: ‘Have you ever made an investment?’, ‘Have you ever made a donation?’ Most people answer yes to both. But for the third question, ‘Have you ever invested in the same organisation you have given a donation to?’ we yet have to find the first person to say yes. This is mind boggling, and exposes a deep divide hardwired in our brains.

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A part of the explanation is culture, but another part is the business model and legal environment. Much of the discussion about what works, what scales and what is worth investing in has been pioneered by a growing community of impact investors. Most have a background in venture capital and private equity, with a language alien to much of the social sector. Even more importantly, they typically use straightforward business models targeting a small range of risk-return profiles and deal sizes. And in contrast to the excitement they create, their footprint has remained tiny, in particular in Continental Europe. There is good reason for this: in its pure form they are a dangerous promise to many social organisations who are not able to deliver the expected financial returns. More often than not, markets remain imperfect and do not translate the whole value created for society into returns created for investors. There is a significant mismatch between the available financing volume, investors’ expectations and the actual needs of social entrepreneurs.

This is why it is time for the other end of the return spectrum to make its play. Philanthropists can create a compelling business case, and respond to the demand from social entrepreneurs. Rather than emulating the restrictive investment models of most impact investors, they could think of investing as recycling of donations, and could develop the flexibility to ask only for partial returns. In effect, by thinking of their grants and their endowment as puzzle pieces that can be combined in creative ways, they could deploy a broad range of financial instruments covering the full spectrum of financial returns from -100% all the way up to positive returns. Even where foundation regulations are not supportive of this approach, foundations can stay within current rules and still implicitly connect grant making, investment and partnership strategies.

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Doing so helps them solve three challenges. Firstly, most grantees come back for the same money after funding ends. Using investments where possible can nudge them towards developing earned income streams and ultimately reduce financial dependency on grant makers. Secondly, foundations can spend (parts of) every dollar, euro and pound multiple times, and increase their portfolio even in times of low market returns. Thirdly, using both grant making and investing and everything in between replaces the one-to-one relationship of a foundation and its grantee with a more collaborative network of players, increasing the potential for learning and impact orientation.

It sounds plausible in theory, but how do we implement this ambitious plan in practice? Philanthropists are neither investing with negative return expectations nor are they going to subsidise the returns of investors or take over the risks for them. Well, in fact, that's exactly what they should do (and some already are doing) if they are really looking for the most effective way to realise their own objectives: generating social impact on a large scale. The most common strategy at present is using guarantees and other de-risking instruments like junior equity or subordinated debt provided by public funders or philanthropists. This mechanism addresses the concern of private capital providers by ensuring their capital can be preserved.

But there are other innovative models in the field of hybrid or blended finance which are paving new ways for full spectrum finance – either through smart combinations of different sources of capital or via innovation in the financial instrument itself. Intermediaries like Roots of Impact, the Financing Agency for Social Entrepreneurship and others are continuously developing models that are ready to be adopted on a broader scale. Here are some examples of these 'game changers':

Impact mezzanine/revenue participation agreement

Mezzanine capital is characterised by a mixture of features from equity and debt. The aim of this 'quasi equity' is to provide growth capital without the need for a social enterprise to sell equity, resulting in less dilution of ownership or loss of control – a key consideration for companies with deep social missions that might be compromised through traditional financing. A specific form of mezzanine is the revenue participation agreement. It entitles the investor to a pre-defined amount of the revenues of the company. The social enterprises pays back in line with its revenue generation capability. The revenue sharing model provides the company with financial flexibility and flexible repayment options.

Hybrid investments – philanthropy plus investment at the same time

There are several ways to bring philanthropic and investment capital together in a single transaction. For example, both types of capital can be brought in at the same time with the explicit intent to reduce the cost of capital for the social enterprise via the philanthropic funds. There are many social enterprises operating with (at least) two legal entities – a non-profit and a for-profit organisation. This hybrid business structure facilitates the combination of different sources of funding. In countries like the UK or the US there are already legal forms for social enterprises established that have hybrid elements from the for-profit and from the non-profit world.

Hybrid investments over time

Another means of using full spectrum finance is going hybrid 'over time'. Examples include convertible grants or forgivable loans. With a convertible grant the social investor provides the organisation with a grant that is converted into equity or debt only in the case of success. Consequently the financing risk of a certain project or intervention is covered by the provider of the convertible grant. The opposite of that is a forgivable loan. It is a loan which is converted into a grant in the case of success. If the social enterprise reaches the goals agreed on beforehand by the investor and investee, the loan does not have to be repaid. The social enterprise bears the full risk of project success and on top of that has a strong incentivation for making it happen as planned.

New pay-for-impact model: Social Impact Incentives

The pay-for-success landscape is currently dominated by the Social Impact Bond (SIB). SIBs are typically based on pre-defined outcome targets and if the service providers achieve these targets, investors are paid back with premiums (returns). This approach has been further developed: considering that there is no simple yes or no answer for impact, the aim of the innovative Social Impact Incentives (SIINC) is to generate a strong incentive for all parties – not only the investors – to continuously outperform the outcome targets and accelerate the impact. This 'incentivation approach' is applied to high-impact social enterprises running market-based models.

How does this work? An outcome payer, e.g. a philanthropic organisation, development agency or other donor, agrees to make premium payments to the enterprise based on the social contribution generated by their operations. These premiums are paid in parallel to the revenues the enterprise generates through its activities – straightforward and without complicated structures. In this way, impact is incentivised with the social performance of the enterprise being directly linked with its levels of profitability and thus its attractiveness for investors. The SIINC model is therefore an effective means of leveraging public or philanthropic funds to catalyse private investment in areas where there is high social impact, but where current conditions would provide below market-rate financial returns.

The first use of the SIINC model will be in Latin America and the Caribbean, where Roots of Impact has launched a Public Private Development Partnership (PPDP) with support from Ashoka and in collaboration with the Swiss Agency for Development and Cooperation (SDC) and the Inter-American Development Bank (IDB).

The challenge in all this is not in the financial engineering. It is a public education task. How many foundation executives will have the courage to seem less generous on the surface as they reduce pure grant making and move along towards investing along the spectrum?

The key to winning the argument lies in clear impact measures for moving from grants towards hybrid investments. There really is a simple imperative: choose the financial instrument that maximises impact over time and look for the most appropriate financiers to make it happen. This needs to be transparent towards grantees/investees as well as the public.

What we envisage is almost a Copernican revolution. Rather than revolving around maximising the utility of one instrument (grants), philanthropy would revolve around the potential impact of a portfolio organisation, and use grants as one of several enabling and highly leveraged tools in a far more collaborative toolbox

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