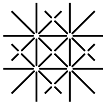

Video Transcript

ENTREPRENEURSHIP IN NONPROFITS

Introduction to impact investing

[Georg von Schnurbein] You have probably already heard the explanation of different forms of capitalism using two cows. The starting point is traditional capitalism. You have two cows you sell one and buy a bull. Your herd multiplies, and the economy grows. You sell them and retire on the income.
Now if we think of traditional nonprofits, we can say a donor gives you two cows. You feed the poor with milk and ham. Next year, you ask the donor for two cows again. The example tells us something about the dilemma of nonprofit finance. Donations are always a 100% loss.

The new forms of impact investing try to overcome this dilemma. Impact investing is best understood as a continuum between 100 percent loss, that is receiving donations only, and full market return, that is making business. On this continuum, we find a lot of different possible methods. Below market investments means that the financial return will be below a typical market rate. Apart from grants, this can be equity, subordinate loans, senior loans, or cash.
On the other side, we see investments at market rate, including private equity, public equity, fixed income, and cash. Guarantees can have different structures and are, thus, in the middle.
Now the basic idea of impact investing is multiplication and leverage. As I said before, a donation is always a 100% loss. You can create milk and ham that is social impact once, and then you have to raise new money. By applying other instruments, such as loans, equity, or guarantees for the same good cause, you can reuse $1 several times before you make it a final grant. Additionally, you can create leverage if the money is invested and generates interest.
In the following, I want to present to you three different classes of new funding that apply to both nonprofits and social enterprises. I will speak about debt-guarantee models, pay for success models, and conditional conversion models.

Debt financing or granting of deficit guarantees enables an early launch of projects. It encourages grantees to pursue projects they otherwise anticipated as being too risky. A deficit guarantee may help attracting other funding partners as it reduces the project risk. In contrast to simple grants, upfront debt financing of projects may not only initiate projects, but incentivize the meeting of certain goals and adoption of entrepreneurial behavior.

Deficit guarantees are conditional grants. Thus, the money underlying the guarantee is not necessarily disbursed as in the case of the grant. Debt financing is currently most often used in the field of start-up financing, reintegration of unemployed people, or education.
There's an interesting combination of both models, debt financing and guarantees, by the Andrew W. Mellon Foundation based in New York. The foundation gives loans, including a deficit guarantee, to the nonprofit finance fund. Which then again grants zero interest loans to different nonprofits and local beneficiaries.
Pay for success models requires certain predefined conditions or milestones to be met in order for the grant maker to release his payment. This provides a certain incentive for the grantee to get out of his or her comfort zone. For example, by improving internal organizational processes or by expanding knowledge. If a pay for success grant is well-designed, it can incentivize grantees to innovate while allowing grant givers to pay out only for success, thus, reducing the financial risk.

There are several models currently in practice, most prominently, the Social Impact Bond, which we will further discuss in a later video.

In contrast to pay for success models, conditional conversion models refer to the idea that already paid out grants or loans will later be converted into another type of financing. This again is based on the idea of incentivizing goal achievement, for instance, the conversion of debt to grand. Or to match the financing type with specific stages of project development. For instance, the conversion of an initial grant to equity. These approaches supply the grant making nonprofit with more flexibility regarding their involvement in supported projects, and allow for a lifecycle optimized type of funding.

Conditional conversion models can be used where economic incentives actually work. For example, in the fields of job creation or start-up financing. Especially in the field of education, debt to gift conversion models are popular, for example, for student loan repayment funds.

Impact investing offers a great variety of different methods and different mechanisms of funding. As financial resources are scarce, it is necessary to analyze where you can create leverage or multiplication in your initiative so that you are less dependent on grants and donations.