



## **A New Template for Funding Philanthropy?**

**April 24th, 2008**

**This note has been written by Arthur Wood, VP Social Financial Services (SFS) Ashoka. It briefly outlines the problems with the current social financing market and outlines the philosophy and three-tier strategy of Ashoka SFS. The mission of Ashoka SFS is to change the way philanthropy and the social capital market is funded.**

This process substantively commenced in June 2005, with the creation of the SFS team and with funding from the RWJ foundation. Although originally US based and focused the team has expanded its remit and is now engaged in projects directly in US, UK, France, Canada, Switzerland, Latin America and Germany – this excludes the global relationships with a number of key banks and the 30 plus Fellows who work globally in Social Finance and who we help scale their models

The ultimate objective is to increase the size, sophistication and reach of the social capital market and reduce the high cost of capital to the social sector, creating greater social and sustainable impact.

The social capital market in the US alone is estimated by McKinsey to have annual revenue in excess of \$1.4 trillion. Despite its size, the current financing system is hallmarked by high degrees of inefficiency and fragmentation: since 1973, only 0.07% of social sector entities have achieved \$50 million in sustainable revenue. Foundations and Individuals account for 8% of that 0.07%. Furthermore, we have a social finance system that allocates capital at an estimated cost of 20-50% or more, over ten times the cost to the commercial for-profit market.

Underscored by such recent *Financial Times* headlines as “Moody states - US (the best of all G7 Countries in terms of trends) in danger of losing AAA status due to healthcare costs,” The bottom line is that demographic trends in the Western world indicate that the current method of allocating social capital is untenable. Therefore, *social provisions by the state (domestic and international) will pull back further*. It is imperative this issue is resolved.

### **What this is not**

This is not about the 5% allocation foundations traditionally make in grants, nor is it an iteration of a venture philanthropy model nor about mission-related investment in its classic form. Indeed these models still have a role

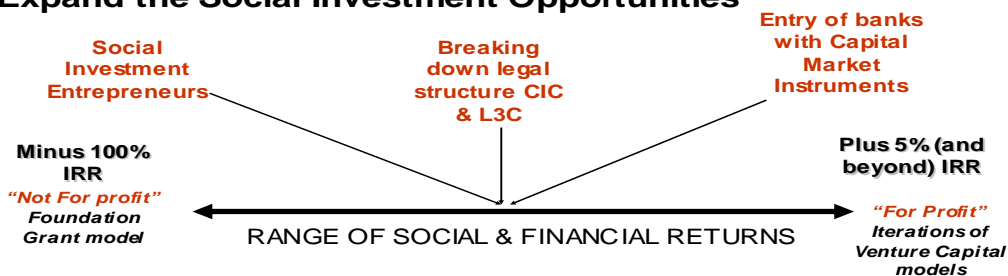
### **What this is**

This is about alternatives for the social sector organizations to raise revenue through the traditional channels other than grants, special events, mailings, major gifts and planned giving campaigns. These traditional channels cost 20% to 50%. Instead, this poses the question of how can we utilize the social assets of society (either allocated by government or foundations) to help leverage larger scale private sector capital and corporate expertise to enter into the social and philanthropic market.

To undertake its mission, Ashoka SFS has a three pronged strategy:

- Social Investment Entrepreneurs
- Legal / Governmental agenda – Breaking down the for profit and not for profit structure to create partnerships between the private, foundation, the social sector
- Business Entry – Engaging the banks

## Expand the Social Investment Opportunities



### THE IMPORTANCE OF COLLABORATION AND CHANGE

To solve the problems on a systemic basis requires:

Collaboration from the Social sector / NGO's to provide size to invest in

Creation / Evolving of Intermediaries to create Collaborative behaviour

Foundations / Donors – Leverage Capital, Increase Innovation but look to HOW to draw in more Private capital

Governments to change legislation – Tax treatment and Legal structures

Banks to bring their skills to bear

Corporates to engage with a “for profit” objective

If you consider any social capital market as a range of risk and returns, practically, there are currently only two investment points: “for profit” and “not-for-profit.” Ironically, most social investment opportunities are actually between these two points. However, as a function of the current financial instruments in philanthropy, compounded by the current legal framework, the social sector is forced to seek capital at just those points.

The actions we are taking (the arrows coming down) are designed to fill that gap. Today, modern capital markets create the ability to place investments and investors along the whole range of social investment returns. Furthermore, on the risk side, social investments can be restructured as higher quality investments, enabling mainstream investment funds to invest in them.

### Facilitation of the expansion of social investment opportunities and financing

#### A. Social Investment Entrepreneurs Fellows

With funding from a number of key Financial institutions and Foundations Ashoka have launched Social Investment Entrepreneurs (SIE) program. Very briefly, Ashoka has elected over 20 Social Investment Entrepreneur (SIE) Fellows to date and aims to identify 30 SIE Fellows worldwide per year. SIE Fellows develop new instruments, institutions, and patterns for social change. Compared to the 2000 other Ashoka Fellows who usually found a “not for profit” organization, many of these Fellows found “for benefit profit corporations”, with high social impact

#### B. Legal Structure – The L3C - Breaking down the silos of “For-Profit” and “Not-For-Profit”

L3C (Low profit Limited Liability Company) is a new legal structure which takes program related investment (PRI) and integrates it into a new form of Limited Liability Company (LLC) with charitable intent. This structure was conceived by Robert Lang, CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation and with the collaboration of Marcus Owens, former Head of the Exempt Unit of the IRS organized in such a way that it consists only a “one page,” simple definition addition, to state law. The beauty of this is that as a variant form of LLC it will immediately be legal anywhere an LLC is legal. It has passed the Vermont Legislature and will be signed by the governor on April 30, 2008. See [www.americansforcommunitydevelopment.org](http://www.americansforcommunitydevelopment.org) for more information.



The key players who contributed to the process met each other at an Aspen Roundtable in January 2007. Supporters, other than Ashoka, now include The Council of Foundations and the Social Enterprise Alliance, Tom Blaney of O'Connor Davies Munns and Dobbins, John Tyler of the Ewing Marion Kauffman Foundation and dozens of others.

An L3C creates a legal entity that can have both for-profits and not-for-profits in the same structure. It potentially achieves the following:

1. Simplifies and templates the use of PRI (currently only one percent of the social funding market), eliminating the complexity of currently doing PRIs and empowering the social sector, rather than large foundations, to utilize it as a tool. The actual cost of forming one in Vermont will be \$75 in state and \$100 out of state.
2. Creates a legal framework that supports both for-profits and not-for-profits in the same structure, allowing a more effective alignment of social and economic objectives in scale.
3. Allows foundations and high net worth individuals to take long term "patient capital" view, leveraging private capital for social purposes into a market at a subsidized rate.
4. L3C as a layered structure (LLC) is the mirror legal structure of the new layered investment structures such as the Eye Fund. This legislation ensures that the "first loss" segment currently provided by government can be more easily provided by Foundations and corporates
5. Potentially creates a quasi-equity vehicle for the banks.
6. Enables foundations to create substantive leverage of their core capital.
7. Encourages corporations to engage, in scale, in the social capital markets rather than using a Corporate Social Responsibility model.

### 1. Legislative Status

L3C legislation is currently before six state legislatures; it has passed the House in North Carolina and Vermont. In Vermont, it will become law on April 30<sup>th</sup>, 2008. At that point, similar to a Delaware company, it can be used across the US. At the federal level, a Washington lobbyist is engaged to move to the federal agenda in front of the likely revamp of the American tax system next year.

### 2. Future Opportunities

We are looking at how the concept can be scaled globally. In the US, OPIC (A major US Govt Development agency) has indicated an interest in potentially providing support to these structure, opening up the possibility of international philanthropy driven by market forces, but with a US government guarantee.

We have been working towards L3C legislation in Canada and Singapore. Singapore seeks to establish itself as a hub for regional Asian corporations, private banking and non-governmental organizations – so this plays into that agenda. Long term the use of an LLC opens up interesting questions of the use of international double taxation agreements to attract these hybrid structures.

### **C. Business Entry - Engaging the Banks**

The reality in philanthropy is that most social ventures / philanthropic endeavours are small and high risks or as bankers would say are "junk" (in its technical sense) However, there are for-profit opportunities for all three core businesses of a bank: private banking, investment banking and asset management. Conceptually, we are looking to increase the return and reduce the risk for investors of engaging in social impact.



We have now engaged a range of banks in strategic relationships, including Deutsche Bank, UBS, Standard Bank, Barclays, Goldman and JP Morgan. The announcement of the SSIU (Social Sector Investment Unit) by JPM solicited 925 members of their staff to offer assistance.

### 1. Risk/Credit enhancement models - the Deutsche Bank/IAPB/Ashoka Eye Fund I

Ashoka SFS took an idea that had been applied to microfinance and scaled it to a specific social issue, in this case, eye care. The resultant fund is managed and sold by Deutsche bank. This has leveraged off the skills of David Green as a social entrepreneur in eye care, the leadership of Nag Rao of International Association to Prevent Blindness (IAPB) and the skills of Deutsche bank. Ashoka's role in this was conceptualizing the idea, facilitating the relationships between the two sectors, there have been cases where Ashoka has been able to facilitate engagement of government (where the bank was not able to do so).

The other key role was representing the interest of the social sector vis a vis the banking sector to ensure the social sector took the minimum risk and yet extracted the maximum margin. It was hailed by *Fast Company* as one of the top best for-profit ideas to fund philanthropy.

Effectively what it does is to take a plethora of small entities and instead of funding them individually, which is risky, difficult and expensive, it groups them together and offers different layers of investment to different investors who seek different risk reward investments. The result is to increase the credit quality of the entire eye care investment and, in turn, draw private capital into the treatment of eye care. This fund supplies seven year capital to small eye care entities in India, China and Africa at around 5 to 7% - as well as capacity grants. It has also been very interesting to note how IAPB's role has changed in the process. The creation of intermediaries which see a benefit (indeed get paid) for creating collaborative behavior (between investors, the corporate sector and the social sector), is a fundamental gap in the market.

Deutsche Bank announced last week that they had raised the first tranche structure of the targeted \$20 million and were looking to launch in June. Investors include OPIC, the French Government and a range of Financial organizations, including Store brand. Ashoka's objective in this has been as demonstrative model "Pour encourager les autres".

### 2. Return Models

It is clear that there has been an explosion of venture philanthropy in recent years and this should clearly be encouraged. Our focus again however has been working with the banks to see how we can create models in larger scale.

One specific model which we believe is of particular interest and which we have just started work on with two separate investment banks is a contingent return model. In this model, a foundation or government is asked to take on a substantive payout based on the achievement of an agreed metric (or metrics over time). The objective is to change the incentive structure for the for-profit corporate world to collaborate with social sector entities and engage in a social mission.

Therefore, instead of funding a range of small high risk entities, a framework is created for collaboration between the "for profit" and "the not for profit" world with a clear defined substantive payout based on the achievement of social success. Another way of thinking about it is that it creates a defined cash flow as a function of the achievement of social success. In a VC model, the hurdle rate which defines an extraordinary return to the investors is normally the achievement of a financial return – in this model it becomes the social metric. Once a banker has a defined cash flow, the full orchestra of capital market tools can be brought to bear



### 3. The Sanitation Project

2008 has been designated the International Year of Sanitation by the United Nations. SFS has undertaken a Sanitation Project, leveraging off the success of the Eye Fund, to similarly enable financing for various players in the sanitation market. This project has been partly driven by Ashoka Fellow, Jack Sim; another 40 Ashoka Fellows are also working in this space.

A Changemakers competition has been launched, backed by the UN Foundation (GWC) ([www.changemakers.net](http://www.changemakers.net)). We are currently in the process of taking the winners and creating, on the back of the Eye Care Fund learning, a financial profiling (Institutions such as OPIC, UBS and Deutsche Bank are offering assistance) mechanism.

We have convened a Financing Facility. The Financing Facility partners include WSSCC (a WHO scion), SuSanna (GTZ-backed), who are the two largest global sanitation entities; WSP (The World Bank) to assist with metrics; Standard Bank (A for-profit carbon scheme, Shell and DEFRA engaged); UBS; Deutsche Bank (both Social Finance and Derivatives), Morgan Stanley (microfinance, through Changemakers); and possibly Acumen. Linklaters (the GAVI deal), have also offered to engage as legal advisors. Each bank has a different financing scheme focused on different parts of the value chain, which become mutually reinforcing and in turn draw their own partners into the financing and scaling process.

### 4. Going Forward

The ability to potentially create hybrid structures in a template able manner has stimulated substantive interest from the foundation, corporate and banking worlds. These solutions should not be considered as individual “silver bullets,” but in creating a social capital market which puts value on creating innovation and scale across all the constituencies (Social sector, Community, Financial, Governmental and Corporate) and creates a mix of social financing solutions to different constituencies, across the whole value chain – not to just the current two financing positions and products. The issue is scale and this should show a greater impact than the existing process where governmental, corporate and other organizations and foundations compete in a siloed manner to fund small entities.

#### Summary

- Legally facilitating [L3C] the easy collaboration and for profit engagement of the corporate and banking sector in the social market
- Facilitating innovation [ ie Social Investment Entrepreneurs] and networks
- Increasing the credit quality of what we invest in [Eye Care model] – increasing access to the capital market
- Practically demonstrating the model in real scale
- Increase the financial incentives [ Contingent Return models] for the for profit corporate and banking sectors to engage in scale

Four out of five of these pillars are now launched – with the last in discussion with banks, government, corporates and key foundations.