

Nonprofit Capital

A Review of Problems and Strategies

prepared by William P. Ryan
for The Rockefeller Foundation
and Fannie Mae Foundation

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— William P. Ryan

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Executive Summary

THIS PAPER WAS PREPARED TO HELP the Fannie Mae and Rockefeller Foundations review the challenges and opportunities nonprofit organizations face in attempting to meet their need for financial capital, particularly in the areas of community and work-force development. Based on interviews and a literature review, the paper presents a summary of notable strategies and practices.

Key Themes. Those interviewed for the scan are generally optimistic, in large part because nonprofits are more inclined and competent than ever to deal with finance and management issues, but they still find that working capital is the hardest to raise. Most feel that performance and capital are inseparable, and that simply supplying more capital — without attention to how it is invested — is not enough.

Defining Nonprofit Capital and Its Benefits. Observers make two sets of distinctions in analyzing the capital problem and its solutions:

1. *Three types of capital* meet different needs and have generated different strategies:
 - **facilities capital funds the building or acquisition of offices and facilities;**
 - **working capital covers expenses during low cash flow and funds strategic investments in an organization's capacity; and**
 - **permanent capital refers both to endowments and to the capital reserves that community development organizations use to invest in housing and business development.**
2. *The purported benefits of capital* all center on improving productivity — especially compelling in today's environment, where:
 - **expensive information technology is believed to be essential to enhanced efficiency;**
 - **an emerging organizational effectiveness movement stresses investment of working capital in management processes; and**
 - **capital can be a competitive asset that might not produce better program outcomes but could enable the organization to survive when faced with larger, better-capitalized competitors.**

Strategies and Solutions. The nonprofit capital solutions that were cited most often in the literature and interviews represent four strategies for dealing with capital challenges:

1. *Reforming the Nonprofit Capital Market* — Some analysts envision a more rational, segmented, and therefore more efficient and responsive, nonprofit capital market, which would create the time and incentives for nonprofit managers to improve their organizations. Examples of this include: reducing transaction and opportunity costs; improving foundation leverage; and encouraging more philanthropy with better information for donors.
2. *Reforming Philanthropy* — Some argue for making grants function more like working capital that nonprofits can use to improve their capacity and performance, and less like revenues that fund direct service provision.

Examples of this strategy include: high-engagement grantmaking (including the much discussed idea of venture philanthropy) in which funders add value and ensure accountability by becoming more involved in grantees' work; proprietary intermediaries, which focus on building the capacity of a chosen few nonprofits, instead of an entire field; stabilization funds, which build capital reserves and financial management capacity; philanthropic tax credits, which promote larger, longer term grants, and management assistance, from corporate donors; and program

related investments, which are often credited with sharpening the focus on results.

3. *Reforming Nonprofits* — Others argue that nonprofits can generate their own working capital by: operating more efficiently; learning to use debt more aggressively; or by earning unrestricted income in the marketplace, although the latter may be built on widespread but dubious assumptions that public and philanthropic funds are shrinking.

Examples of nonprofit reform strategies include: making nonprofits bankable; generating working capital internally, primarily through better pricing of services; creating self-sufficient nonprofits or social enterprises; growing nonprofits; and converting to for-profit status.

4. *Expanding Access to Private Capital* — The big prize for a growing field of analysts, innovators and policymakers is access to the private capital market, a prospect that has inspired a variety of innovations aimed at supplying permanent capital for community development projects.

- **Institutional strategies to access private capital focus on creating the infrastructure for community investment by funding and strengthening a wide array of community development financial institutions (CDFIs).**
- **Technical innovations for accessing the private capital markets include the use of tax-exempt bonds (generally for facilities); net-lease finance (in which nonprofits convert real estate into capital by selling it and leasing it back); and secondary markets to replenish the capital supplies of CDFIs.**
- **Public policy uses tax credits to encourage lending to and investment in CDFIs.**
- **Social investment strategies attempt to cultivate socially motivated investors, both individual and institutional, often willing to accept low returns as a trade-off for capitalizing social ventures.**

Introduction and Background

This paper was commissioned by the Fannie Mae and Rockefeller Foundations to review current practices and thinking on how to meet nonprofit organizations' need for financial capital. Both foundations, joined by the Surdna Foundation, wanted a map of this vast, sometimes technically complex landscape to aid in their own analysis and strategy development.

The paper is based on interviews (with nonprofit managers, consultants, researchers and bankers) and a review of the literature, highlights of which are summarized under "Related Reading." The interviews were open-ended discussions aimed at identifying both new and important practices and the underlying assumptions that shaped them. The interviewees cited dozens of practices and strategies in use across the nonprofit sector. But the paper gives special attention to those that grow out of or may be most relevant to two program areas of special interest to the foundations: community development and work-force development.

The final result of this exercise is in fact much like a map. The paper attempts to provide an overview that might help decision makers better understand their options. So while it does not pretend to be a technical manual that readers can use, for example, to learn how to issue tax-exempt bonds, it does provide a context for considering the potential of tax-exempt bonds. It could help in thinking about some key questions: What kind of capital will a given approach generate? What can nonprofits accomplish with that capital? What are the alternatives? How else can we think about the problems of capital?

The paper has four parts. Part one sketches a few cross-cutting key themes that emerged from the interviews and literature review. Part two defines nonprofit capital, and the problems that various types of capital attempt to solve. Part three — the bulk of the paper — reviews the strategies and solutions offered in response to nonprofit capital problems, organized into categories that highlight the strategies that shape them. Part four is devoted to brief concluding reflections. Following that is an annotated bibliography of some notable books and articles on capital issues.

1: Key Themes

THE OBSERVERS INTERVIEWED FOR THIS PAPER and reflected in the literature approach nonprofit capital questions from very different angles. Yet three themes emerged so consistently they are worth noting at the outset:

1. Observers are generally optimistic.

While many were eloquent in describing barriers and frustrations they face, most observers described important shifts in attitude, practice and opportunity that they felt were already enabling real progress in meeting nonprofit capital needs. Observers did almost universally describe a culture marked by nonprofit ignorance of, and indifference to, finance issues, and to funders who were often as much part of the problem as the solution. But most suggested that attitudes and technical competence had improved markedly in recent years, creating yet more opportunities for progress.

2. Working capital presents the biggest challenge.

As the paper makes clear in many cases, working capital, which enables nonprofits to invest in their own capacity, is critically important and generally difficult to come by. Even nonprofits that are part of the community development financial infrastructure — dedicated to providing capital for economic development — find that they themselves are in need of working capital.

3. Performance and capital are inseparable.

Nonprofits need capital to perform, yet no one wants to provide capital to a nonprofit that is not capable of performing. This conundrum has profoundly shaped many of the responses to capital challenges. It may account for the general scarcity of philanthropic working capital, and it surely explains the emergence of several new approaches that stress accountability for performance as a condition of capital investment. Several observers even argued that providing too much working capital from external sources could be a problem, not a solution: nonprofits might “hide behind the capital,” using it to compensate for poor performance, not for investing in better performance.

Before getting to the strategies that raise these themes, a review of the meaning and purposes of nonprofit capital is necessary.

2: Defining Nonprofit Capital and Its Benefits

THE DISCUSSION IN THIS SECTION defines several types of capital, their functions and their benefits. More than an exercise meant to clarify terms, it is an important part of the mapping of nonprofit capital development because it helps answer several fundamental questions:

*What is the nature of the nonprofit sector's capital problem?
Is that problem different today — more complex or more urgent — than in previous years?
What do we gain by solving by it, and by trying to solve it now?*

The following types of capital are treated in this discussion:

1. Facilities Capital.

Facilities Capital funds the building or acquisition of real estate to house nonprofit offices and programs. Although observers argue that the process of raising facilities capital can be an excellent opportunity to address a nonprofit's longrange strategic and financial goals, many nonprofit managers mistakenly conclude that once they have a facility, it will generate a sustainable flow of revenue by attracting more program participants.

2. Working Capital.

Working Capital is the most sought after and most scarce type of capital for most nonprofits. It can fund routine expenses during periods of low cash flow or more strategic investments in an organization's capacity to grow or improve its services. Since many funders find it risky to invest in an organization they do not control, they may make working capital available through more hands-on grantmaking that gives them the opportunity to ensure the capital is used productively.

3. Permanent Capital.

Permanent Capital refers both to funds granted for an organization's endowment and to the capital reserves that community development organizations use to invest in housing and business development. While the capital development pools of many community development financial institutions have been expanded, the permanent capital in these pools is to be passed through as investments in the community, and does not necessarily supply working capital to the nonprofit making those investments.

The following discussion of these types of capital will provide a context for the later review of strategies and solutions aimed at addressing capital problems.

Facilities Capital

NO ONE CONTESTS THE IDEA that capital made available for acquisition or improvement of facilities for a nonprofit will produce better-housed organizations. That is why facilities funds — most notably for arts and cultural organizations and, more recently, child-care operators and human service organizations — have found such a useful niche. Observers do differ, however, on the more far-reaching effects of facilities funding. Can it strengthen an organization's broader fiscal and organizational capacities? Or does it distract weak organizations from developing those other capacities?

As a platform for building better organizations. Nonprofits that buy and manage their own facilities are sometimes imagined to get the same benefits as households that move from renting to homeownership: more security, the ability to develop equity and more sophistication for managing all of their financial affairs.

Carl Sussman, a nonprofit consultant and operator of a child-care facilities fund, argues for these benefits in a recent paper reviewing the prospects for nonprofit facilities funds:

Facilities loan funds often stimulate broader systemic changes that affect operating income and the willingness of providers to assume debt, leverage new sources of capital and in other ways stimulate higher levels of capital investments in community-based child and family support facilities. These are the indirect benefits of a specialized facilities loan program.¹

More capital for facilities, according to this logic, will produce not only better-housed nonprofits, but better-run nonprofits as well.

As a substitute for building better organizations. Other analysts argue that making more facilities capital available — in the absence of comprehensive financial planning and strategy development — can do more harm than good. According to Clara Miller, president of the Nonprofit Finance Fund, nonprofits often look at facilities questions in isolation from business planning and strategy development. In these cases, she says, facilities capital can be “an albatross,” encouraging nonprofits to “take on a building that’s too big without looking at the business inside. Instead of getting security and equity, they get debt service and maintenance obligations that they underestimated.”

The **Nonprofit Finance Fund**'s recently launched Building for the Future program helps nonprofits cope with these sometimes overwhelming obligations. As the feasibility study for the new program found, facilities ownership does not necessarily beget good programs or better-managed organizations. Reviewing the situation of a sample of Boys and Girls Clubs in the northeast United States, the Fund discovered that “the best-attended Clubs generally had the highest number of permanent staff, indicating that dedicated leaders (not square footage) attract young people...Square footage attracts neither members nor money.” And those who regard facility ownership as a potential cash cow (generating revenue from facility rentals, for example) tend not to invest in facilities maintenance. Clubs generating the highest percentage of their revenues from building-driven activities are the very ones that “spend the least on their buildings per square foot.”²

As with the Boys and Girls Clubs, so with arts and cultural groups, and even with community development corporations (CDCs): it can be easier to acquire or develop facilities than it can be to manage them effectively over time.

Working Capital

WORKING CAPITAL ENABLES AN ORGANIZATION to make strategic investments in its own capacity: to develop new programs; conduct research; evaluate its work; engage in planning and analysis; upgrade technology; support staff or board development; and expand the organization. Not surprisingly, it emerges as the most important type of capital from this scan: it is the most sought after by nonprofits; it is potentially the most productive type of capital, with a number of claims made for it; and by most accounts, it is the hardest to obtain. Working capital can come in the form of either equity (sometimes seen as grants in the nonprofit context) or debt.

Though this paper does not explore it at length, working capital has a second important meaning. In contrast to the more strategic investments mentioned above, working capital can also serve as a ready supply of cash to cover the organization's routine expenses during periods of low cash flow (e.g., before expected payments are made on grants or government contracts). Though no less vital and often more pressing than the strategic working capital, this type of cash-flow funding may be more readily available to nonprofits. For example, nonprofits can establish lines of credit with commercial banks, or take "bridge loans" from loan funds specializing in nonprofit organizations.

It is the idea of working capital as a source of strategic organizational investment that seems especially salient today, in large part because of a number of (sometimes-implicit) claims about the potential benefits of working capital. The discussion below reviews these claims and their underlying assumptions.

The generic working capital claim: productivity. In competent hands, working capital makes an organization more productive. Susan Kenny Stevens, a nonprofit financial consultant and manager of over a dozen nonprofit loan funds, observes that "nonprofits with working capital have more choices, more staying power and are more likely to strengthen organizational capacity."³ Economists make the same argument slightly differently: because of " 'diminishing returns to production,' at some point, without the addition of further units of capital, adding one more unit of labor leads to a negative increase in a firm's output. At that point, a firm cannot produce additional units of goods or services without additional infusions of capital. Thus, access to capital is strongly related to growth in the productivity of labor."⁴

Without the benefit of economic theory, nonprofit advocates and observers are advancing a series of more specific claims about the need for and benefits of working capital, some made more compelling by recent developments in the nonprofit environment.

Better organizations. Working capital could help nonprofits become more efficient and more effective. And as efficiency and effectiveness have become ascendant concepts in the nonprofit sector, so has the idea of working capital as a resource to support them.

Efficiency is increasingly framed as a matter of technology, which quickly leads to questions of capital: nonprofits feel they need better technology, and capital investments to purchase it. The work-force development managers interviewed as part of a seven-city survey for the Rockefeller Foundation in 1998 consistently cited lack of information technology as a barrier to efficiency. They felt it hindered administration, case management and, ultimately, program evaluation and improvement (because it left them with weak databases that were hard to work with).⁵ The growth of information technology — and the fear that nonprofits are lagging behind for profits and government in their technological capacity — is surely driving a good deal of the recent attention to working capital.

A more comprehensive analysis, also growing in popularity, argues that investment in organizational processes will improve the overall *effectiveness* of a nonprofit, helping it deliver better-quality services and more efficacious programs. Systems for learning, innovating and improving services, for example, can all contribute to effectiveness, and all require working capital to design and implement. Like information technology, interest in organizational effectiveness may be at an unprecedented high point in the nonprofit sector.⁶

We can explain why these arguments are salient, but are they compelling? There is, after all, no guarantee that supplying nonprofits with working capital will lead to more efficiency or effectiveness, which may explain why foundations still tend to favor program-specific grants over general operating support. It may also explain why foundations that do make more working capital available may also want better oversight and input into nonprofit affairs, an important phenomenon discussed later.

Bigger organizations. Proponents of working capital almost always point out how important it is to organizational growth⁷, and their logic is unassailable. Growth means more staff, more facilities or equipment and more systems to manage all of these — often in advance of any revenue from government contracts or philanthropic donations. As in business, where capital is generally raised to grow an organization, so with nonprofits: no capital, no growth.

But how many nonprofits really want to grow? And how many foundations are interested in supporting that growth? At best, many nonprofits might be considered ambivalent about growth. Their devotion to a local mission and to personal one-on-one contact with their clients leaves many nonprofit employees indifferent to growth. CDCs and work-force development organizations, for example, often see their mission in place-based terms. They may want to increase their volume through more contracts or development projects, but they are not likely to want to pursue multi-site expansion. And foundations, often more interested in the general public good than in the fortunes of any one organization, have the option of investing in replication or diffusion strategies instead of in organizational growth.

So organizational growth may be both an irrefutable rationale for increasing the supply of working capital — and an irrelevant one.

More competitive organizations. Working capital can also be a competitive asset, particularly in markets where for-profits are active.⁸ The research literature does not seem to suggest that better-capitalized organizations produce more value for clients or communities. Comparative studies of day-care, home-health and other programs suggest that the outcomes of nonprofits and for-profits (which often enjoy better access to capital) are quite similar.⁹ But even if program outcomes are the same, better-capitalized organizations may have a distinct *competitive* advantage over thinly capitalized ones. So where and when is lack of capital a significant competitive disadvantage for nonprofits? Two types of markets would seem to pose special challenges: scale-sensitive and risk-sharing markets.

Scale-sensitive markets. In some cost-competitive markets, the only way for organizations to realize a profit or surplus is through growth, which reduces their overhead as a share of total operating expenses. As the founder of a for-profit afterschool program said of the economics of her program, “It doesn’t work for one school. It doesn’t even work for five schools, and it just begins to start making sense for 100 schools.”¹⁰ Once larger organizations gain such efficiencies of scale, they can begin offering yet more competitive prices. The result, for smaller organizations, is competitive disadvantage. One way to cope is to grow, which in turn would require expansion capital.

Risk-sharing markets. Some competitive markets are shaped by risk-sharing contracts. For example, under competitive performance-based contracts, providers contracting with a government agency forego some or even most of their fee if they cannot deliver the result specified in the contract. Only organizations with a capital base — and one they are willing to put at risk — can be competitive in these markets. Even if the provider delivers the result, it may still need a reserve to cover expenses until it passes the final milestone and triggers the full payment. It is important to note, however, that few nonprofits (or for-profits) are subject to pure performance contracts. As an earlier scan suggested, work-force development organizations often

found ways — short of accessing new capital — to mitigate the effects of these contracts, which were sometimes not as austere as advertised.¹¹

Permanent Capital

PERMANENT CAPITAL NORMALLY REFERS to endowments or reserves that are not meant to be liquidated until the organization goes out of business, although they might be drawn upon occasionally for special needs and opportunities, and the income they generate is often used as working capital.¹² For the purposes of this paper, permanent capital will also be used to refer to the capital pools of CDFIs, the organizations that provide credit and equity for community economic development projects (including housing, commercial real estate and business development).

How to categorize these capital pools for community development is a thorny problem, and it points to a special challenge facing the nonprofit community development field. On the one hand, as will be clear by the end of this report, the challenge of capitalizing CDFIs has been met with impressive ingenuity and innovation: most of the technical solutions reviewed later are aimed at capitalizing these loan pools. On the other hand, capitalizing CDFIs does not, in the end, speak to the capital challenges of *nonprofit organizations themselves*. The end-users of CDFI funds are often businesses — not nonprofit organizations. And it is the end-users, not nonprofit financial institutions that are accessing new supplies of working capital to expand their operations. The CDFIs — though a critical conduit for this capital flow — end up facing many of the same cash-flow and strategic working capital challenges as any other nonprofit.

So these community development capital pools are not like permanent capital in the strict sense: they are not for the benefit of the organization itself. But it would be wrong to treat them as working capital, since they do not function as such for the nonprofit organizations that hold them.

...
Even this fairly simple classification of different forms of nonprofit capital and their purposes can help get us from thinking about a monolithic capital problem to a more refined assessment of the various capital needs of a given nonprofit, or group of nonprofits. Facilities, working and permanent capital satisfy different needs. The strategies reviewed in the next section collectively address all these capital challenges, but individually they tend to focus on only one of them. Making these distinctions is critical to understanding how to respond to any or all of the nonprofit capital challenges.

3: Strategies and Solutions for Nonprofit Capital Problems

THIS SECTION SUMMARIZES THE NONPROFIT CAPITAL SOLUTIONS that were cited most often in the literature and interviews. The solutions are organized into four strategies. This approach emphasizes how various innovators conceive of the nonprofit capital challenge, organizing them around four underlying theories of change:

1. Reforming the Nonprofit Capital Market.

Some analysts envision a more rational, segmented and therefore more efficient and responsive nonprofit capital market, emphasizing not so much the amount of capital available but the terms and consequences of that capital.

2. Reforming Philanthropy.

Many have focused on optimizing the impact of philanthropic dollars by making grants and gifts function more like working capital that nonprofits can use to improve their capacity and performance, and less like revenues that fund direct service provision.

3. Reforming Nonprofits.

Others argue that the nonprofits can generate their own working capital by operating more efficiently or by earning unrestricted income in the marketplace.

4. Expanding Access to Private Capital.

The big prize for a growing field of analysts, innovators and policymakers is direct access to the private capital market, which has led to a variety of innovations, most of which generate capital for community development projects (though not always the nonprofits that manage them).

A few innovations seemed to defy easy categorization, and one could argue about where to assign them, but it seems more useful to propose a comprehensive view of all the innovations, even with a few wrinkles, than to offer a mere catalogue.

Strategy #1

Reforming the Nonprofit Capital Market

SOME ANALYSTS AND ADVOCATES PROPOSE a better organized nonprofit capital market as a lever for improving nonprofit performance; enhancing foundation leverage strategies; and expanding the supply of philanthropic capital available to nonprofits. They argue that the way that capital is organized and deployed is nearly as important as the absolute amount of money available.

Reducing Transaction and Opportunity Costs

This market-reforming analysis sees an indirect but powerful link between the nonprofit capital market and nonprofit performance. The current nonprofit capital market is disorganized and not clearly segmented, which imposes high transaction and opportunity costs on managers, who are forced to spend huge amounts of time fundraising. And, argues Jed Emerson of the Harvard Business School, the funding they do get is often packaged and conditioned — in small amounts, with many restrictions, and without regard to the developmental stage of the nonprofit — in unhelpful ways.¹³ “The disorderliness and complexity of the philanthropic funding environment,” according to Allen Grossman of the Harvard Business School, “distracts nonprofit management, shifting focus away from organizational performance.”¹⁴

As significant as these transaction and opportunity costs are, Emerson emphasizes that a better organized capital market is not in itself any guarantee of performance. It is a market that supplies the appropriate forms of capital, “together with the presence of talented management and staff along with a little luck in the form of market timing, which makes for success or failure in the nonprofit world.”¹⁵

Improving Foundation Leverage

This disorganized capital market affects foundations as well as nonprofits. As Emerson suggests in a discussion about the respective roles of government and philanthropy in funding nonprofits, the potential for leverage is greater in clearly segmented markets. If foundations are working on the assumption that their grants will leverage government spending, while at the same time government funders are hoping to attract private philanthropic capital, can either have an effective leverage strategy? Even within philanthropy itself, if all funders prefer to fund early stage work in the hopes of attracting other donors, who will be left to take up the challenge? In response, the market-reforming strategy calls for more segmentation, with funders making explicit their willingness to fund nonprofits at various stages of their development.

Encouraging More Philanthropy With Better Information for Donors

Efficient markets are characterized by good information, which enables both customers and firms to make informed choices. Building on this insight, the market-organizing proponents advocate better information, particularly better information for donors, which could raise their confidence and therefore their willingness to donate more money to nonprofits.

At the conceptual level, several proponents of market organizing are working on the development of standard metrics for assessing “Social Return on Investment;” Jed Emerson’s work toward developing SROIs is both comprehensive and grounded. His model, developed with colleagues at the Roberts Enterprise Development Fund (REDF), tries to capture three distinct types of value created by nonprofits: the “economic” value of their services; the “social” value of the improvements to clients’ lives; and the “socio-economic” value enjoyed by society when nonprofits relieve it of more expensive, remedial government services.¹⁶ REDF has run a two-year pilot effort to use SROIs to assess the value created by its grantees.

The **CDFI Data Project**¹⁷ is creating a CDFI data collection and management system that has the potential to transform the way information is collected and used in the development finance field. Data on CDFIs is now collected by a variety of funders, trade associations and researchers,

each interested in different characteristics and segments of the CDFI field. This comprehensive system will minimize reporting requirements on CDFIs; it will also improve the quality of CDFI data and enable practitioners to compare their organizations and programs to a broad group of peers. The project will make an important contribution through the standardized data set it produces. Eventually, this data will include standard outcome metrics for the field. Considering the difficulty of measuring social returns on investment and other outcome metrics, these indicators will emerge after the first year, after ample consultation with CDFI practitioners.

Others are working not on better metrics, but on more accessible information for donors, often by using the Internet. **SEA Change**, a new association advocating for the interests of social entrepreneurs, is considering launching a variant of **Garage.com**, which is a Web site where entrepreneurs can seek venture capital backing, and other resources, for their business ideas. In this variant, **Garage.org**, social entrepreneurs and philanthropists would seek each other out.

In the San Francisco Bay Area, **Craigslist Nonprofit Venture Forums** provide an opportunity for start-up nonprofits to pitch their concepts and strategies to potential donors in a fast-moving process aimed at cutting down the pain of philanthropic matchmaking. The sponsor, **Craigslist.org**, sees the forums as an extension of their extremely popular Web site, which helps Bay Area residents connect with one other through postings about jobs, events, housing and volunteer opportunities. The venture forum was founded by Jane Leu, founder of **Upwardly Global**, a nonprofit work-force development organization for new immigrants, after a series of frustrating and time-consuming experiences trying to present her idea to established foundations.

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The market-reform strategies envision an environment more responsive to the needs of nonprofits at various stages of their development. The capital strategies that follow propose new roles and tools for the various actors within that market.

Strategy #2

Reforming Philanthropy

IT'S PROBABLY NOT AN EXAGGERATION to say that a new consensus is emerging that philanthropy could be the most important source of working capital for nonprofits — if foundation practices were reformed so that restrictive grant funds could function more like capital.

The initiatives reviewed below are all premised on this assumption, one shared by many of the observers interviewed for this paper. The manager of a stabilization fund complained that too many foundations are “promoting grant-seeking behavior” that does not improve the ability of the organizations to perform or grow. A nonprofit finance consultant said the problem with most grants is that they are “controlling, not enabling.” These, of course, are the sentiments traditionally voiced by nonprofit advocates seeking more general operating grants.

The emerging consensus, however, argues for more than unrestricted funds: As much as nonprofits need working capital, it is not always wise for foundations to deliver it — unless they can do so in a way that ensures nonprofits will use it to improve productivity and outcomes. Short of such measures, general operating support can become, in the words of Susan Kenny Stevens, “a budget balancing wild card doled out by foundations as a philanthropic allowance.”¹⁸ Instead of providing the stimulus and resources for nonprofits to make strategic investments in their own capacity, she argues, unrestricted funding can encourage a “dependence mentality” in which desperate nonprofits greet each new grant with enormous relief — and then treat them as cash, not capital for organizational improvements.

High-Engagement Grantmaking

In high-engagement grantmaking, foundation staff work closely with their grantees, both to help them achieve their organizational improvement goals and to satisfy themselves that their funds are being well used.

The most visible form of high-engagement grantmaking is a style inspired by or modeled after venture capital. Since at least the 1970s, philanthropists have compared their role to that of venture capitalists, pointing out that both focus on the development of new ideas for broader application. By the early 1990s, a new set of practitioners and analysts began appropriating the metaphor to emphasize a different point — that venture capital (and grantmaking styled after it) is important for its ability to strengthen an organization’s capacity to perform. This distinction between support for an innovation (in conventional grants) and support for an organization is emphasized in the pioneering work of the **Roberts Economic Development Fund** and the **Peninsula Community Foundation’s Center for Venture Philanthropy** (both in the San Francisco Bay Area), and was explicated in a 1997 analysis that ran in the *Harvard Business Review*.¹⁹

Much of that analysis is now often obscured by “venture philanthropy” — a catchall phrase sometimes used to suggest strategic investment in organizational capacity, but often used much more generally to denote a results-oriented style or ambience favored by many newly wealthy donors.

Meanwhile, a number of less visible foundations have been pursuing high-engagement philanthropy without reference to venture capital or venture philanthropy. Preliminary analysis of research conducted on six such models by the **Hauser Center for Nonprofit Organizations** suggests that grantees benefit in two ways. First, the grants from high-engagement funders tend to run longer than average, and are therefore a reliable source of working capital for the nonprofits. Second, the grantees benefit as much, or more, from general assistance with overall strategy as they do from any technical management assistance the funders might offer or pay for. The net result is larger blocks of capital with a relationship that aims to ensure that it is used as a strategic investment in the nonprofit’s organizational capacity.²⁰

Proprietary Intermediaries

If we normally think of an intermediary as an organization that raises money for and works to build the capacity of a field of nonprofit organizations, we could think of a proprietary intermediary as one that takes a narrower focus in funding and improving a select handful of nonprofits in a given field. The tactics of a proprietary intermediary would be very similar to those of high-engagement funders and venture-capital philanthropists, although the intermediary is not incorporated as a foundation.

New American Schools (NAS) provides an excellent example. Started in 1991 with grants from foundations and corporations for the purpose of promoting education reform, NAS had awarded over \$150 million in grants, mostly to help seven education reform organizations achieve largescale implementation of their programs, before redesigning its strategy. NAS concluded that it could never raise enough money in grants to fund large-scale implementation. It decided instead to help the nonprofit school-reform organizations sell their services to school districts, which were benefiting from increased federal and state funding for school reform.

NAS then began envisioning its role as that of an investor, providing working capital and other forms of assistance that would help the nonprofits market their reform ideas to school districts. NAS literally took a proprietary stake in the organizations by claiming ownership of their intellectual property — the school reform program designs. Although it continues to offer working capital grants, it now plans to offer debt that the nonprofits will repay when their larger-scale businesses generate enough income. Prudential Insurance has made a 10-year loan of \$10 million to NAS, bringing its capital base to \$15.7 million; it eventually wants a capital base of \$25 million.

Although the Local Initiatives Support Corporation (LISC) is a premier *field*-building intermediary, advocating for and working with CDCs across the country, it has helped launch a

series of funding programs that provide CDCs with working capital and technical assistance, more in the style of a *proprietary* intermediary. In a typical LISC Operating Support Collaborative, a group of funders capitalizes a special fund and hires staff to manage it. The fund targets a small number of CDCs in one city and provides relatively large blocks of capital (as general operating support grants) over as much as five years. The grants support specific organization-building objectives that have been formulated by the participating CDCs and endorsed by the funders. The funders, through their staff, then work closely with the CDCs to monitor and improve their progress toward the designated goal.

Stabilization Funds

Pioneered by funders of the arts over 20 years ago, stabilization funds provide nonprofits with endowment or cash-reserve capital as part of a larger effort to improve their financial situations. The capital provided is generally not meant as working capital for immediate needs, but as a base that will generate income over the long-term and, in some cases, be available as a reserve fund for special projects.²¹

The logic of the original funds for arts organizations is straightforward: if these nonprofits had the capital and knowledge needed for better marketing, financial management and general administration, they could improve their chances of generating more revenue from ticket sales and become more stable. Although they might not be expected to become totally self-sufficient, foundation grants would not be what Stevens calls the “wild card” in balancing perennially mismanaged budgets. Instead, they would provide resources for organizational improvement.

The management assistance components of the stabilization funds can be significant. National Arts Stabilization, the flagship of the funds, conditions release of funding on achievement of designated milestones. It offers assistance with financial planning, management and board development, all aimed at strengthening the arts organization. It has recently embarked on what may be one of the few attempts to evaluate the outcomes of management assistance to nonprofits.

The Ford Foundation, which has long been a promoter of stabilization funds, made a series of large grants in June 2000 that are also aimed at improving the capacity and financial stability of arts groups. Called “New Directions/New Donors,” the Ford initiative granted \$40 million to 28 organizations, with grants ranging in size from \$1.25 to \$2.5 million. The grants carry a matching requirement, and are intended to help arts organizations find a new donor base among the newly wealthy. The Nonprofit Finance Fund will document the process and its outcomes.

The Rockefeller Foundation has extended the stabilization concept beyond the arts in a 15-year program “to encourage independence and improve the financial stability of four major civil rights litigation organizations.” Begun in 1985, the program offered major grants that were to be used as quasiendowments (i.e., mostly for generating income over the long-term, but also available as cash reserves for special needs or opportunities). This Basic Rights Stabilization Program was ambitious in its time commitments and grant sizes, granting the four nonprofits a total of \$15 million in capital in three five-year cycles, but was not designed to provide management assistance.

Philanthropic Tax Credits

State tax credits for corporate philanthropy are emerging as an appealing means for converting philanthropic grants into significant sources of working capital for nonprofits. Commonly known as “neighborhood assistance programs” (NAPs), they are available in 16 states; four other states are considering instituting the programs. The annual value of the credits varies from \$2 million to \$15 million per state.

NAPs offer state tax credits to corporations that agree to make commitments for large grants, over a long period of time, to selected nonprofits. Most require corporations to work with the

nonprofits on strategy development or organizational capacity building, sometimes mandating plans that outline the major objectives and milestones of the nonprofits. In most cases, eligible nonprofits must be community-based organizations working to improve low-income areas, the goal being to move capital and expertise from downtown to struggling neighborhoods.

Pennsylvania was the first state to launch a NAP and is considered to have the most ambitious and innovative program. Enacted in 1967, and expanded in 1994, the Neighborhood Assistance/ Comprehensive Service Program offers \$15 million in credits. A participating corporation receives a 70 percent state tax credit on donations made to a maximum of two nonprofit “partners.” The corporation must agree to make grants of \$250,000 per year, per nonprofit for a 10-year period. The grants are to advance the goals specified in a Comprehensive Service Plan developed by the nonprofits and submitted to the state. Participating nonprofits must be engaged in “comprehensive service programs” aimed at meeting both the physical and social needs of the neighborhood.²²

Program Related Investments

PRIs may be most notable in a discussion of nonprofit capital for their untapped potential. Authorized in the tax reform act of 1969, PRIs allow foundations to “invest” in nonprofits by making below-market loans, provided that financial gain is not the primary motive of the foundation and that the funds are not used for political lobbying.

Although the data on PRI use is thin, it does support the widely voiced sentiment that PRIs are not widely used. The Foundation Center’s most comprehensive analysis tracks the use of PRIs from 1993 to 1995. At that point, Ford and MacArthur accounted for approximately one third and 10 percent of total PRI activity, respectively. Nonprofits working in housing and community development attracted 63 percent of PRI dollars. Almost half of all PRIs were made to intermediaries.²³ Although most were probably CDFIs, this review has noted the use of PRIs in intermediaries brokering tax-exempt bonds, a school-reform intermediary and long-standing intermediaries like LISC.

Several observers concluded that PRIs are too demanding for foundations and nonprofits. Program officers (many carrying large grant portfolios) would have to invest considerable time in due diligence, deal structuring and negotiation to execute PRIs. And nonprofits, many averse to any kind of debt finance, may find the process too demanding as well. In opting out, according to some observers, they forego an excellent opportunity to assess nonprofits in a more “holistic way” and to address underlying capacity problems that might make it difficult to repay the PRI.²⁴ The demands of PRIs may explain why so many are delivered through specialized intermediaries, which presumably have developed the technical competence to execute PRIs.

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The philanthropic reform strategies hold real promise for meeting the capital needs of nonprofits. Though it’s true that foundation grants comprise a relatively small share of nonprofit income, foundations have the freedom, motivation and, increasingly, the knowledge to make their grants function more like working capital. We turn next to the work nonprofits can do to meet their own capital challenges.

Strategy #3 Reforming Nonprofits

WHILE MANY STRATEGIES ATTEMPT to change the environment within which nonprofits work — by organizing a more efficient market, reforming philanthropy or making private capital markets accessible — others see nonprofits themselves as a major part of the solution to their own capital problem. Various analysts have proposed five ways nonprofits can ease their own capital challenges:

- *Become bankable* — so they can access the huge banking finance system.
- *Generate working capital internally* — by pricing services correctly and aiming to accumulate surpluses.
- *Create/become self-sufficient nonprofits* — by making them “social enterprises” that are not dependent on subsidies but earn unrestricted revenue in the market.
- *Grow nonprofits* — since many of the barriers to capital can actually be understood as the problems of small-scale organizations.
- *Convert nonprofits to for-profit status* — since investment equity is only available to for-profits.

Proponents of most of these tactics emphasize that nonprofits will need to change their own culture, which often does not value capital, financial management or organizational capacity. As Susan Kenny Stevens points out, “Too many nonprofits believe that producing even a modest year-end surplus is either against the rules or will render them unfundable.”²⁵ Another says the biggest barrier for CDFIs — ironically, since they themselves are purveyors of capital to businesses — is their “ideological opposition to business thinking” when it comes to making their own operations more efficient and sustainable.

These attitudes — as the review of practices below will affirm — are giving way, where they have not entirely vanished, to a much greater willingness to accumulate equity, use debt finance and approach financial management more as a strategy, and not just administrative competence. As Tim Freundlich of the Calvert Foundation says, “There’s a growing maturation of capital structures in the nonprofit sector. People understand you can have debt.”

Become Bankable

Some observers emphasized that with some more technical competence and management assistance, most nonprofits can become bankable and access mainstream financial services. A long-familiar analysis suggests that the gap between nonprofits (especially smaller ones) and banks is enormous. But that view seems to be giving way in the face of a new reality.

The traditional observation about banks is that they have not regarded nonprofits as profitable customers, and have therefore been largely indifferent and inaccessible to them. Tuckman provides a good roundup of explanations for this view in his overview of nonprofit finance. Most banks, he reasons, do not understand nonprofit finances, and, because of their ignorance, “see these entities as risky investments.” Even if they see a viable market, banks might “fear adverse publicity that accompanies foreclosure on nonprofit property.” Those willing to foreclose on nonprofit property might end up with assets too specialized (e.g., a botanical garden or rural hospital) to resell.²⁶

The longstanding view of nonprofits suggests that even willing bankers would not have found much of a nonprofit market. Nonprofits have long been viewed as simply not interested in, or educated about, bank financing. They see themselves, according to one loan-fund manager, as “grant-dependent nonprofits, not social enterprises.”

Several observers challenged these conventional views. They see banks actively courting nonprofits, and nonprofits increasingly aware of their banking options. Fleet Bank has invested heavily in nonprofit business development — with advertising, a dedicated sales force and cultivation techniques like sponsorship of conferences on topics of interest to prospective nonprofit customers. Citigroup has begun a systematic effort to market its vast array of financial services to nonprofits, and develop new products as well. Scores of other banks, most on a smaller scale, are following suit.

As a result, a few observers now emphasize a new challenge for nonprofits. Instead of needing an education about the availability of banking services, they now need an education to help them select bank products that will be appropriate to them. “Bank products,” cautioned one, “are designed for bank profitability” — not for nonprofit needs. As an arts stabilization fund manager put it: “When we needed banks, we weren’t bankable. When we didn’t need them, we

were.”

Generate Working Capital Internally

A number of observers argued that nonprofits could and should generate their own working capital by steadily accumulating surpluses to cope with cash-flow problems and, more ambitiously, fund the development of new programs or organizational improvements.

As Tuckman argues, internally generated capital has some important advantages for nonprofits: funds are available when needed, the organization does not have to disclose information to outsiders and accountability is managed through normal board oversight²⁷ (as opposed, for example, to some of the intensive relationships with high-engagement funders).

Several observers who emphasized the need for internally generated capital stressed that it is not only desirable but essential. If a nonprofit is unable to generate internal working capital, then capital provided by foundations will be very risky. Capital in the hands of an organization that cannot manage to generate a surplus may not be an investment in improved capacity or productivity at all, but rather a bailout for incompetence.

A banker specializing in nonprofit markets (also a nonprofit board member), argued that “it doesn’t make sense to get nonprofits worried about access to capital when they haven’t taken care of the basics of running the operations well.” He sees a different progression, in which nonprofits work their way through a series of milestones, asking:

Do I have enough to get started? Do I have enough to make payroll? How fast am I getting paid from public agencies? Can I speed it up? How far can I push people in paying what I owe? Am I getting the most out of my board [in donations]? Then, when the operation is running tightly and it’s time to think about growing it, you’re ready to start looking for working capital [from external sources].

A CDFI advocate actually argued that too much external working capital would distract CDFIs from focusing on changing their pricing to generate self-sustaining revenues. To avoid the possibility that nonprofits would “hide behind capital” — e.g., use it to compensate for poor management, not for improving management — he urged outsiders supplying capital to structure it around milestones, releasing it in a series of installments when agreed-upon organizational goals had been achieved.

The expectation that most nonprofits could generate equity by preserving surpluses may seem misplaced. Yet research suggests that the vast majority of nonprofits, including smaller ones, are in fact able to generate their own working capital. Some do so by taking income from endowments, but “funds accumulated out of cash flow are almost certainly a major source of capital funds.”²⁸

Tuckman and Cyril F. Chang (see Related Readings) studied the IRS filings of over 4,500 charitable nonprofits for 1983 and found that more than 86 percent of them reported a surplus of revenues over expenditures. A 1986 study of a larger sample confirmed the finding. And when the researchers weighted the data to account for the fact that the smallest nonprofits (with under \$25,000 in revenues) were not represented (because they aren’t required to file tax statements), they found 75 percent of nonprofits were generating surpluses they could use as equity.²⁹

How do these findings square with the general assertion that nonprofits lack capital? One possibility is that nonprofits, many of whom exhibit a scarcity mentality, may be developing scarcity budgets that are easy to meet. They are budgeting not against what they aspire to accomplish, but against what they think is available. Having set the bar low, they then pass it. Nonetheless, the findings do suggest that the habit of aiming for surpluses has already been cultivated, and that what remains is to expand the scale of this practice.

In the interviews, several observers argued that cost accounting was the major challenge for nonprofits seeking to generate significant supplies of working capital internally. According to

Gary Mulhair of Community Wealth Ventures, nonprofits should be “externalizing their costs” by charging government funders the true cost of services and “internalizing their cash” by saving surpluses. The same applies for nonprofits that charge fees, such as CDCs with development fees, and CDFIs with loan fees. “The savvier and less ideologically constrained” CDFIs, for example, “recognize you can charge loan fees and they don’t break deals.” But to charge the true cost of services or appropriate fees requires some competence in cost accounting, still a challenge for many nonprofits.

Become Self-Sufficient, or Create Social Enterprises

Far more ambitious than a strategy of generating surpluses as working capital is the emergence of a new paradigm, in which nonprofits are considered capable of becoming virtually self-sufficient by selling services or products in the marketplace.³⁰ Although hardly a new concept,³¹ it is more prevalent and influential than ever.

Roots of the self-sufficiency paradigm: Funding scarcity. Not surprisingly, the idea of a nonprofit that earns its revenue in the marketplace is almost always linked to funding questions — of where nonprofits will get revenue and how they will access capital. Observers and proponents cite a scarcity of public and philanthropic funds as the underlying rationale for converting nonprofits from heavily subsidized charitable institutions into self-sufficient social enterprises.³²

Although they do not link their analysis to social enterprise, Alan J. Abramson, Lester M. Salamon and C. Eugene Steuerle do make the most elaborate case supporting the popular view that nonprofits face debilitating scarcity. Reviewing two decades of federal spending, they conclude that “budget shifts generally increased the pressures on nonprofit organizations to expand their services, while reducing the resources they had available to do so, at least outside the health field.”³³ Federal spending on community development, for example, was one percent lower in 1997 than it was in the study’s benchmark year of 1980. While spending on social services was up 22 percent over 1980 levels, the analysts argue that if federal outlays had remained steady in the intervening years, an additional \$35.1 billion would have been spent between 1980 and 1997.³⁴

But the picture is more complicated — and almost certainly not as dire as the analysts suggest. As Steven Rathgeb Smith argues, state and local governments have often stepped in to compensate for the loss of federal funds. More nonprofits, moreover, have been able to fund a wider range of services out of Medicaid — one of the few areas enjoying real growth in spending. Finally, the federal cutback analysis failed to (or could not on account of timing) recognize some important sources of funding — including both long-standing tax expenditures like the Low Income Housing Tax Credit and new funding for welfare-to-work services. Federal spending may be preferable to state or local spending, and direct funding may be more efficient than tax credits, but it doesn’t follow that nonprofits lose revenue as a result of these policies.³⁵

Social enterprise proponents also point to the ever-increasing competition for philanthropic dollars.³⁶ Yet philanthropy is growing briskly, at this point probably faster than nonprofit expenditures. According to The Foundation Center, “Overall, foundation giving has grown more than two and one-half times since 1990.” Foundations made grants worth \$22.8 billion in 1999, up from \$19.46 billion in 1998. Even the pessimistic analysis of Federal funding concludes that “the real growth in private giving...was 3.7 times the revenue losses experienced by nonprofits.”³⁷

Although the idea that nonprofits must become self-sufficient because government and philanthropic funds are shrinking may be flawed, this does not necessarily make the argument for social enterprise less attractive. A more compelling rationale may be based on self-sufficiency as a value in its own right.

Roots of the self-sufficiency paradigm: Affirmation of Values. For many proponents, social enterprise is not merely a strategy for responding to scarcity, but more fundamentally an affirmation of values. According to J. Gregory Dees, a leading academic observer of social enterprise, many nonprofit leaders “now consider extensive dependency on donors as a sign of weakness and vulnerability.”³⁸

Indeed, nonprofits are operating in a society that has never valued or promoted entrepreneurship more, or more widely, than ours does today. Several think tanks and nonprofit consulting firms are dedicated to promoting entrepreneurship in general, or social enterprise more particularly. The Kauffman Center for Entrepreneurial Leadership funds and documents dozens of entrepreneurship efforts — aimed at Boy Scouts, community-college students, 8- to 12-year-olds, elementary school students of all ages, teams of mothers and daughters, business-school students, unemployed people and, of course, nonprofits.

Several initiatives promote social enterprise by nonprofits more specifically. Community Wealth Ventures, a subsidiary of Share Our Strength, is a for-profit that helps nonprofits develop “earned income activities.” The National Center for Social Entrepreneurs offers both consulting and training. The Denali Initiative promotes social enterprise as a means of improving neighborhood quality of life. Most recently, SEA Change emerged as an association for social entrepreneurs and their proponents. While it may be doubtful that nonprofits need to attain self-sufficiency, it’s clear that many *want* to.

Social enterprise and capital. Social enterprises aimed at self-sufficiency solve one type of capital problem, but generate another. A nonprofit that succeeds in offering a service in the market can gain the enormous benefit of unrestricted income, the surplus of which becomes working capital. But in order to develop the capacity and scale to reach that point of self-sufficiency, social enterprises, like any enterprise, normally require upfront or working capital.

An assessment of social-purpose businesses funded in six cities as part of the Venture Fund Initiative suggests that social-purpose businesses often face the same kind of capital crunches as traditional nonprofits. The Initiative was launched to assess the financing and technical-assistance needs of nonprofit-sponsored businesses. (Many of these were formed on the sheltered-work model, which creates a business for the purpose of employing and training people who need intensive support before they are ready to compete in the open labor market.) The study found the capital problem was especially acute when a social-purpose business:

begins to grow and needs to expand its facilities, equipment, staff, inventory or some combination of these, in order to keep up with demand. By this point, many nonprofit organizations are effectively “tapped out” — they have already invested whatever discretionary funds might have been available when they created the business. And whereas potential sales growth might easily justify a loan, there is little or nothing left to collateralize that loan.³⁹

This capital gap notwithstanding, social-purpose businesses that manage to develop a large enough revenue base still might be able to generate their own working capital, and thereby become less dependent on government and philanthropic funders.

Even more ambitious than these social-purpose businesses, which accept the need for some subsidy, is the idea of totally self-sufficient social enterprises, designed explicitly to generate revenue to support the nonprofit’s mission. Several observers are cautious about the prospects for these. Dees points to research findings that over 70 percent of all business start-ups fail within eight years, suggesting that a social-enterprise path is hardly a guarantee of success, or even any easier than traditional fund-raising.⁴⁰ Jim Thalhuber of the National Center for Social Entrepreneurs makes a similar point, suggesting that many nonprofit managers ought to start thinking like entrepreneurs, seizing the opportunities available within the world of subsidies, before starting real businesses.⁴¹ One observer argued in an interview: “Most nonprofits aren’t ready for this.

They don't have enough staff, risk tolerance or enough commitment to growth.”

Others question whether self-sufficiency may even be a harmful goal. Joshua Wallack, in an analysis of 14 social-purpose businesses, argues that profitability should be a secondary goal in many social enterprises.⁴² It may be better, for example, to offer extensive sheltered-work opportunities to some clients, even if it requires a subsidy. Seeking profits first might create a work environment unsuitable for the very clients meant to benefit from the program.

Though it may represent a healthy affirmation of innovation, risk-taking and determination, social enterprise can hardly be a panacea to the capital challenges of nonprofits. Self-sufficiency is not always feasible nor, given the potential conflicts with mission, is it always desirable.

Grow Nonprofits

Since it is small nonprofits that tend to face the biggest barriers to capital, some observers reason that we should encourage the development of fewer, larger nonprofits. Bigger nonprofits, in short, get more capital. If we exclude religious nonprofits and private foundations, about five percent of organizations that have enough revenue to require them to file statements with the IRS control 80 percent of the assets among those organizations.⁴³ Closer to community development, a recent study of CDFIs, for example, showed five percent of the sample organizations controlled 49 percent of the capital.⁴⁴

Clara Miller of the Nonprofit Finance Fund describes access to capital as a function of both the organization's size and the complexity of its financial needs. Big and small nonprofits alike, if they need only simple loans, can work with banks. Big nonprofits seeking more complex forms of finance — such as tax-exempt bonds — can still find underwriters or investment banks willing to service them. It is the small nonprofits that want access to more complex forms of capital that face the most daunting challenges.

Though Miller doesn't argue that small nonprofits should grow their way into a more friendly market, others do. Several argued that CDCs, in particular, suffered from their small scale: they have trouble generating development fees because of their small markets; they lack the capital to develop big projects; and they suffer from inefficiencies because they end up managing a relatively small asset base. “Why have 2,000 small CDCs each managing 250 housing units unprofitably,” asks one, “when you should really have lots fewer, each managing thousands of units profitably?” Some responded by arguing that small nonprofits often fill important but narrow niches by offering specialized services or dealing with specialized client populations.

It is possible to improve access to capital without necessarily growing an organization. Secondary markets, says Frank Altman, can help “hundreds of organizations with little pots of money” get more capital into their communities, often targeting capital where it is most needed because their small size gets them closer to the grass roots. And strategic alliances of many kinds — joint ventures, subcontracts or variations on health care's preferred provider networks — can allow nonprofits to attain the benefits of scale without having to grow.

Convert to For-Profit Status

Another option, rarely noted because it's rarely feasible, is for a capital-starved nonprofit to convert to for-profit status as a means of accessing the private capital markets. The logic is straightforward: since nonprofits are prohibited from distributing profits, and therefore cannot attract investors, convert them to social-purpose businesses that benefit both a mission and their investors.

That is a plausible strategy only in certain circumstances. First, the nonprofit seeking to convert must be in a profitable market that will reward investors with steady and growing revenues. While conversions of nonprofit hospitals to for-profit status increased steadily over a 20-year period, they were driven entirely by the prospects for profitability. When profitability declined, in part because of caps on spending by Medicaid and Medicare, “deconversion” — from

for-profit to nonprofit — actually outpaced conversions.⁴⁵ Second, much of the logic of investment turns on scale: greater profits come with growth, and, by the same token, larger size enables organizations to raise money by issuing publicly traded shares of stock. For a nonprofit to convert to for-profit status without the benefits of operating and investment scale may not make sense. It may simply convert from a struggling nonprofit to a struggling for-profit. Meanwhile, the new for-profit would no longer be eligible for philanthropic funding.

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Reforming philanthropy to increase working capital and then reforming nonprofits to encourage self-sufficiency would go a long way toward addressing the working capital problems of nonprofits. But they pale next to the prospect of easy access to the private capital market, the final strategy in our review.

Strategy #4

Expanding Access to Private Capital Markets

PERHAPS THE MOST ATTRACTIVE STRATEGIES for better capitalizing the work of nonprofits are those that aim to improve the access of nonprofits to the private capital markets, where hundreds of thousands of individual and institutional investors are seeking investment opportunities to suit many tastes. The private capital market — with its vast sums — has enormous appeal to nonprofits accustomed to small and unreliable flows of philanthropic and public funds. The challenge is to find spots where the missions of nonprofits and the objectives of investors intersect.

Although they all rely on access to these huge capital markets as their lever, the strategies reviewed below stress different means toward that end, with four tactics predominating:

- ***Institutional strategies.*** When willing investors and appropriate finance tools are available, new institutions — able to work with distressed communities and investors — are sometimes seen as the critical resource.
- ***Technical innovation.*** Many finance techniques that are standard in business remain exotic to nonprofits. Several efforts aim to adapt the most promising of these financing tools for use by nonprofits, thereby helping them reach private investors.
- ***Government policy.*** Even with appropriate tools and institutions, many investors find community development or other nonprofit opportunities too risky, which has prompted public policymakers to offer various incentives and regulations to induce more investment.
- ***Investor behavior.*** Even when government inducements are not available, it still may be possible to cultivate a new breed of social investors who willingly invest part of their portfolio in community development or other nonprofit opportunities.

These tactics (which in some cases are combined) help nonprofits access different forms of capital. While some of them generate sought-after working capital, most actually generate or expand permanent capital pools that nonprofits are charged with lending and investing as part of their community development activities. The result, in some cases, is that nonprofits can gain a toehold in the huge private capital markets but may still lack working capital for their own operations.

Institutional Strategies

Particularly over the past 15 years, a growing number of lending and investment institutions have been designed to help low-income communities access philanthropic, public and private capital to support their mission of community development. The larger universe of these institutions — and one notable subsector — are described below.

Community Development Financial Institutions. The term Community Development Financial

Institution (CDFI) emerged in the early 1990s as advocates from a number of specialized community development finance organizations began to advance a more coherent and comprehensive agenda. Both the name and the field became more prominent with the passage of the Riegle Community Development and Financial Institutions Act of 1994. This law directed the Treasury Department to establish the CDFI Fund, which provides relatively small capital infusions to CDFIs that meet its criteria for advancing community development. Over \$300 million has been awarded to date.

Though the term describes the mission they share, CDFIs themselves take many forms, including community development loan funds, credit unions, community development banks, venture capital funds, microenterprise loan funds or even commercial banks or their subsidiaries. They offer both debt and equity, including mortgages for affordable housing, community facilities financing, commercial loans and investments for business development, and finance for housing rehabilitation, construction or acquisition.

National Community Capital, as an association for the field, conducted a detailed study of 51 of an estimated 475 CDFIs to identify critical characteristics and challenges.⁴⁶ They found:

- **CDFIs were better capitalized in 1998 than 1997, with the sample's aggregate base up 56 percent for a total of \$742 million.**
- **Only about 25 percent of the sample's capital was liquid, indicating that most of the capital is at work in investments and debt aimed at community development.**
- **Though they are making progress, most CDFIs are not self-sufficient. Forty-nine percent of the sample was able to cover 70 percent or more of its operating costs through earned income, up from 39 percent the previous year.**
- **The cumulative loss rate was 1.7 percent.**
- **Consistent with the distribution of assets in the nonprofit sector at large, the five largest CDFIs in the sample held 49 percent of the sample's total assets.**
- **The smallest 10 CDFIs accounted for only 1.2 percent of the sample's total aggregate capital base.**

As these findings suggest, CDFIs represent a maturing institutional strategy, and form the base on which other efforts to attract private capital can build.

Community Development Venture Capital Funds (CDVCFs). CDVCFs represent only a small share of CDFIs and an even smaller share of the entire nonprofit capital system, but they are important because they attempt to provide equity capital — as opposed to debt — to new or growing businesses, often in economically depressed communities.

According to the Community Development Venture Capital Alliance (CDVCA), there are over 50 funds, with over \$300 million under management. The average median capitalization per fund was \$9.6 million.⁴⁷ CDVCFs typically make investments of \$100,000 to \$1 million in companies with as few as 10 to as many as 100 employees. Although some fund sponsors are incorporated as for-profits, most were started by nonprofit community development organizations that discovered that “debt simply was not an option” for many of the businesses they wanted to grow.⁴⁸

Mainstream venture capital is a high-risk investment strategy, and community development venture capital is even riskier on several counts, most related to its small scale. The funds are generally working not only in depressed areas but in small markets within them — often a specific neighborhood. This reduces the chances of their finding viable (much less extremely profitable) business propositions. While mainstream venture capitalists vet on average between 450 to 500 proposals to find a small handful worth backing, CD venture capitalists have much smaller pools to choose from.⁴⁹

In addition to serving small areas, the funds themselves have small asset bases. Their average capital base of \$5.8 million (compared to the average \$80 million mainstream venture capital

fund), does not usually generate enough income to pay for the fund management. A fund of that size, with a standard 2.5 percent management fee and two full-time staff, generally requires a subsidy of \$75,000 per year to sustain itself.⁵⁰ Most observers consider \$10 million to be the minimum for creating a self-sustaining fund.⁵¹

But as Kerwin Tesdell of the CDVCA points out, many of the newer funds may well prove to be self-sustaining over a longer period of time; if several profitable deals pay off, they could well cover expenses incurred over a number of years.

With small portfolios and target markets, CDVCFs have fewer opportunities for big profits. The companies they back are often not likely to reach the stage where they can issue stock, which means there are few opportunities for the initial CDVCF to sell its stake and take a profit that could be reinvested in other deals. And the small, less profitable investments of CDVCFs cost as much as larger deals because the “level of assistance required for often lower-skilled entrepreneurs in distressed areas can be substantially greater.”⁵²

A recent analysis by policy student Luiz Lopez explores a troubling consequence of these difficulties: CDVCFs have difficulty attracting investment capital. Current investors are primarily motivated by social concerns, not financial return, keeping CDVCFs at the margins of the mainstream market. Given all these difficulties, it is not surprising that a 1992 study by the Community Development Research Center found that more than 40 percent of CDVCFs that started venture capital funds later abandoned them.⁵³

None of this means, of course, that the mission of CDVCFs is not compelling or worth the trouble. Nor is every CDVCF a small-scale struggling enterprise. **DVCRF Ventures** — for Delaware Valley Community Reinvestment Fund — is one of a few especially promising leaders in the field. One of a number of work-force and community development programs operated by the parent Reinvestment Fund, DVCRF Ventures has amassed a \$10 million capital base after only two and a half years. According to Fund president Jeremy Nowak, about half the 26 limited partners are high net-worth individuals, and the other half are institutions — including foundations, banks and other venture capital firms.

The Fund’s objective is the creation of good entry-level jobs in greater Philadelphia. The eight companies in their first-round portfolio have created 750 jobs in less than three years — a figure expected to surpass 1,000 by 2001. All the jobs pay a minimum hourly wage of \$9 and offer medical benefits. The companies are in high-end manufacturing and fast-growth service areas, including call centers and child-care centers.

Though the Fund’s staff and partners’ network can deliver general management and strategy assistance to the investees, it focuses its value-added assistance on human resource issues. Specifically, it helps employers recruit, retain and develop entry-level employees by drawing on the resources of the work-force development subsidiary of the parent nonprofit.

The prospects for CDVCFs may improve further as the field matures and works on educating investors and policymakers. The Community Development Venture Capital Alliance, in addition to advocacy and learning, has established its own central fund to help capitalize CDVCFs. With \$3.4 million from the CDFI Fund and \$2 million in PRIs from the Ford Foundation, it is aiming for \$10 million.

Technical Innovation

The last five years have seen several important technical innovations aimed at helping nonprofits access the private capital markets.

Two of them — the **Capital Markets Access Program** and the **Community Economic Development Program of New Hampshire College** — are developing a comprehensive approach to this strategy. The Capital Markets Access Program, a program at the New School University run by Greg Stanton, is a combination think tank and laboratory. It convenes practitioners from community development finance and the investment community to develop

new mechanisms for enhancing capital access, while it also functions as a technical-assistance resource, helping nonprofits access lower-cost debt, improve cash flow through bridge financing and issue tax-exempt bonds. New Hampshire College is just organizing a Financial Innovations Roundtable, where community development finance specialists will work with investment and finance experts to explore similar strategies.

Already, the Capital Markets Access Program has sharpened what some observers see as a fundamental challenge in accessing private capital markets. As one observer from community development finance described it, strategies like these assume “we’re trying to build a bridge across the Charles River when it’s really the Pacific Ocean.” He observes that Wall Street finance experts come to the conversation with the “assumption that ‘once you see how much money we have — you’ll do whatever it takes to get access’.” The community development finance practitioners, meanwhile, come to the conversation saying, “We need [what investors would consider] illiquid, low-cost, high-risk capital.” The capital markets, in other words, would have no interest in community development.

As another observer worried, if nonprofits push too hard to make themselves appealing to mainstream markets, they will abandon the kinds of difficult, riskier and unusual deals that they were created to develop in the first place.

Several promising innovations, however, suggest that there are some opportunities for progress short of such a difficult trade-off.

Secondary Markets. Effective secondary markets have enormous appeal for lenders. In a secondary market, a lender can sell all of the outstanding debt it has issued to individual consumers, and then use the capital raised by the sale to make a new generation of loans. The purchaser of the debt can hold the mortgages, or as is often done, convert them into bonds and sell them to other investors. This is the practice that Fannie Mae and Freddie Mac have perfected for single-family home mortgages, and its success in replenishing the capital pool of lenders is credited with the high rate of homeownership in the United States.

Community developers have been working for over 10 years to extend secondary markets from single-family homeownership to multi-family and other economic development projects. Public and nonprofit loan funds hold an estimated \$4 billion in loan assets that support community development projects. Generally, these lenders (who are “loan originators” in the secondary market food chain) support multi-family mortgages and economic development projects.⁵⁴ They have assembled their original capital pools with difficulty, combining public, philanthropic and social-investment dollars to reach a critical mass. “To survive,” according to financial analysts Kathleen Kenny and Frank Altman, “community development lenders must look to an emerging secondary market to replenish their capital.”⁵⁵

The **Community Reinvestment Fund (CRF)**, formed in 1988 in Minnesota, pioneered creating a secondary market for community development loans. Capitalized by foundations and corporations, CRF has purchased more than 700 economic development and housing loans from 73 loan funds in 18 states, returning more than \$114 million into the community development lending system. Though it holds much of the debt it acquires (sometimes leaving the servicing of the loan with the original lender), it has issued 10 series of Community Reinvestment Bonds totaling \$34 million to 30 investors.

Kenny and Altman point out that the emerging market faces several challenges. Chief among them is a lack of shared practices among the community development lenders. Consistent loan documentation, common approaches to underwriting and uniform risk-weighting practices are the key to successful markets because they improve the information available, make transactions more efficient and, in the process, reduce the cost and risk of the transactions. Unfortunately, the local, usually small, loan funds do not enjoy any of these standardization benefits. The “financial infrastructure” — like a “‘string’ of relationships along the financing pipeline from loan originators to investors” — is also weaker and less predictable than its private counterparts.

Finally, pricing is a problem, in that originators often lack the experience and knowledge needed to value their assets for sale in a mainstream marketplace

Because of these obstacles, and the nature of the underlying loans, the secondary market “may always require some form of credit enhancement to attract large numbers of investors.” Foundations or socially responsible investors, for example, can take higher-risk stakes in intermediaries like CRF.

The flagship in the secondary market, the **Local Initiatives Managed Assets Corporation (LIMAC)**, illustrates a second-generation innovation aimed at improving the secondary market for community development lenders. Created by the Local Initiatives Support Corporation (LISC), LIMAC’s goal was to purchase mortgages on properties (e.g., small, scatter-site or assisted-living) not normally served by the mainstream secondary market. Capitalized with grants and PRIs from foundations, it had steadily increased its purchases of loans, until its own capital base dwindled to \$4.5 million, raising the question of how to expand the secondary market if upstream funds were drying up.

Like many other nonprofits, LIMAC wanted what nonprofits cannot get: equity from investors. It resorted to conversion to for-profit status, just as insurers and hospitals facing capital crunches have over the past 20 years. By converting itself to a real-estate investment trust (REIT), though, LIMAC got the best of both worlds. It could access capital from investors but take advantage of the fact that REITs do not pay corporate income tax. (A REIT combines the capital of many investors to acquire real estate or provide financing for it; it functions like a mutual fund for investors, offering them diversification but no property management responsibility.)

The REIT operator, the for-profit **Community Development Trust (CDT)**, launched in 1998, quickly assembled a capital base of more than \$30 million. LISC contributed \$1.5 million, and a group of 18 investors (including Prudential Insurance, Fannie Mae and Met Life) invested as well. LISC has seven of 15 board seats, with other investors holding the balance. The Trust, in addition to purchasing community development loans, will also acquire selected affordable-housing properties through a swap with owners who, for tax planning reasons, would rather own units in a REIT than individual properties. CDT will commit to long-term ownership of the affordable housing.

Tax-Exempt Bonds. Larger nonprofits long had the option of issuing tax-exempt bonds if they could secure the sponsorship of a willing government agency (often a state facilities authority). The transaction costs for evaluating, underwriting and servicing bonds, however, have typically been too high for smaller nonprofit organizations. An innovation developed to service the needs of smaller community health providers could offer a model for other smaller nonprofits.

The **Community Health Facilities Fund (CHFF)** was incorporated as a nonprofit by three national associations representing local community health organizations. Capitalized with PRIs from the Robert Wood Johnson Foundation, the Fund is managed under contract by the firm of Capital Express Limited, LLC. The Fund is a vital link between the nonprofits and the investment community, and can package and explain nonprofits’ needs in ways the market can accept. This intermediary function is critical. As Tuckman points out in a review of various nonprofit finance tools, “Bond houses are not likely to issue bonds in many of the areas in which nonprofits might wish to borrow because of the effort involved in developing loan criteria and in learning the intricacies of a new industry.”⁵⁶

The Fund’s biggest job with investors is to explain the nature of the nonprofits’ government funding. Although backed by real estate, underwriters need evidence of reliable income, and those unfamiliar with nonprofits are apt to see all government funding as unreliable. Nonprofits offering government-funded services that might be considered essential are the most attractive to investors. A provider of residential care to severely disabled, for example, is unlikely to have its government funding disrupted, since these clients are entirely dependent on the service and the government has no easy alternative. In contrast, a provider of job training and placement services

— which are not considered essential — is much more at the whim of changing public policies and would be a much higher risk.

The Fund also works intensively to educate nonprofits about the advantages of debt in general, and lower cost tax-exempt debt in particular. According to the Fund’s research, debt as a share of total assets is 50 percent for the largest nonprofits (with budgets of over \$50 million), and a quarter of that debt is in the form of tax-exempt bonds. For smaller nonprofits (with budgets of \$1 million to \$10 million), debt is generally only 20 percent as a share of total assets and, of that, only five percent is in the form of tax-exempt bonds. Consequently, the Fund serves only a small slice of a huge market — the small to medium-sized nonprofits with assets and income between \$500,000 and \$20 million, seeking average loans of \$1.5 million. It figures that total annual demand of nonprofits in this target market might be close to \$1.5 billion.

The Fund’s first approach was to bundle the borrowing needs of smaller nonprofits into pools that would justify the transaction costs of issuing the bonds. This process forced each participating nonprofit to wait until all others in the pool were ready to participate in the bond issue, creating long delays for many of the nonprofits. Under a new securitization model, the Fund is able to provide debt finance to nonprofits on a rolling basis, as soon as they have met all the requirements. The Fund then converts the debt into investment-grade bonds for sale in the market.

Since bonds are issued for new construction, purchase or rehabilitation of facilities (or for refinancing of them), and are secured by real estate, they are, strictly speaking, another form of facilities capital. But as Chris Conley of Capital Express points out, “We see ourselves as enterprise developers using real estate as collateral.” If the facilities in question support a viable business plan, long-term, low-cost debt can support and strengthen the organization’s capacity for growth.

As with all suppliers of capital to nonprofits, the challenge is ultimately one of creating the initial capital pool. Beyond the initial PRIs from the Robert Wood Johnson Foundation, the Fund seeks social-investment capital (at concessionary rates) or recoverable grants to: (a) subsidize its operating costs as intermediary; (b) provide credit enhancement (commitments to make payments to investors in case of default); or (c) provide “warehousing” — funds that enable the intermediary to issue debt to borrowers before bonds have been sold on the market.

Securitization of Accounts Receivable. A few observers proposed, and then several more were asked to react to, the idea of extending a bond approach from facilities to working capital. They propose that a nonprofit could raise important sums of working capital by issuing bonds that would be secured not by real estate but by accounts receivable, presumably from government contracts.

There are several challenges to this securitization approach (so-called because it converts an asset into a security that can be sold on the market). For one, the risk of unsecured lending, particularly to smaller nonprofits, would be prohibitively high, and the idea almost by definition would require the involvement of a philanthropic-backed intermediary to provide credit enhancement and guarantees.

Additionally, as one observer pointed out, securitization works in commercial markets by exploiting huge volumes of debt with the same characteristics. The credit-card debt held by banks, for instance, can be converted into bonds and sold on the market because everyone understands the historic default rates, and therefore, can assess the risk. Most of what nonprofits would want to securitize is “non-conforming, small-scale debt,” which would require an intermediary to bundle it into larger-scale offerings, just as CHFF does with facilities-backed bonds for the mental health nonprofits.

The intermediary would doubtless have to take on the challenge of educating potential investors about the nature of government funding streams (which would provide the income needed to repay the debt). Many investors, according to the observers who have considered this

idea, consider government funding almost entirely unreliable, which dooms the prospects for accounts receivable securitization. As one banker who has explored, and likes the idea, rejoined:

Let's not overcomplicate it. We consider U.S. Treasuries [e.g., government-backed bonds] to be the ultimate conservative investment, and need to get people to see that government contracts are ultimately backed by the same government. They will pay. It's true that they can change the rules of the game, but they're not going to do that willy nilly. Practical and political considerations will keep them in line.

In addition to providing credit enhancement, an intermediary would need to assess the reliability of various funding streams, looking for what the operators of CHFF call “essentiality” — evidence that the government funded service is so important that payments are unlikely to be halted.

This idea also assumes a financially and managerially sophisticated nonprofit that is able to understand the role of debt in its capital structure, has enough confidence in its plans and abilities to justify amassing working capital, e.g., for expansion, and the ability to participate in complex transactions.

Net-Lease Finance. Net-lease finance, sometimes called “sell-leaseback,” allows organizations to convert their real estate or equipment into working capital. Pioneered with aircraft owners in the 1960s, the transaction appeals to organizations that have capital locked up in equipment and facilities, but need cash to expand or improve their operations.⁵⁷

In a typical deal, the property owner sells its asset to a buyer who, for diversification and tax purposes, wants to hold a depreciating asset. The new owner then enters into a long-term, renewable lease, returning both control and asset-management responsibility to the previous owner, who now has a new supply of working capital as well.

Peter Nessen of **Corporate Realty Investment Corporation (CRIC)** in Boston has begun structuring net-lease finance deals for nonprofits. As an intermediary, CRIC buys the properties of nonprofits that need working capital, and then leases the property back to the nonprofit. CRIC then converts the leases it holds into investment-grade bonds and sells these at market, generating income for its investors. It also resells the newly acquired property and collects a transaction fee from the property seller.

The arrangement, according to Nessen, can be extremely beneficial for nonprofits. He offers the case of Northwestern Human Services, a multistate operator of residential and community-based human service programs. Northwestern sold 39 properties — offices, residences, community facilities and a new juvenile detention center — for \$27 million, providing important capital at a time of intense competition. (Another nonprofit in the same field, Abraxas, faced similar demands for capital and ultimately decided to allow a publicly traded for-profit prison management firm to acquire it.⁵⁸)

As with other sophisticated tools, this requires a nonprofit with the ability to assess the benefits and risks of such a transaction. It must be confident that working capital today is worth more than property ownership over the long-term, and be confident that properties are valued fairly.

Donating Debt-Encumbered Real Estate to Nonprofits. A new product that effectively circumvents an IRS prohibition on the donation of debt-encumbered properties to charities could expand the supply of working, philanthropic capital available to nonprofits.

Traditionally, only unencumbered properties — e.g., entirely debt-free — could be donated to nonprofit organizations. **Thornburg Foundation Realty (TFR)** has created an instrument that allows donors to make tax-deductible gifts of encumbered properties, potentially “unlocking real estate, the nation's largest store of wealth” as a greater source of capital for nonprofits.

The donor of a mortgaged property conveys it to TFR, which operates a REIT — an instrument that allows many investors to acquire and own portfolios of real estate without becoming responsible for property management. TFR pays off any debt on the property, and issues REIT shares to the owner. The property owner then donates its shares to a nonprofit of its choice. The nonprofit then owns shares in the REIT, which will pay quarterly dividends.

At least initially, this promising innovation seems likely to benefit nonprofits that already receive gifts of property. If that is true, it seems that neither CDCs nor work-force development organizations would stand to benefit significantly.

Public Policy Strategies

If it were not for public policy, CDFIs might be entirely dependent on socially motivated investors; the risks of investing in community development projects might simply be too high for most investors, particularly those who are poorly informed about low-income communities. But a combination of tax policy and bank regulation has provided new opportunities for generating permanent capital for community development projects. The most cited public policies are reviewed below.

Low Income Housing Tax Credit (LIHTC). This federal tax credit, introduced in 1986, is the most important federal program for financing the development of affordable rental housing. The LIHTC is no longer novel, and has long been criticized as inefficient.⁵⁹ But it is frequently mentioned in discussions about nonprofit capital for two reasons: for its central role in supplying federal support to capitalize affordable housing programs; and for inspiring interest in similar efforts to support other nonprofit programs.

To summarize this important benchmark briefly: the LIHTC offers federal tax credits to investors who provide equity for the development of affordable housing. State housing finance agencies usually administer the program — awarding the credits, ensuring that projects meet the specified public goals and monitoring long-term compliance.

Developers of low-income housing apply to their state agency for the credits, which are awarded to developers who best satisfy the state's goals for affordable rental housing. When nonprofit organizations are awarded tax credits, they sell them to investors who, unlike the nonprofits, have federal tax liabilities they would like to reduce.⁶⁰

To create a more efficient market, the **National Equity Fund (NEF)** (of the Local Initiatives Support Corporation) has become a syndicator of the tax credits. It raises funds — \$2.9 billion to date — from investors through the sale of LIHTCs, and has become a vital element of the infrastructure.

New Markets Tax Credit. This credit hopes to do for commercial economic development what the LIHTC has done for affordable housing. Enacted as part of the Clinton administration's New Markets program, it aims to leverage up to \$15 billion in equity investment for community development projects and institutions.

Investment funds geared primarily to serving low- and moderate-income communities are eligible to apply to the Treasury Department for participation in the program. The funds can be community development banks, community development venture capital funds, CDCs — or national or regional funds that, in turn, invest in these institutions. The funds selected to participate are authorized by Treasury to allocate credits to investors, who can then claim tax credits worth 25 percent of their total investment. The funds (not the investors) decide what projects to invest in.

Welfare-to-Work Tax Credit. Though wage subsidies like this are not new, a recent innovation has enabled at least one enterprising nonprofit venture to use the subsidies as a way to generate

working capital.

Federal law now provides a tax credit to employers who hire long-term welfare recipients. The credit can reduce employers' federal tax liability by as much as \$8,500 per new qualified employee.

The Local Initiatives Support Corporation and **Structured Employment and Economic Development Corporation (SEEDCO)**, New York — another community development intermediary, have jointly created **EarnFair**, a temporary staffing company. Three features of its design enable EarnFair to take advantage of the credit. First, it is incorporated as a for-profit (limited liability corporation), and could use the credits to reduce its tax liability. Second, instead of acting only as a placement agency, EarnFair itself becomes the employer of the eligible worker, contracting with companies who use the employee as a temporary worker, making it eligible for the credits. Third, it plans to sell some of the credits to for-profits, who can reduce their tax liability without necessarily hiring any long-term welfare recipients. This sale of the credits will provide a supply of working capital to help EarnFair cover its expenses while it develops its business and income base.

Employers who contract for EarnFair workers pay the company a fee based in part on the job and the worker's experience. The fee also covers EarnFair's case-management services, which will provide support aimed at increasing the job retention of the newly placed worker.

America's Private Investment Companies (APIC). Modeled on the Overseas Private Investment Corporation, the APIC program uses government guarantees of debt to leverage creation of "a new generation of large-scale private investment companies that find and invest in promising untapped market opportunities in distressed areas." Although the proposal failed to win congressional approval, it remains a notable example of an ambitious use of government policy to stimulate investment in community development.

Investment funds that secure commitments from investors to create an APIC would apply to the U.S. Department of Housing and Urban Development (HUD) and the Small Business Administration for participation in the program. If the application to establish an APIC is approved, HUD would award government guarantees of debt issued by the APIC. The government would guarantee two dollars of debt for every dollar of equity that investors add to the APIC.

The guarantees are meant to benefit both the investors and the government. Deals made by the APIC would have favorable returns, in part because of the low cost of the guaranteed debt. Meanwhile, taxpayers are protected in the event of failing investments because every dollar of equity must be lost before any debt is affected.

The guarantees would aim to create large investment funds able to finance major job creating businesses. Funds would be required to have a minimum capitalization of \$25 million, and each APIC would be expected to conduct nine to 12 large-scale deals.

Equity Equivalents. Building permanent capital pools of CDFIs is difficult because investors find returns on CDFIs too low, or are ignorant of the opportunities they present.

The equity equivalent attracts private capital to CDFIs by applying government regulation in a new way. The equity equivalent (EQ2) builds on the Community Reinvestment Act (CRA), which has required banks to make minimum investments or loans in low-income communities since 1977. For banks that are constantly searching for low-risk ways to meet CRA requirements, EQ2 presents a new opportunity. It allows them to receive CRA credit not merely for the amount of the EQ2 investments they make to a CDFI, but instead for up to 50 percent of all the loans or investments made subsequently with funds that the CDFI was able to leverage with the initial EQ2.

For CDFIs, the EQ2 provides capital that functions like equity. Pioneered in a transaction between National Community Capital (a CDFI association) and Citibank, and later endorsed by

CRA regulators, the EQ2 is a long-term, deeply subordinated loan that functions like equity because:

- **It is not secured by CDFI assets;**
- **It is fully subordinated (meaning the bank making the loan is the last of all creditors to be paid);**
- **The lender cannot demand any acceleration of repayment, unless the CDFI changes its primary mission of community development; and**
- **It has a rolling term of 10 years minimum, with a yearly renewal option.**

This is an important innovation for capitalizing CDFIs. The larger their capital base, the lower their cost of funds, and the lower interest the CDFI can charge.

Social Investment Strategies

Many nonprofit analysts are looking beyond government policy and new finance products to another source of capital for nonprofits and their causes: individual and institutional investors.

“Social investing” refers primarily to three strategies aimed at directing private capital toward social goals:

- ***Socially responsible investment* is the most common strategy, in which investors use social, not just financial, criteria for selecting companies to invest in, often through mutual fund operators that establish social standards and select companies that meet them.**
- ***Shareholder activism* — with no direct benefits to nonprofits — enables investors to use the powers granted to every shareholder (e.g., to vote for directors and participate in shareholder meetings) to bend corporate policy toward more socially suitable goals.**
- ***Community investment* directly benefits nonprofits, but is the least used strategy, in large part because it is newer and because it requires investing in CDFIs at below-market rates of return.**

According to a recent *Business Week* overview, socially responsible investing, especially through mutual funds, has grown remarkably in recent years. Between 1997 and 1999, social investment mutual funds grew from \$96 billion to \$154 billion. Over the same period, the amount of all money under socially responsible investment grew 82 percent, from \$1.2 trillion to \$2.16 trillion, representing 13 percent of all money under professional management. Some investment analysts credit the rise of technology stocks with part of that tremendous growth. They provide socially responsible mutual fund operators an excellent opportunity: most are considered socially “clean,” as well as profitable.⁶¹

Options for Individual Investors. The dollar volume of social investment is up, and so is the variety of causes investors can support. The original practice, as far back as the eighteenth century, simply aimed at avoiding the “sin stocks” of companies that traded in tobacco, alcohol and gambling. The mutual fund strategies made popular in the 1970s favored progressive policies like environmental safety, prohibitions on child labor and equal rights for gay employees. The newest fund options are conservative, focusing on companies that decline to offer health benefits to the partners of gay employees or that have no involvement in abortion.⁶²

Under the more socially ambitious but financially unimpressive “community investment,” investors can invest directly in CDFIs, or in mutual funds with stakes in a variety of CDFIs. While conceding that the financial returns are modest, proponents of community investment argue that the “benefits at the community level in many cases outweigh diminished financial returns, making community investing one of the most satisfying and promising venues for socially responsible investors in the future.”

The Calvert Social Investment Foundation operates **Calvert Community Investments**, which allows individual and institutional investors to invest in CDFIs. Calvert offers information on over 100 CDFIs online, where investors can learn about the CDFI’s portfolio (housing, small

business, micro-lending, etc.); geographic area of operations; populations served; and assets. Investors can purchase a Community Investment Note in an amount of \$1,000 or higher, choosing a term of one, three or five years, and choose a fixed rate of return between 0 to 4 percent, depending on how charitable the investor wants to be. Investors can take a mutual fund approach — investing in a block of CDFIs selected by Calvert — or, for investments of \$25,000 or more, make a direct investment in one or more CDFIs.⁶³

Domini Social Investment, which operates the largest socially screened index mutual fund, has created a new product that combines socially responsible and community investment. The new **Domini Social Bond Fund** is a socially screened mutual fund that will be operated under a submanagement agreement by South Shore Bank, the country's largest community development bank. South Shore will invest up to 10 percent of assets in debt instruments and other investments that directly support and promote community development. **A.G. Edwards, Inc.**, is developing a “socially responsible equity linked note” that also attempts to enable nonprofits to benefit by participating in investment transactions.

Options for Institutional Investors. Government policies to encourage “economically targeted investments” were promoted by the Clinton administration in its early years but never gained congressional approval. Many advocates of community development had argued for years that institutional investors — particularly pension funds, with billions of dollars under management — could supply relatively enormous amounts of private capital for community development by targeting only a small share of their portfolios toward such investments. Conservatives opposed the concept as mischievous social engineering that would force investment managers to violate their fiduciary responsibility to maximize earnings.

Absent government inducements or regulation, institutional social investment is the province of the socially motivated. Pension fund managers are still able, of course, to make investments that reflect both financial and social objectives. And social investment proponents are working to convince institutional investors to channel one percent of their capital to community investments. But many now view foundations — who have over \$350 billion in assets — as an appealing source of new capital for social-purpose businesses. Beyond the social screening that many already do, foundations could devote some of their assets (not just grant dollars) to social-purpose businesses.

A number of foundations are experimenting with such approaches. The **F. B. Heron Foundation** has made some investments in commercial real-estate developments that will bring shopping malls, badly needed retail operators and jobs to economically distressed central-city locations. While the investments may well prove profitable, none of the present investors in the real-estate deals is, according to one program officer, “indifferent to social concern.”

The Rockefeller Foundation has established a formal program to find and make social investments. The Foundation's **ProVenEx** (for Program Venture Experiment) program “seeks to redirect private capital, knowledge and innovation in ways to ensure that the poor and excluded have access to the benefits of globalization.” It invests in early or expansion-stage companies, or in public-private joint ventures in areas that reflect the Foundation's philanthropic priorities in education, health and inner-city employment.

...

Clearly, the appeal of private capital access is enormous. But its real potential for nonprofits may be somewhat restricted. Many of the funds provide permanent capital for community development organizations to invest in the economic development of their target areas, without necessarily satisfying their own need for nonprofit working capital. To meet the nonprofit capital challenge in its entirety will therefore likely require more than access to private capital. The best approach will probably draw on several of the strategies reviewed in this paper.

4: Concluding Reflections

IF THIS PAPER REPRESENTS A MAP OF SORTS that describes the nonprofit capital landscape, it will be difficult to draw a single key lesson from it. Different parts of it will have different values depending on where it is the reader is trying to go. But it's fair to assume that anyone who has actually pored over this whole map has an interest in understanding and advancing the dialogue about nonprofit capital. These brief concluding reflections therefore focus on that dialogue, and how it might be improved to generate yet more effective responses to nonprofit capital problems.

1. Focusing the Dialogue.

The idea that different nonprofits need different types of capital for different purposes is almost self-evident. Yet the general discourse among both nonprofit managers and funders seems to make few of these distinctions. It might be helpful, therefore, to develop a more refined assessment of the capital needs of any given nonprofit, or class of nonprofits. Drawing on the simple distinctions offered in part two of this paper — about facilities, working and permanent capital — it would be fairly easy to characterize the overall capital position of a nonprofit, or a group of similar nonprofits.

Some nonprofits will have intense capital needs: they might be in competitive markets that require capital; need improved facilities to offer quality services; deal with capital-intensive development programs; and perform so well that investing in their capacity for effectiveness will likely pay off. But most nonprofits do not need capital on all these counts. We can be more focused — by industry, by organizational profile, by market position — in contemplating solutions to capital needs. It's not enough to talk about “nonprofits,” “funders” and “capital.”

2. Broadening the Dialogue.

Paradoxically, it seems that we need to broaden — as well as focus — the dialogue about capital. The leaders, managers and proponents of each of the four strategies mapped in this paper seem to inhabit quite separate worlds. Those working on access to the private capital markets have amassed extraordinary expertise, which has been deployed mostly in the community and economic development arena. Many of their finance strategies, however, could be of great value to the broader field. At the same time, those working on reforming philanthropy are not explicitly targeted at community development. Yet they have developed insights and practices that could address one of the great challenges facing nonprofit economic development organizations: how to invest in organizational capacity that produces results. More traffic among the proponents of various strategies could give everyone a stronger conceptual and practical base for serving their missions.

3. Deepening the Dialogue.

At the risk of presenting a baffling image of this proposed dialogue, one more feature should be added: depth. It seems that the more we have developed consensus, capacity and sophisticated innovation on any of the capital strategies, the further we get from the underlying assumptions and rationales for them. To take an example hinted at in the discussion about reforming nonprofits: We have a broad consensus about the need for nonprofits to become self-sustaining social enterprises, and about the benefits that strategy confers. Yet revisiting some of those assumptions might stimulate yet more creative responses. Are we really living in an age of scarcity — with declining government and philanthropic funding — that requires self-sufficient nonprofits? Is extending the discipline of the market the only framework for thinking about nonprofits' impact? Couldn't we develop, for instance, a capital framework that is built on the discipline of market *failure* — identifying and giving priority to exactly those areas where the market, and public funding, do not reach effectively? Each of the strategies in play today is built

on deep layers of assumptions. While we're busy with technical innovations, it might be productive to revisit those assumptions and question them, so as perhaps to become inspired by new problems and possibilities.

...
Even if we thought a more focused — yet broader and deeper — capital dialogue were valuable, how would we achieve it? It would be foolish to attempt to engineer such a comprehensive approach to a problem so broad that it belongs to everyone in the nonprofit sector. Instead, it would probably do if more of the innovators and proponents of the various capital strategies continued to work in their chosen areas but occasionally crossed their boundaries into nearby territory, which this mapping exercise may facilitate.

RELATED READINGS

Abramson, Alan J., Lester M. Salamon, and C. Eugene Steuerle. "The Nonprofit Sector and the Federal Budget: Recent History and Future Directions" in *Nonprofits and Government: Collaboration and Conflict*, Elizabeth T. Boris and C. Eugene Steuerle, editors. (Washington, D.C.: The Urban Institute) 1999.

This comprehensive and influential analysis tracks federal spending from 1980 to 1997. It concludes that budget shifts in this period "generally increased the pressures on nonprofit organizations to expand their services while reducing the resources they had available to do so, at least outside the health field." The analysis also considers whether charitable giving offset the federal cuts, and concludes that while philanthropy did compensate for direct losses to nonprofits, it did not offset declines in "areas of interest to nonprofits" — a broader category that describes direct federal spending *and* spending channeled through nonprofits. The authors are at pains to demonstrate that nonprofits and their causes have suffered as a result of federal spending shifts, e.g., real increases in spending are given a negative cast when expressed as a share of Gross Domestic Product (GDP). But they give little attention to other important factors, e.g., the rise of state and local spending to offset federal spending cuts and the use of tax credits in areas like community development — that suggest that overall public funding may in fact have increased.

Dees, J. Gregory. "Enterprising Nonprofits," *Harvard Business Review*, January-February 1998.

This piece analyzes the rationales of, and prospects for, nonprofits that develop revenue-generating programs or subsidiaries. Enterprise activities appeal to nonprofits because they face "rising costs, more competition for fewer donations and grants, and increased rivalry from for-profits." They are also seeking "the holy grail of financial sustainability." Dees offers a social enterprise spectrum, which runs from purely philanthropic to purely commercial nonprofits. In the middle are blended organizations — where revenues cover many costs, but not the start-up and initial capitalization. Dees then outlines some of the serious tensions and risks that nonprofits need to manage in seeking commercial income. These include: (a) following revenue, even when it leads away from mission; (b) failure of the enterprise; and (c) alienating important constituencies (including staff) that might not like the culture or consequences of commercialization. He urges nonprofits to hire more business-oriented staff, but only if they are willing to accept the challenge of building an organizational culture that accommodates and values them.

Emerson, Jed, Jay Wachowicz, and Suzi Chun. *Social Return on Investment: Exploring Aspects of Value Creation in the Nonprofit Sector*. (San Francisco: The Roberts Enterprise Development Fund) 1999. (Available at www.redf.org)

The authors argue for the general usefulness of new methods for quantifying the "social return on investments" (SROI) made by philanthropic and public funders, and then discuss in detail prototypical metrics and the challenges they present. They argue that the "true impact of the collective work taking place in the nonprofit sector is grossly undervalued by both those within and outside of the sector," and that

better information about the value created by nonprofits could increase public support for nonprofit work, and even improve the compensation of nonprofit workers. The paper explicates the SROI model used by the Roberts Enterprise Development Fund (REDF) during a two-year pilot effort to measure the value created by the foundation's grantees. The model attempts to capture three types of return generated by nonprofits: economic value (embodied in products or services offered in the market); social value (reflected in the improved quality of life of clients or program participants); and socioeconomic value (representing the savings to society generated by nonprofits, which relieve the public sector of potentially more expensive, remedial service-delivery over time). The most pressing challenges in the evolving SROI model are finding an appropriate discount rate for SROI calculations and valuing the degree of difficulty of nonprofit work.

Emerson, Jed. *The U.S. Nonprofit Capital Market: An Introductory Overview of Developmental Stages, Investors and Funding Instruments*. Unpublished manuscript, 1998. (Available at www.redf.org)

The author argues that the various sources of funds available to nonprofits should be viewed as a capital market — not “simply a variety of charitable fundraising efforts.” In its present state, the nonprofit capital market “does not offer enough capital in the size, form and appropriate stages required to be of greatest use to the nonprofit sector.” After presenting a detailed typology of funders, Emerson reviews the major barriers that inhibit the development of a more productive nonprofit capital market. Chief among them is the “equity gap”— the inability of many nonprofits to accumulate surpluses or reserves that can support their growth or improvement. He goes on to enumerate over a dozen other barriers — ranging from lack of metrics for tracking “return on investment” to the complacency of foundations that could learn from more candid review of failures in grantmaking.

Grossman, Allen. *Philanthropic Social Capital Markets: Performance-Driven Philanthropy*. Working paper, Harvard Business School, 2000.

This analysis depicts the nonprofit funding environment as disorganized, inefficient and ultimately hostile to the needs of nonprofit organizations attempting to grow or improve their performance. “It is the absolute amount of capital, the stages at which it is available during organizational development and the conditions of its acquisition that all work together to create a powerful influence on management behavior and organizational culture.” After analyzing the ways in which nonprofit managers are disadvantaged by this ineffective market, the author argues that part of the solution lies in the reform of philanthropy — to create large pools of capital aimed at meeting the unique needs of nonprofits at their various stages of development.

Jegen, David L. “Community Development Venture Capital: Creating a Viable Business Model for the Future,” *Nonprofit Management and Leadership* (San Francisco: Jossey-Bass) Winter 1998, Volume 9, No. 2.

Based on an analysis of nine community development venture capital funds (CDVCF), the author explicates several of the tensions between profitability and social returns. Although he is generally sanguine about the usefulness of the funds, he points out that CDVCFs share all the disadvantages and risks of traditional venture capital funds — and more. If the average venture firm will lose money on over a third of its investments, CDVCFs can expect to lose more because they deal with less experienced businesses and must choose (because of mission and geographic preferences) from a much smaller pool of potential companies. This in turn limits the number of big wins and even viable exit possibilities from their investments. They are also constrained by their very small fund size and an inability to attract co-investors, which leaves some of them unable to cover typical operating costs of \$75,000 per year. Jegen points to two advantages of CDVCFs: their deep roots in their communities give them access to the best local prospects; and their common experience working with very new entrepreneurs positions them to help the most promising but inexperienced ones develop business plans and strategies

Morino Institute. *Venture Philanthropy: Landscape and Expectations*. Undated report produced for the Morino Institute/Youth Social Ventures by Community Wealth Ventures, Inc.

Prepared to inform the development of a philanthropic venture fund targeting youth-serving nonprofits in the Washington D.C. area, this report reviews the emergence of “venture philanthropy” as a concept and offers examples of over 20 funders using venture capital investing techniques. It proposes a continuum of “return expectations” — with traditional philanthropy at one extreme, traditional venture capital at the other and social venture funds in the middle ground, where both financial and social returns are in play.

Proscio, Tony. *A Double “Bottom Line”: Lessons on Social-Purpose Enterprise from the Venture Fund Initiative*, a summary of *The Venture Fund Initiative: An Assessment of Current Opportunities for Social-Purpose Business Development, and Recommendations for Advancing the Field* (San Francisco: Roberts Economic Development Fund) 1999.

This report offers highlights of findings from the Venture Fund Initiative (VFI). Funded by six national foundations with matching grants from seven local funders in six cities, VFI enabled a number of funders and nonprofits to experiment with new funding strategies for nonprofits that were operating social-purpose businesses. Among the major findings: most social-purpose businesses need more capacity for business planning and market analysis; better access to business expertise and technical assistance; access to specialized resources (like information technology and legal and tax services); help raising capital, particularly equity; and both board of directors and funders with experience and knowledge useful to growing businesses.

Smith, Steven Rathgeb. “Government Financing of Nonprofit Activity.” *Nonprofits and Government: Collaboration and Conflict*, Elizabeth T. Boris and C. Eugene Steuerle, editors. (Washington, D.C.: The Urban Institute) 1999.

This piece provides an overview of the government financing of nonprofits, which has seen a “marked increase, albeit quite variable depending upon the state, in government funding of nonprofit activities.” The author reviews trends and practices in government grants, contracts and payments through third parties, as well as tax credits, public bonding and regulation (e.g., via the Community Reinvestment Act). He also reviews alternatives to government funding, and offers some analysis of their impacts. He discusses, for example, the dilemmas some community development corporations (CDCs) face in exploiting development fees as a revenue source, a practice that may sometimes induce them to undertake projects that do not necessarily advance their missions.

Stevens, Susan K. *All the Way to the Bank*. (St. Paul: The Stevens Group, Inc.) 1997.

Informed by the experiences of a well-respected financial consulting firm that works with nonprofits and operates over a dozen loan funds, this very accessible how-to guide is aimed primarily at nonprofit managers. It covers the basics of financial planning and management, and includes a well-organized account of various sources of capital for nonprofits, and the character and limitations of each.

Stevens, Susan K. “Making Working Capital Work,” *Foundation News & Commentary*. July/August 2000.

This piece aims to educate funders about the need for nonprofit working capital. She contrasts working capital — a “critical cash cushion to handle overall capacity costs, that is, the costs required to achieve organizational competence” — with the old-style general operating support grant — a “budget-balancing wild card doled out by foundations as a philanthropic allowance.” After elaborating on the purpose of working capital, Stevens describes possible sources (internally generated surpluses, cash reserve grants and bank loans) and argues for more willingness by nonprofits to use debt to meet their working capital needs.

Sussman, Carl. *Building for the Future: A Guide to Facilities Loan Funds for Community-Based Child and Family Services*. Washington, D.C.: The Finance Project. January 2000.

This analysis is aimed at decision makers who want to assess the potential of specialized lending programs aimed at nonprofit organizations serving children and families. After reviewing the need for improved facilities, the author argues that facilities funds are more feasible today than ever. (This is in part because of Community Reinvestment Act (CRA) requirements and the emergence of the U.S. Community Development Financial Institutions (CDFI) Fund as sources for capitalizing loan pools). He is also optimistic that facilities funds can be an entry point for improving overall performance, as they “stimulate broader systemic changes that affect operating income and the willingness of providers to assume debt [and] leverage new sources of capital.” Subsidized, alternative lenders are needed to deal with nonprofits, however, because the transaction costs and risks of lending to nonprofits, especially small ones, are unappealing to banks. Perhaps more importantly, specialized nonprofits are needed to create a market. Just because nonprofits need facilities capital does not mean they are generating demand for loans, in large part because they lack the capacity to assess their needs and options.

Tuckman, Howard P., and Cyril F. Chang. “Accumulating Financial Surpluses in Nonprofit Organizations.” *Governing, Leading and Managing Nonprofit Organizations*, Dennis R. Young, Robert M. Hollister, Virginia A. Hodgkinson et al (San Francisco: Jossey- Bass) 1993.

The authors examine the positive and negative effects of nonprofits’ accumulating financial surpluses. Accumulated surpluses, the authors reason, can make nonprofits stronger and more independent. In macroeconomic terms, they allow nonprofits to develop specialized capacities. Because they use volunteers, tend not to accumulate inventory and work at the margins of the market, they can actually “dampen the business cycle” by providing an oasis of stability in hard times. On the down side, they see the possibility for inefficient use of the resources and even for monopoly-like predatory behaviors on the part of well-endowed nonprofits that can edge out competitors. Asset-building can also lead to “contract failure” — when, for example, a donor’s desire to affect a social problem today by making a gift to a nonprofit is thwarted because the nonprofit preserves the gift as part of its asset base. Although they argue that the benefits of nonprofit equity accumulation are little understood, they summarize earlier research that found most nonprofits are accumulating surpluses. Even after weighting data from a review of nonprofit tax filings in 1986 (which tend to overrepresent larger nonprofits), they find that the average surplus of 112,000 filers was \$2.5 million, and that 75 percent of the filers reported a surplus.

Tuckman, Howard P. “How and Why Nonprofit Organizations Obtain Capital.” *Nonprofit Organizations in a Market Economy*, David C. Hammack, Dennis R. Young, editors. (San Francisco: Jossey-Bass) 1993.

This overview of nonprofit capital issues starts with the economic case for capital: “At some point, without the addition of further units of capital, adding one more unit of labor leads to negative increases in a firm’s output... Thus, access to capital is strongly related to growth in the productivity of labor.” The author also reviews the organizational rationales for capital, including growth and diversification; technology and equipment acquisition; and program improvement and innovation. After reviewing fairly conventional sources of capital — surpluses and endowments and foundation and government grants — he discusses the untapped potential for nonprofits to access commercial banks as a supply of debt capital. Industry observers estimate that only about two to 10 percent of commercial loans are made to nonprofits for a variety of reasons, including: unfamiliarity with nonprofits as a market; reluctance to foreclose on nonprofits, which might lead to adverse publicity; and the specialized nature of nonprofit assets (e.g., botanical gardens or rural hospitals) that have little resale value. Also promising is tax-exempt bond finance.

Waldhorn, Steven A., James O. Gollub, and Joyce A. Klein, “New Approaches to Financing Nonprofit Organizations: The Role of Lending.” *The Future of the Nonprofit Sector*, Virginia A. Hodgkinson, Richard W. Lyman and Associates (San Francisco: Jossey-Bass) 1989.

Based largely on a consulting assignment led by SRI International in 1987, this piece explores how program-related investments (PRIs) could serve as a source of working capital for nonprofit human service organizations. The authors are optimistic about the prospects for extending PRIs from brick-and-mortar projects to support programmatic innovation and adaptation. They conclude that the use of loans (as opposed to grants) can create new management discipline and competence among nonprofits. PRIs as working capital could support not only the development of new programs but also the development of business opportunities that could generate revenue for nonprofits. Some nonprofits would resist — either on cultural grounds, or because they work in a funding environment where repayment of PRIs would be nearly impossible. After assessing the hesitancy among funders to use PRIs more aggressively, the authors discuss the prospects for special intermediaries that could be created to receive and distribute PRIs, an idea they favor.

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ENDNOTES

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- 19 Christine W. Letts, William P. Ryan, Allen Grossman, “Virtuous Capital: What Foundations Can Learn from Venture Capitalists,” *Harvard Business Review*, March/April 1997. For a critique, see Bruce Sievers, “If Pigs Had Wings,” *Foundation News & Commentary*, November/December 1997.
- 20 Research findings from “Rethinking Nonprofit-Foundation Relations,” Christine W. Letts and William P. Ryan, Hauser Center for Nonprofit Organizations, Harvard University. Forthcoming.
- 21 The Stevens Group, *Working Capital Fund*.
- 22 The National Congress for Community Economic Development (NCCED) had been, until recently, the only facilitator of dialogue among states with NAPs, and has documented the programs and developed model legislation in an attempt to encourage consideration elsewhere. Although grant funding for this function has run out, NCCED’s Carol Wayman is still an informal resource to the states and NAP

proponents. LISC is now working with associations of CDCs in several states to promote NAPs, which are ideally suited to meet the working capital needs of CDCs. Proposals for a companion, federal tax credit has not advanced beyond the discussion stage.

- 23 The Foundation Center: www.fndcenter.org/grantmakers/trends/prindex.html
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- 25 Stevens, *Making Working Capital Work*, p. 45.
- 26 Tuckman, p. 219.
- 27 Tuckman, p. 209.
- 28 Tuckman, p. 209.
- 29 Tuckman.
- 30 This approach to earned-income generation, which is inspired by and does address questions of capital and funding, is often conflated with a repackaging of nonprofit leaders and managers as *entrepreneurs*, regardless of their source of income. Many use the term *social entrepreneur* metaphorically to describe a nonprofit or social leader who, like a commercial entrepreneur, is dedicated to innovation and demonstrates exceptional zeal in overcoming obstacles. To many, *social entrepreneurs* and *social enterprises* are more apt, affirmative labels than *nonprofit manager* and *nonprofit organization*, which are inspired by the tax code. The confusing result, in some cases, can be self-styled social entrepreneurs who may be entirely dependent on public and philanthropic funds.
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- 40 Dees.
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