

Should We Consider a PRI? **Basic program-related investment criteria for foundations and nonprofit organizations**

by Christa Velasquez and Francie Brody, 2002

Foundations can use the tools of banking and corporate finance to pursue charitable program interests. For example:

- A loan to a community development loan fund expands its ability to invest in affordable housing or small businesses in a disadvantaged neighborhood,
- A loan guarantee persuades a bank to provide a mortgage to a child-care agency to purchase its new facility,
- An equity investment in a business enables it to hire and train formerly homeless people in the manufacturing of a product that is then sold to the public.

All of these are real-life examples of program-related investments that foundations have made to nonprofit or social ventures in pursuit of the foundations' program priorities.

A program-related investment (PRI) is an investment by a foundation to support a charitable project or activity. To be classified as a PRI, the production of income or the appreciation of property cannot be a significant purpose of the investment. Typically structured as loans, PRIs also can be loan guarantees, equity investments, recoverable grants, or other financial tools.

Although in existence for more than 30 years, much of that time PRIs were used by only a small number of the thousands of foundations in the United States. Only during the past decade has the PRI tool been embraced by foundations of all sizes and program interests. The use of PRIs expanded further during the rapid rise of the stock market during the late 1990's. For example, new program-related investments increased 31% from \$203.4 million in 1998 to \$266.5 million in 1999. Annual PRI distributions increased by more than 80% from 1997 to 1999¹.

Like grants, PRIs can provide strategic benefits to the borrower. PRIs can be used to help organizations directly, by providing a large sum of capital or attracting other sources of funds. They also can provide borrowers with indirect benefits such as improving financial management planning and systems, and enhancing the borrowers' credibility with commercial lenders.

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As one of the few consulting firms in the country with a PRI practice, we often hear from foundation staff or trustees when they are trying to determine if a particular project is appropriate for a PRI, or from non-profit staff when they are trying to determine if their project is eligible for PRI financing. This article is intended to serve as a tool for both foundation and nonprofit organization staff when making an initial decision about whether to consider a PRI.

The first section of this article reviews the three key criteria required for PRI consideration. If you answer all of these questions with “yes”, it is worth your time to consider the possibility of using a PRI to help support the project. Although additional review, analysis and documentation will be required before making a decision to use a PRI, these criteria offer a framework for a quick preliminary assessment.

A PRI is unlikely to be an appropriate way to support the proposed project if you answer “no” to any of the following the three questions.

1. Does the project closely fit the programmatic priorities of the foundation?
2. Is there a source of funds that will enable the proposed project or the investee organization to repay the investment – either a stream of income or projected funds from a one-time event?
3. Is there stable and competent management and board leadership in place?

If the answer is “no” to the first question, it may not make sense for the foundation to support the project at all. If the answer is “yes” to the first question, but “no” to one or both of questions two and three, a grant or non-financial assistance such as convening or technical assistance is likely to be a more effective means of support.

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Required PRI Criteria

1. Does the project closely fit the programmatic priorities of the foundation?

A PRI, like a grant, is a tool to support foundation program interests. The IRS definition of a PRI is an investment whose primary purpose is to further the charitable, tax-exempt objectives of the foundation, making program purpose a legal requirement. While on occasion PRIs are used to pursue foundation interests not supported by its grants, the majority of PRIs are used to extend the priorities and initiatives that foundations establish for grant programs.

2. Is there a source of funds that will enable the proposed project or the investee organization to repay the investment — either a stream of income or projected funds from a one-time event?

Although both grants and PRIs are used to support program goals, PRIs have one fundamental difference from grants. PRIs are recoverable, made with the understanding that the foundation will receive the funds back from the borrower or investee, to be re-used in another project. PRI borrowers or investees are taking on an obligation to repay the funds at a future date. Therefore, one of the key activities in assessing a potential PRI is to determine whether and how the borrower will generate enough income—either through ongoing operations or a one-time event—to repay the obligation.

Revenue streams can be generated in a variety of ways, representing a spectrum of risk. Typically, foundations look to a revenue stream directly associated with the project that will be supported by the PRI, such as:

- Rental income from affordable housing, land, or facilities
- Sales income from transfer of single family housing to its owners or land to the entity planning to preserve it
- Repayment from loans or investments made by a community development financial institution (loan fund, bank, credit union, venture capital fund)
- Income from social purpose business activities (sale of services or products)
- Royalties from new product licensing or
- Proceeds from refinancing of asset

In some instances, foundations may allow an organization to use a fundraising campaign as the PRI repayment source. While a campaign could produce the funds necessary to repay a PRI, it is not one of the examples on the list because it is very risky. The outcomes and time involved in fundraising campaigns are not entirely predictable and can fall considerably short of the goal. In addition, it may be difficult for the borrower to generate new contributions in order to repay a foundation.

3. Is there stable and competent management and board leadership in place?

The definition of a successful PRI is one that generates both positive program outcomes and repayment of the initial investment. Failure to repay a PRI can damage a borrower's reputation with funders and lenders and weaken its future programs. Since PRIs are multi-year investments (sometimes as many as ten years or more), the long-term sustainability and strength of the organization is critical.

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A strong management team helps ensure that the organization has adequate vision, strategic planning, financial management, operations systems, and strong programs. If an organization has a weak or inexperienced management team, is inexperienced in the proposed type of work, or doesn't have a track record of good planning and financial management, a grant and technical assistance may be more appropriate tools than a PRI. In many cases, a grant or other resources to support planning or staff development are the most helpful strategies to overcome organizational weaknesses. This kind of support can lead to a more viable PRI request in the future.

Additional questions to consider

The three previous questions are the basic criteria for considering a PRI, and if the proposed project doesn't meet all three of them, a PRI is not the right type of support for the project. If the proposed project does meet the above criteria, the additional questions below help to clarify the case for using a PRI for the project.

If only a portion of the project will earn income, a PRI / grant package may be the best type of support.

4. Is a grant feasible or desirable for the project, or portion of the project for which you are considering a PRI?

As you review the proposed project, think about the activities involved. Do all of the activities directly result in a stream of income for repayment of a PRI? Will only a portion of the activities generate income? If only a portion of the project will earn income, a PRI / grant package may be the best type of support. A grant may be an important part of the package for other reasons also, such as providing a cushion to help the borrower manage risk or underwriting staff training or the development of new internal management systems.

In addition to examining the activities, what is the size of the proposed investment? Is it larger, smaller, or about the same as your institution's typical grant? If it is smaller or about the same, it may make more sense to support the project with a grant or recoverable grant. Since PRIs require a financial and business review as well as a programmatic review, they require a larger expenditure of time and resources (consultants to conduct the review, attorneys to draw up the closing documents). Although not a requirement, these pragmatic issues make PRIs more attractive when they are considerably larger than the foundation's typical grants to justify the added expense. Most PRIs are at least twice the size of the foundation's average grant, and often they are at least ten times larger.

5. Has the foundation ever supported this kind of project or something similar to this before? Has any foundation supported anything similar before?

Although PRIs are made with the intention of repayment, there is always risk that they cannot be repaid. A PRI is unlikely to be the best way to support the project when the repayment risk is extremely high. A foundation's prior experience in the field and with the type of project under consideration can provide a framework to assess the level of risk and determine what can be done to increase the likelihood of success. Examining whether your foundation, or any foundation, has invested either grant or PRI support in a similar project sheds some light on the risk involved in the proposed project. How did your foundation support the project? What was the experience? Were there lessons learned that might inform this project? If a PRI was used, did it get repaid? If not, grant support may be more appropriate.

6. Is there a local context or history of relationships between the foundation and the organization that creates a level of comfort within the foundation for the transaction?

Sometimes, if the organization is a key grantee or an important part of a program initiative of the foundation, the foundation may make a PRI when it normally wouldn't in other circumstances. The long-term relationship can provide incentive for the foundation to accept additional risk and for the borrower to make extra effort to repay. For example, foundations have made PRIs to some of their key grantees despite the following concerns:

- One organization had only recently hired a new executive director, but had a good staff of middle-managers and strong board;
- Another organization didn't have direct experience with the activities in the proposed project but hired a new program director that did;
- An organization with a history of business success developed a new untried program model.

In all cases, the foundation and the organization had a long history of working together, and that relationship provided the foundation with the confidence that the projects and the borrowers were worth the risk.

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Review Process

After completing this preliminary assessment you should have a general idea of the appropriateness of a PRI for the proposed project. If a PRI seems like a good option, a foundation still should conduct its regular programmatic review, as well as an in-depth financial and business re-

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view before committing to the PRI.

The process and timing for reviewing and making a PRI varies by institution. Some foundations use the same review process for grants and PRIs and require only a few months. Other foundations have separate review processes that may take up to a year or more to complete.

The review period tends to be shorter when the proposed borrower approaches the foundation with its business plan in place. When conversations begin at an earlier stage of project development, the borrower often needs weeks or even months of planning in order to respond to substantive questions. Similarly, the time period can be shortened when both the borrower and foundation have experience in the field and a prior relationship. As a general rule, larger PRI amounts, new models and more complex proposed projects tend to increase the time required to review and structure a PRI.

Conclusion

Despite the risks involved in and resources required to make a PRI, it can be a valuable tool in a grantmaker's toolbox, with benefits to both the investing foundation and the investee organization. The investee organization may raise a larger pool of funds than it could with grants alone, deepen its financial management and long-term planning and become more "bankable" by establishing a good credit history. In turn, the foundation can recycle funds for more than one project, increasing its long-term impact. The PRI also may enable the foundation to expand resources available for an important project, draw new funding partners into its work and develop long-term relationships with organizations that will enhance the foundation's learning and program impact.

1 From *The PRI Directory: Charitable Loans and Other Program-Related Investments by Foundations*, 2001 Edition. The Foundation Center.

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Brody · Weiser · Burns helps complex nonprofits develop strategic and business venture plans, assists foundations with structuring and managing program-related investments and facilitates partnerships between businesses and nonprofits. Clients have included the Ford Foundation and MacArthur Foundation PRI Programs, Prudential Insurance Social Investments and The Moriah Fund. Brody · Weiser · Burns partners have served as faculty of the MIT Project on Social Investing, teaching PRI workshops for foundations throughout the United States for nearly 20 years.

Brody · Weiser · Burns also works with PRI borrowers and other socially motivated businesses, developing strategic and business plans, preparing for growth, facilitating internal changes, and evaluating program impact and financial strength.

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