

TROPMAN REPORT

2003 SERIES

volume 2 : number 3

IDENTIFYING FINANCING OPPORTUNITIES FOR PITTSBURGH-BASED SOCIAL ENTERPRISES: *Challenges and Opportunities for Capitalizing Entrepreneurial Ventures*

The Forbes Funds commissioned Community Wealth Ventures (CWV) to examine and document financing opportunities potentially available to nonprofits starting or growing social enterprises. This study comes at a critical time when it is ever more apparent that philanthropy and government funding are insufficient to address the pervasiveness of social problems.

Innovative nonprofit organizations are increasingly looking to the small business sector — analyzing, learning from, and even co-opting business practices and ideas in order to launch market-based ventures. These ventures hold the promise of generating revenues, furthering mission objectives, and improving organizational sustainability. While many of these organizations and individuals have the knowledge of the marketplace and the necessary passion to succeed, they often lack the wide array of financial tools and resources that have been developed to assist the traditional small business owner.

A major hurdle faced by small businesses is capitalization, and capitalization is an even greater hurdle for nonprofit organizations seeking to launch a business venture. The process of raising the necessary capital to seed the creation and growth of a business is often difficult and time consuming. At the same time, adequate capitalization is one of the most critical determinants of small business success. In many cases, businesses fail not because of a flawed business model, but because they do not have the necessary capital to manage negative cash flows or to invest in infrastructure to support growth.

Much has been written on the financing process for traditional for-profit businesses, and, to a lesser extent, on financing the start-up and growth of nonprofit organizations. However, very little research has focused on the unique capitalization challenges faced by nonprofit organizations when attempting to launch and grow social enterprises.

SOCIAL ENTERPRISE IN PITTSBURGH

Pittsburgh is poised to stand as the Silicon Valley of Social Enterprise. The region's nonprofit community gathered for its annual summit in 2001 to learn about social enterprise; social enterprise is again the subject of the 2004 nonprofit summit. All the while, local foundations have convened workshops among practitioners to meet with strategists, attorneys, and venture capitalists to discuss social enterprises. Peer learning groups have continued and advanced the learning. Local universities have offered substantive social enterprise courses to students and practitioners alike. National and international experts have advised local nonprofits about earned-income revenue strategies. And local and national business plan competitions are preparing Pittsburgh's nonprofits to implement and launch the promising practices of social enterprise.



Envisioning Pittsburgh's nonprofit sector as innovative, informed, and engaged, The Forbes Funds advance capacity-building within and among the region's nonprofit organizations.

THE COPELAND FUND FOR NONPROFIT MANAGEMENT

The mission of The Copeland Fund for Nonprofit Management is to strengthen the management and policymaking capacity of nonprofit human service organizations to serve better the needs of their communities.

- Management Enhancement Grants
- Emergency Grants
- Cohort (Professional Development) Grants

THE TROPMAN FUND FOR NONPROFIT RESEARCH

The mission of The Tropman Fund for Nonprofit Research is to support applied research on strategic issues that are likely to have profound effects on nonprofit management and governance, especially among human service and community development organizations.

- Applied Research Projects
- Annual Research Conference

THE WISHART FUND FOR NONPROFIT LEADERSHIP

The mission of The Wishart Fund for Nonprofit Leadership is to encourage pioneering nonprofit leadership by promoting public learning and discussion about issues critical to ethical and effective management, as well as by celebrating exemplary practices.

- Leadership Roundtables
- The Frieda Shapira Medal
- Alfred W. Wishart, Jr., Award for Excellence in Nonprofit Management

In 2002, The Forbes Funds published "Profit Making in Nonprofits: An Assessment of Entrepreneurial Ventures in Nonprofit Organizations." This study, conducted by Olszak Management Consulting, Inc., documented the earned-income revenue strategies of 25 nonprofits located in the Pittsburgh region. Olszak set forth 7 'promising practices' and 34 specific activities associated with successful social enterprises. Of note, Olszak documented that start-up funds for social enterprises were most commonly granted by foundations, and that, while some organizations derived continued support from sales or fees, nearly 1/2 of the respondents turned to foundations for on-going operating costs. While local foundations — such as the McCune Foundation, the R.K. Mellon Foundation, and the Alcoa Foundation foremost among them — have generously funded social enterprises to assist nonprofits in attaining more diverse and self-sustaining revenue mixes, as well as to build community wealth generally, the pool of potential investment to initiate social enterprises has not been fully developed nor realized.

REPORT OVERVIEW

The Forbes Funds commissioned CWV to seek answers to questions relevant to financing social enterprises in Pittsburgh:

- How do the capital markets for social enterprise differ from the traditional for-profit capital markets?
- What criteria should be used to evaluate a social enterprise investment?
- What financing instruments and sources of capital are most appropriate for social enterprise?
- Based on the financing needs of social enterprises, where do Pittsburgh-area financing sources fall short?

CWV reviewed the existing literature on financing for-profit enterprises and funding nonprofit organizations. In addition and more importantly, CWV talked to dozens of foundations, bankers, venture capitalists, academics, and social enterprise practitioners in order to understand the experiences and lessons learned by those in the field.

CHALLENGES IN FINANCING SOCIAL ENTERPRISE

A social enterprise is defined as a market-based business venture that is operated by a nonprofit organization. Because social enterprises have the goal of self-sustainability or profitability, they are often more akin to a for-profit business than to a nonprofit organization. Depending on the legal structure and balance between social and financial outcomes, social enterprises can access both nonprofit and for-profit sources of capital. However, the unique nature of a social enterprise often means that neither the for-profit nor the nonprofit capital markets can provide the appropriate financing instrument for its need. Straddling the nonprofit and for-profit worlds creates several conditions that make financing a social enterprise challenging:

- **Double "Bottom Line"** — Social enterprises often have dual goals of providing mission-related outcomes as well as financial outcomes. From a capitalization standpoint, these often-competing goals deter traditional investors, such as foundations or lenders.

- **Limited Understanding** — The field of social enterprise is still relatively early in development, and without a track record many investors are hesitant to take a financial risk.
- **Restriction on Private Benefit** — Nonprofits are forbidden from disbursing a profit to investors and are therefore effectively cut off from the largest source of investment capital, the public markets.
- **Familiarity** — Innovative hybrid forms of financing may be appropriate for the needs of a social enterprise, but nonprofits are more likely to approach the same sources of funding that support their programmatic activities. Similarly, many potential investors are reluctant to develop and utilize new tools to serve this emerging market.
- **Type of Entrepreneur** — While traditional small businesses are frequently launched by an individual, social enterprises are started and owned by a nonprofit. Nonprofit ownership may cause potential investors to be more risk averse, for fear of unclaimable collateral or foreclosing on "community" assets.

Thus, while social enterprises should, in theory, have access to a broad array of both nonprofit and for-profit sources of capital, market realities hinder their ability to appeal to many potential sources of investment.

ANALYZING AN INVESTMENT IN A SOCIAL ENTERPRISE

Traditional private investors examine both the risk and financial return of a venture when determining whether to make an investment. A social enterprise investor, in order to value the full return of the venture, also takes into account the venture's social impact. The creation of positive social impact by a venture will cause a socially motivated investor to accept a lower risk-adjusted financial return than would be acceptable from a traditional investment. While most investors value either financial return or social impact, a growing number of investors expect a combination of both from organizations in which they invest.

THE RANGE OF INVESTMENT TOOLS

Depending upon the legal structure of a social enterprise, it can raise investment money through traditional nonprofit means, traditional for-profit means, or hybrid types of financing specific to ventures that offer both social and financial return. The five broad types of investment are:

- **Internally Generated Cash Flow** — The cash reserves of the nonprofit parent are the most frequent type of funding for social enterprise start-ups. Self-financing is flexible and shows commitment to the social enterprise. While a nonprofit will have to overcome the "opportunity cost" of not investing in programs in the short-term, a high-risk venture may have no other choice for capitalization.
- **Grant** — A grant refers to money that is given to an organization with no expectation of repayment. In essence, a grant becomes the nonprofit's equity stake in the social enterprise. Because the money does not have to be repaid, in most cases grants are the preferred type of capital to raise from the social enterprise's perspective. However, depending on the source of the grant, it may take significant time,

effort, and expenditure to secure. Specific types of grants include technical assistance grants, in-kind donations, “angel” grants, foundation grants, government grants, and business plan competitions.

- **Equity Equivalent** — An equity equivalent investment is unsecured, long-term money that is expected to be repaid by an organization at a defined rate of return. Equity equivalent investments can take several forms, including recoverable grants, below market rate loans, or loan guarantees. Equity equivalents are an attractive option for a social enterprise because the investor often takes on a large portion of the risk in exchange for financial and social return. Unfortunately, equity equivalents require a level of tracking and reporting that most foundations or individual grantmakers do not wish to undertake. Moreover, banks, which have the necessary tracking structures in place, are not interested in the below-market rate returns. As a result, very few equity equivalent investments are made.
- **Debt** — Debt is money that is borrowed by an organization with the expectation of repayment over a certain period of time. Debt can be an attractive form of financing because the interest rate is often fixed at a rate set by the market, and no exchange of ownership is required. Additionally, lenders often provide technical assistance to ensure that a debtor can repay the specific loan obligation. Debt is most often reserved for organizations with predictable cash flow that can provide collateral or other security to a lender. Credit cards, lines of credit, term loans, leasing, customer/supplier financing, receivables financing, and tax-exempt bonds are all forms of debt.
- **Equity** — An equity investment refers to money that is given in exchange for an ownership interest in a venture. Equity investments, including joint ventures, angel or venture capital, and public growth financing, are attractive to ventures that may not have significant or predictable cash flows in the near future to qualify for a loan, but predict considerable future growth. However, an investor will only be willing to make an equity investment if he or she believes that it will result in a larger financial return over time. Equity investments will dilute the ownership of the venture and can result in a loss of control. Equity investments cannot be made in nonprofit organizations, but may be an attractive option for a social enterprise operating as a for-profit subsidiary.

The above types of investment capital illustrate that, while a social enterprise may have to overcome limited understanding and familiarity on the part of external investors, there are numerous and varied types of financing available. (The full report delves into sub-types of financing and illustrates each with real world examples.) As with any business, however, a social enterprise must understand specifically what a potential investor is looking for; what the enterprise has to offer an investor in terms of financial return, social return, or a combination of both; and, as a result, what is the most appropriate type of financing.

STAGES OF SOCIAL ENTERPRISE GROWTH

The appropriate type of financing for a venture is often determined in part by the stage of development of the social enterprise. **Seed** or **early stage** ventures will often involve high risk and negative cash flow, and internal financing or grants will often be the most reasonable type of capital. As a social enterprise matures, it may represent lower risk and have a greater ability to repay investment, but its capital needs tend to increase as well. **Survival** and **expansion stage** social enterprises may still be able to attract grants, but should look to equity equivalents (or straight equity if the venture is a for-profit subsidiary) and flexible forms of debt for larger infusions of capital. When a social enterprise reaches a **mature stage** it will have developed a track record of success and can self-finance its day-to-day capital needs. If needed, external capital of all types will be available, and, because investors and lenders want to be involved with stable, successful businesses, the social enterprise will be in the position to go after the cheapest terms.

SOURCES OF CAPITAL FOR SOCIAL ENTERPRISES

The underdeveloped capital market for social enterprise means that a nonprofit venture will often have to be persistent and creative to locate willing sources of financing. While traditional charitable funding comes from a limited array of sources — donors, foundations, or governments — the combination of social and financial return of a social enterprise opens up access to a broader array of types of capital and, therefore, sources of capital. Each type of investor will have differing goals and expectations for its investment, and it is important that a social enterprise not only find the right type of investor but also the right fit with a specific investor. Potential investors (described in detail in the full report) include:

- Parent nonprofit
- Angel
- Private foundation
- Community foundation
- Business plan competition
- Corporation
- Venture philanthropist
- Government
- Strategic partner
- Community development financial institution
- Venture capitalist
- Commercial bank
- Investment bank

IMPLICATIONS

Nonprofits pursuing social enterprise often lament that neither traditional grantmakers nor traditional for-profit investors are willing to provide appropriate financing to support the launch and growth of their business. Four changes in strategy on the part of social enterprises and potential funders would improve access to capital:

1. **Increased Willingness to Bootstrap Ventures** — Nonprofits need to be more willing to invest their own funds in the seed and start-up of a social enterprise. An investment on behalf of the nonprofit organization in its social enterprise signals a true commitment to, and interest in, the success of the venture.
2. **Openness to Repaying Capital** — In order to access broader pools of capital, both from for-profit and charitable sources, nonprofits will need to be more open to repayment of capital. Recoverable forms of financing allow the initial funds to be recycled and used to help other social enterprises get off of the ground.
3. **Improved "Dual Bottom Line" Financing Options** — Traditional funders, specifically foundations and donors, will also need to think more creatively. Increased use of financing tools such as recoverable grants and program related investments has the potential to improve the accountability of social enterprises and lead to greater total impact from foundation assets.
4. **Focused Capital-Raising Strategies** — Rather than simply responding to multiple grant applications in search of funding, social enterprises will need to examine more carefully their own financing needs in order to focus on the most appropriate sources of capital.

THE PITTSBURGH-AREA SOCIAL ENTERPRISE CAPITAL MARKETS

With an understanding of the larger trends and theories behind the emergence of a capital market for social enterprise, CWV conducted research into potential sources of capital for social enterprises in the Pittsburgh area. A detailed directory was developed to catalog the various potential financing sources. Based on this research, a number of characteristics were identified that define the social enterprise capital markets in Pittsburgh.

- **Strong Regional Foundation Community** — Pittsburgh has many large foundations that provide for the community. Additionally, a few of these foundations have taken a leadership role in supporting social enterprise through technical assistance and other grants.
- **Underdeveloped Individual Donors** — A side effect of a strong foundation community in Pittsburgh is that individual donors have traditionally not been aggressively pursued for philanthropic contributions.
- **Limited Availability of Equity Equivalent Financing Instruments** — No set of institutions or individuals is focused on providing the survival or growth capital necessary to support maturing social enterprises. However, several community development financial institutions (CDFIs) are positioned to fill this gap.
- **Innovative Government Funding but Limited Knowledge** — Pennsylvania has one of the most innovative state governments for providing support for community development and emerging businesses. However, few social enterprises have the knowledge of these resources or the expertise to access them.
- **Large, Progressive Banking Community** — An array of large banks, through community reinvestment departments, and community banks, with a willingness to execute more

creative deals, may be willing to finance social enterprises. Regardless of the size, however, traditional banks may view social enterprises as high risk investments. CDFIs may be a better resource for innovative lending solutions.

- **Equity Investors Focused on Technology** — Because of the technology focus of many angel and venture capital investors in Pittsburgh, social enterprises looking for equity investment may be better off looking to regional or national community development venture capital firms.

THE ROLE OF THE PITTSBURGH SOCIAL ENTERPRISE ACCELERATOR

The Pittsburgh Social Enterprise Accelerator (the Accelerator) supports emerging social enterprise ventures and helps accelerate their development through implementation assistance and financial support, knowledge sharing, and connections with key organizations. As such, it is a logical player to help fill gaps in the social enterprise capital markets and improve the flow of capital to deserving ventures in Pittsburgh.

The profile of the social enterprise capital markets in Pittsburgh suggests that the most appropriate and efficient role for the Accelerator to play is not that of a financier, but rather of an intermediary educator and matchmaker between social enterprises and potential investors. This role can be broken into five parts:

1. **Educator, Broad Information Provider, and Advocate** — The Accelerator should provide educational resources to help social enterprises and potential investors understand each other. Because a lack of familiarity has limited investment in social enterprise, the Accelerator should strongly encourage the groups to take the steps necessary to position themselves for mutually beneficial financing arrangements.
2. **Broker of Technical Assistance for Ventures** — The Accelerator can facilitate the provision of the necessary consulting to help nonprofits develop stronger financial systems, understand their capital needs, and target appropriate sources of investment.
3. **Network Builder and Relationship Manager** — In addition to educating potential investors about social enterprise, the Accelerator should build a network of potential investors with the ability to provide various types of capital. These relationships will allow the Accelerator to broker meetings between social enterprises and potential investors.
4. **Technical Assistance Provider and Underwriter to Financiers** — The Accelerator could provide a valuable service to key financial partners by producing objective and candid assessments of social enterprises from a financial perspective. Additionally, the Accelerator could provide technical assistance to foundations and lenders as they assess and track new types of investments in social enterprises.
5. **Guarantor** — The final way that the Accelerator can facilitate greater flows of capital to deserving social enterprises is through the creation of a guarantee program. Where appropriate, the Accelerator can provide a guarantee or level of financial security to lessen the risk and increase the willingness of financiers to invest in a promising social enterprise.

This TROPMAN REPORT is one of a series of briefing papers generated by The Tropman Fund for Nonprofit Research. TROPMAN REPORTS in this 2003 series are:

1. The Precarious Billion Dollar Sector: *Nonprofit Human Services in the Pittsburgh Metropolitan Area*
2. Strategic Restructuring: *A Tool for Improving Organizational Effectiveness*
3. **Identifying Financing Opportunities for Pittsburgh-based Social Enterprises: *Challenges and Opportunities for Capitalizing Entrepreneurial Ventures***
4. Keeping Our Promise: *The Use of Modern Quality Assurance in Nonprofit Management*
5. The Challenge of Nonprofit Leadership: *A Comparative Study of Nonprofit Executives in the Pittsburgh Region*
6. When the Current Is Strong, Only the Big Fish Swim: *The 2002 Wage & Benefit Survey of Southwestern PA Nonprofits*
7. The Insurance Muddle: *Addressing Healthcare Costs for Nonprofit Sector Employees*
8. Diversity Within and Among Nonprofit Boards in Allegheny County, PA

To read the full text of this study, log onto The Forbes Funds' web site at www.forbesfunds.org.