CCIF
Conservation and Community Investment Forum

From Donor to Investor:
Applying a Venture Capital Model to Foundations

Venture capital (VC) firms and foundations could not be more different in structure, style and operating practices. VC firms are set up to thrive in an always-changing environment: decisions are made rapidly, follow-up is highly aggressive with principals taking a lead role in shaping their portfolio companies, returns are fanatically tracked, losing investments are quickly pruned and principals are held accountable for the returns of their portfolios. Foundations, by contrast, tend to front-load their efforts with extensive and protracted proposal and due diligence processes and, as is required by current IRS regulations, adopt a hands-off policy once their grants are made. Although the science of outcome measurement is rapidly growing, foundations track and manage their returns nowhere near as comprehensively as a typical VC firm.

Nobody would suggest that foundations should become as single-minded in their pursuit of returns as VC firms – the outcomes are far more elusive, complex and long-term. However, foundations have become greatly interested in exploring avenues to selectively use VC capital sources, investment skills and private sector know-how to pursue specific social and environmental program objectives. A number of factors have conspired to make the VC model potentially interesting for foundations, including:

- **Private sector partnerships are essential.** Many environmental and socially-oriented foundations are realizing that investments in entrepreneurial initiatives are essential to achieving the transformative program goals they are seeking.
- **Money is tight.** Many typical foundation grant initiatives could be significantly leveraged if a source of private equity or debt funding were available.
- **Interest in program-related investments (PRIs) is increasing.** In recessionary times like these, PRI investments are a highly leveraged alternative to grant funding.

Naturally, most foundations are weary of moving into the VC business on their own, or even of adopting many of its operating practices – understandably so. Expansion into more risky equity and debt instruments requires considerable investment expertise, which most foundations are currently lacking, and which they are unlikely to acquire in the near future.

The Conservation and Community Investment Forum (CCIF) recently joined the David and Lucile Packard Foundation on a series of conversations with leading Silicon Valley VCs. The objective was to find out how a foundation could structure a VC-type funding model which combines the considerable program expertise of Foundations with the world class investment expertise of a major Silicon Valley VC firm. The Packard Foundation is deeply involved in a number of conservation programs with a strong entrepreneurial/private sector component, such as marine conservation on the U.S. western coast and the preservation of the coastal forests of British Columbia. Potential investments which are complementary to these program goals include MSC-certified seafood processors, FSC-certified timber operations, conservation-driven timber investment management organizations ("green TIMOs"), and the like.

CCIF went into this exercise with considerable skepticism. After all, many of the deals of potential programmatic interest to a typical foundation do not offer the explosive levels of returns which these technology-oriented funds typically seek. We were greatly surprised and delighted at the thoughtfulness and enthusiasm we encountered, and a number of potentially very interesting alternatives emerged.

Criteria for Evaluation

VC investment practices, while potentially of significant interest to foundations, cannot be simply transferred to a grant-making and/or PRI context. Foundations must carefully balance financial and program-related objectives, and often do not have the capacity for complex equity investment programs. We therefore evaluated potential models in light of four major criteria:

- **Are capital requirements reasonable?** All investment vehicles will require enough initial funding to allow for a set of investments broad enough to mitigate risks. However, different fund structures allow for varying levels of syndication, i.e. participation of other investors with similar programmatic objectives. Also, there are significant structural variations in the degree to which foundations, as a limited partner, would have to commit funds before specific deals are on the table.
- **Is capital preservation assured?** We were careful not to set too high a hurdle for financial returns. Even a capital preservation strategy requires that each individual deal must have the potential to return over 20 percent on the investment – the good deals must subsidize the bad. The return hurdle used in this analysis is that a given fund structure must at least be able to preserve its real capital, while yielding spectacular program-related returns.
- **Are investment programs fully aligned with program goals?** Besides achieving reliable returns, the foundations' most important concern is that investments are reliably aligned with their program roles. This implies that the foundation has to have some level of case-by-case control over the deals chosen – a badly placed deal could become a major embarrassment.
- **Is the complexity manageable?** While foundations could conceivably expand considerable effort in setting up and syndicating a suitable investment vehicle (either alone or with other foundations), they cannot be responsible for day-to-day operations of such a vehicle.

Potential Alternatives

The following alternative fund structures emerged as most promising.[1]

1. **"Grant Funded Equity."** The basic structure of this fund is simple. A foundation, or a number of foundations with very similar programmatic goals, provides grant funding to a newly established non-profit investment fund. For example, such a fund might focus on sustainable forest investments in Canada. This fund is managed by investment professionals as well as program experts, and is managed for capital preservation. The grantors are not paid back their principal – investment returns are put back into the fund. Fund managers are free to invest funds as grants, debt or equity, as long as the total principal is preserved in the long run. This allows the managers considerable programmatic freedom: they can use grant

[1] Two alternatives were eliminated very early in the process: A "do it yourself" fund where the Foundation builds in house venture capital capacity, and an "opportunistic" approach where the Foundation makes scattered equity investment whenever it is programmatically appropriate. For a variety of reasons, neither of these is likely to meet the risk/return criteria.

funding to develop solutions and to set the stage for follow-on debt or equity financing. For example, grants could be used to develop an integrated landscape protection strategy, debt to help local land trusts bridge their land purchase within that landscape and equity to help underwrite the tax-exempt bonds required to eventually purchase the land.

This structure has a number of distinct advantages. From the Foundation's point of view, it is a very easy model - grant funding of a non-profit entity raises few technical, legal or political issues. Since no returns will be generated, there will be no tax implications. The new organization will be able to supplement the Foundation's "traditional" grant funding strategy with a tightly focused private sector investment strategy, and it can do so with all the technical expertise, flexibility and speed that is required to do so.

Here's how this approach stacks up vs. the major criteria:

- Capital preservation: High. The fund will be designed to preserve the paid in capital. However, funders will not receive capital payments – all gains will be re-invested. This re-investment feature allows funders to realize unprecedented leverage, since their one-time investment is put to work over and over again. Funders also have complete discretion in setting return expectations – they can even decide to draw down the capital if the situation calls for it (for example, if a grant investment with spectacular program returns becomes available). There is, of course, a risk that even a capital preservation strategy will not work, that an "involuntary" erosion of principal will occur over time.

- Program alignment/control: Very high. Foundations can determine the appropriate level of oversight at will. The new organization is established to pursue highly specific program goals and objectives. The investment process can be structured to include foundation representative(s) on the investment committee. There is no alternative fund structure which offers this level of programmatic oversight.

- Complexity: Low to medium. From the foundations' perspective, funding this type of organization poses no new challenges. However, much depends on the successful recruitment of fund managers and program experts who are equally comfortable in the private and non-profit worlds. Because no significant capital gains are likely to be realized, it might be difficult to recruit world-class fund managers. However, several interviewees indicated that a number of highly capable and proven managers might be willing to take this on as a way to pursue their mission-driven life goals.

- Capital requirements: Medium. At the very least, $25 million would have to be syndicated to attract the best available talent. This would allow, at a 2.5 percent management fee, for yearly operating expenditures of $625,000 – enough to attract a small, highly qualified core staff. Eventually, there would be an expectation that $40 million would have to be raised to reach critical mass. This investment vehicle is perfect for syndication among foundations with similar program goals. For example, there are a number of foundations currently struggling with the development of an integrated approach for the support of sustainable forestry in the U.S. Why not pool forces and assign the private sector part of the solution to a team of hand-picked investment and program professionals?

2. **"Gatekeeper Program."** The very large institutional investors, such as pension funds, university/foundation endowments, etc., employ gatekeepers to identify those venture capital

funds which most closely meet a set of rigorous investment criteria. Once identified, these gatekeepers broker the institutional investment into these funds, monitor performance and provide regular counsel to both parties. Large gatekeepers will place $ billions in capital, work with 50+ VC funds and have access to hundreds of specific deals in progress at any one time.

The foundation could work with these gatekeepers in one of two ways:

- **Opportunistic program.** The gatekeepers could simply perform regular screens of the deal flow of "their" VC funds to identify candidates which might fit the profile of program-related investment for a foundation. These deals would then be offered to a foundation for co-investment at the same terms offered to the fund in question. The foundations would have to rely on the due diligence and deal management done by the originating venture fund.

- **Custom program.** Under this alternative, the gatekeeper would provide an extra, customized set of services to a foundation. In essence, a de facto venture capital firm would be built within the gatekeeper's organization which draws exclusively from the affiliated funds' deal flow, but which also represents the foundation's particular programmatic and economic interests. Specially assigned personnel would perform specific due diligence on programmatic issues, and would serve as the foundation's representative for the management of specific deals.

For the purposes of this evaluation, we have excluded the opportunistic program for a number of reasons. Most importantly, a foundation with limited capacity for due diligence and on-going deal management must have representation which is fully committed to its program and economic goals, and whose incentive structure reflects these goals. Part-time "champions" shopping around deals do not qualify. Worse yet: this setup could lead to negative pre-selection of deals, because a foundation would most likely be presented with those deals which the other investors have found wanting.

The custom program, though, is worth exploring:

- Risk/return profile: Medium to high. These will typically be deals which are "mainstream" i.e. from a strictly economic point of view they are attractive enough to warrant the attention of a major VC fund. While the risks are correspondingly higher, the foundation(s) could potentially get a "free ride" here, since each deal would be carefully selected and managed by very successful VC managers, in addition to being continuously monitored by the Foundation's dedicated gatekeeper staff.

- Program alignment and control: Medium. The deal flow is limited to those mainstream deals among the gatekeeper's portfolio which also happen to qualify as programmatically aligned with the foundation(s). There is no guarantee that the resulting portfolio could, in fact, have transformative impact on the environmental problems that the Foundation is trying to solve – there will always be a temptation to stretch the Foundations' constraints to programmatically accommodate marginal deals. Once a deal is consummated, the foundation(s) would have adequate control through their dedicated representatives.

- Complexity: Medium. Foundations would have none of the day-to-day responsibilities of deal selection and management. However, the potentially significant magnitude of economic returns could make a "straight" PRI investment difficult under current tax law.

Therefore, this vehicle may be suitable mostly for endowment investments. This might constitute a considerable departure from current investment practices.

- Capital requirements: Very high. Gatekeepers manage $ billions. In order to build and maintain the necessary mindshare among the staff (both at the gatekeeper and at the fund level), and in order to build a relatively balanced portfolio, investments should exceed $75 million. This is realistic only if the foundation's endowment managers got involved, or if several foundations pooled their PRI programs. The latter is unlikely – there is not enough programmatic cohesion in this model. Foundation endowment managers, at this point in time, might not have sufficient appetite for higher-risk investments.

3. **Independent Equity Fund.** This is the classic VC fund model. It requires the foundation(s) to set up a new and independent professional firm which, on their behalf, pursues a highly specific investment program. The new firm is managed by VC professionals who earn a management fee as well as a share of the investment profits (carried interest). The foundation(s) can choose the depth of their programmatic involvement: they can help identify deal flow, develop private sector solutions to environmental problems, participate on the investment committee and help monitor the environmental performance of the investments. Alternatively, the foundation(s) could adopt a laissez faire attitude and simply entrust their PRI investments to a group of carefully selected professionals pursuing a focused set of investment objectives.

   Using our criteria once again, here's how the independent equity fund comes out:

- Risk/return profile: Variable. The fund can be set up to pursue any given point on the risk/return scale. Programmatic priorities will critically determine expected returns. A focus on sustainable forestry practices, for example, would point toward a range of returns from 8 percent to 12 percent, while a focus on energy-related investments could yield far higher returns.

- Program alignment and control: Medium to high. As fund designers, the foundation(s) would obviously have every opportunity to shape the mandate. However, as the fund commences operations, management has to be given the full trust and authority to realize that mandate.

- Complexity: Very high. Probably prohibitively high. The participating foundation(s) would have to find an established team of highly successful venture capital managers, complement these with additional program experts, syndicate at least $50 million of capital and structure a limited partnership to accommodate all parties. They would have to do so knowing that the deal flow, restricted by program constraints, is unlikely to produce the world class returns most highly qualified fund managers thrive in pursuing. Lastly, they would have to determine how to deal with potential PRI returns which do not meet IRS standards. A tall order.

- Capital requirements: See "complexity" section above.

Our Choice

Each foundation will come to its own conclusion, but we clearly come out in favor of the "grant-funded equity" alternative. It is simple, flexible and honest. It poses no new challenges for foundations since it involves grant funding only – no PRI involvement is necessary. It is, in our opinion, the very best way to integrate the speed, discipline and rigor of the VC model with the programmatic excellence of a foundation. The model is already working in the educational sector. It is our hope and ambition to help propagate these ideas widely in the foundation community, and (potentially) to provide foundations with the technical tools necessary to structure and establish the pioneering efforts in this area.

If you are interested in pursuing any of these ideas further in the context of your program objectives, please give any of us at CCIF a call. Andreas Merkl can be reached at (415) 421-4213 ext. 25 (andreas@ceaconsulting.com), Kirk Marckwald at ext. 12 (kirk@ceaconsulting.com).