The multiplication effect of innovative philanthropic capital

The important multiplier role that philanthropists and foundations play as early investors

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Leveraging early philanthropic capital is a huge opportunity. Innovatively structured philanthropic capital has the potential to trigger the future flow of social capital by absorbing the first – and most challenging – layer of risk. Today, there are still many investors who are waiting for the right opportunity to deploy capital into the growing impact investing market. What is usually preventing them from investing is the lack of another party, who takes the first step to provide risk capital.

Forward-thinking philanthropic investors are currently finding new ways to leverage their funding for the maximum social benefit. Their seed- or knock-on financing bridges the gap to scalable impact investing opportunities, which typically comprise mature investment opportunities in social organisations that have reached the late-stage venture or the expansion stage. In particular foundations can play a crucial role as multipliers of innovative philanthropic capital by broadening the access to further funding and by creating new social investment opportunities. Thus, the allocation of innovative philanthropic capital is a very efficient way of making impact investible and to help the impact investing market to scale up further. The injection of early philanthropic capital may in particular help an impact fund to overcome the seed-financing phase and assist with its creation or it may help a social enterprise to become bankable.

Introduction

Until about 15 years ago, philanthropy and investing were two separate worlds. Now as impact investing is on the route to mainstream investing, the innovative power of the philanthropic dollar is becoming more and more obvious. Traditionally, foundations have provided donations, simple grants or classical loans to implement their charitable mission. Today, new hybrid forms of financing that blend charitable money and grant-elements with debt and equity characterise the investment-style of forward-thinking foundations and the next generation of philanthropists. They are innovative in their investment structuring and approach with respect to their philanthropic capital.

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Recent studies – like the Impact Investing Benchmark, released by the Global Impact Investing Network (GIIN) and Cambridge Associates – provide some robust research and confirm that market-rate returns are also attainable with impact investments. This opens up an interesting investment potential for private investors. In particular the institutional investor segment has enormous power in leveraging the impact-investing market to become mainstream. No doubt, there is a massive surplus of capital (both private and public) seeking a blended social and financial value return waiting to be invested.

On the other hand – the lack of a track record of successful impact investment deals and the shortage of quality investment opportunities are usually cited as hindrances for new impact investors to get involved. On a deeper look, it becomes evident that there are potentially a lot of institutional-quality social investment opportunities out there; many of these, however, lack initial funding or the support of lead investors and thus never surmount the initial project- or start-up phase.

In order for the field to become further scalable, innovative philanthropic funding is an important pre-step to incentivise more risk-averse investors to also invest in social causes they otherwise would not have invested in. In that respect, innovative philanthropic capital has two important roles.

Firstly, in its 'signalling' capacity, the early philanthropic investment signals to other investors that the investment is 'legitimate'; thus it has the potential to unlock additional funding from third parties. In particular, if an early investor is a reputable investor like a sophisticated foundation, the seed investment can improve the investee's credibility and strongly enhance the visibility for other investors whether private or institutional.

The second role is the important 'risk-reduction' role that early philanthropic investors play. They do so by lowering the risk for traditional investors and by encouraging them to support initiatives that otherwise might not meet their criteria for investment. Early philanthropic investors become risk-catalysts for social good. For example, the strengthening of the business case for institutional investors to integrate non-financial factors into their investment portfolios and to invest large sums into the impact-investing field often depends on the existence of investible quality deals. Innovative philanthropic funding helps impact investors to enhance risk-mitigation and to participate in impact-investment options that have overcome the initial funding hurdle.

Unlocking of innovative philanthropic capital

In order to unlock innovative philanthropic capital, philanthropic investors such as foundations must show some form of pioneering spirit and be open to experiment where other investors cannot. Of course innovation is always a risky game, but foundations have a good amount of experience in sectors and regions where more risk-averse investors don't have access. In practice, this means that foundations need to go beyond classical grant or loan funding. If they dare to fill this initial financing gap, they become enablers of the emergence of new social investment products and help cutting-edge social organisations to become investible.

How can more innovative philanthropic capital be unlocked in practice? Education and peer-to-peer

sharing play a major role among philanthropic investors as they may encourage like-minded investors to re-evaluate their risk-return profiles with their social investment goals. The Toniic Institute speaks of the 'collaboration gap' in that regard in one of its most recent publications. Foundations may also move from individual impact deals to multi-investment impact portfolios where patient capital as well as market-rate social investments are covered. Also foundations should be encouraged to further innovate, share their investment stories and continue to align their assets with their mission to further help building the infrastructure and roots for the impact investment sector.

Structuring possibilities of innovative philanthropic capital

Innovative philanthropic capital can be structured in various different forms – a variety of both new as well as established structuring vehicles exist with different risk-return profiles and diverse levels of liquidity, time horizons, involved parties, cost and complexity.

Traditionally simple grants have played a major role in philanthropic funding. They are the primary tool most people think of when it comes to philanthropic support of social enterprises or non-profits. In recent years many new innovative structuring forms of philanthropic capital have been developed. Today, there are many ways to use traditional grants more effectively by incorporating or taking into account the specific financing needs of the recipient such as a social enterprise. For example, recoverable grants, performance-based grants or convertible grants are very helpful funding mechanisms if there is no equity capital available, if the business does not create enough value yet to attract equity investors or if the business does not have collateral or cash flow to service commercial debt. Also loan guarantees are an efficient way to enhance the credit quality of a social enterprise and make it easier to obtain commercial funding. Bridging loans, forgivable loans or subordinated loans are other innovative philanthropic financing mechanisms. Quasi-Equity debt combines debt and equity elements and is particularly useful for social enterprises that are non-profits and cannot obtain equity capital.

Other innovative philanthropic funding instruments or mechanisms include, for example:

- Demand Dividend Investment structures, which tap into the free cash flow of social enterprises at the time that the cash flow is available (i.e. when the social enterprise can actually pay back)
- Forms of credit enhancement like Catalytic First Loss Capital. Such capital typically catalyses the participation of investors that otherwise would not have participated by absorbing first losses of an investment (e.g. a social enterprise), thus de-risking further investment.

Summary

The innovative structuring of philanthropic capital can be a very effective tool for the impact-investing field to reach maturity. Innovative philanthropic capital bridges the financing gap between the seed-funding stage and market-rate, mission-driven capital. Large impact investors usually prefer some form of matured investment options that have overcome early funding phases and offer stable investment participation possibilities during the expansion stage of a venture.

Innovative philanthropic capital has the potential to catalyse funding where otherwise commercial funding typically is impossible. This catalytic effect arises by triggering the future flow of capital and by attracting further investors and similarly reducing their risk. In particular, foundations can become important multipliers as their experience in certain sectors, their flexibility and higher risk-tolerance enables them to lay the ground for helping one of the most promising investment fields to become mainstream.

Dr. Christin ter Braak-Forstinger *is the founder of PVA Advisory, an independent philanthropic advisory firm for financial intermediaries based in Zurich (founded in 2011). Christin has 15 years of experience as a financial lawyer and project manager for HNWI and a deep knowledge and personal passion in the area of philanthropy and impact investing. She also has extensive grass-roots experience in Africa. Christin is the author of several books and peer-reviewed articles in banking, law, philanthropy and impact investing. She completed her postgraduate study at Duke Law School and wrote her doctoral thesis at Harvard Law School. She is a regular lecturer at universities and speaker at panels. Privately, Christin is the co-founder and president of an Austrian, Swiss and Ghana-based NGO supporting vulnerable children in Africa (www.braveaurora.com). Her private NGO recently got awarded with the highest award of the Upper Austria Government (Human Rights Award 2014). The Int. Alpbach Forum Austria elected her as one of the 40 Young Emerging European Leaders 2014.*