

Stanford SOCIAL INNOVATION^{Review}

Supplement
Leveraging the Balance Sheet
By David Bank

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Leveraging the Balance Sheet

A conversation with **Julie Sunderland**, founding director of Program Related Investments at the Bill & Melinda Gates Foundation.

BY DAVID BANK

The idea came from a conversation between Bill Gates and Alex Friedman, the once and future investment banker who was then the chief financial officer at the Bill & Melinda Gates Foundation. How might the foundation leverage its huge balance sheet to help bring private-sector innovation and entrepreneurship to bear on urgent challenges in global health, agriculture, education, and other areas?

Friedman recruited Julie Sunderland, who as head of Oriane Consulting had already worked in Africa, Eastern Europe, and other challenging markets to support great entrepreneurs and big ideas. Sunderland launched the foundation's program-related investment (PRI) effort as a \$400 million "pilot" in 2009. It has since grown to a \$1.5 billion mandate, of which more than \$1 billion has been committed in 47 investments, including equity, debt, guarantees, and fund investments. As Sunderland got ready to move on to new challenges, she reflected on the lessons she has learned from seven years of PRI-making.

David Bank: What did the folks at the foundation ask you to come and do? Was it Bill's idea?

Julie Sunderland: Bill Gates had just moved over from active management at Microsoft to spending a lot of his time at the Gates Foundation. One of the things that he saw when he joined the foundation was that it was doing a lot of great work in the nonprofit and academic sectors, but—not surprisingly given his background—he wanted to think more proactively and effectively about how we partner with the private sector.

Bill was really intrigued by the possibility of using program-related investments, PRIs, to form partnerships with the private sector as well as to support some of our nonprofit partners. The original idea for the PRI program at the foundation came out of a conversation between Bill and Alex Friedman who was the CFO at the time. Alex had come from Lazard and was looking at the huge balance sheet at the Gates Foundation. We had at the time about \$35 billion in capital in the endowment—it's probably more than that now—in addition to Warren Buffett's gift.

Alex recruited me to come in and start the PRI program. We weren't sure whether it was going to work. We started it from scratch. It was me and our assistant Jill. We started with a \$400 million pilot and have grown it from there.

How would you define the problem that the investment you were going to make could solve?

Our work is grounded in trying to understand the particular strategies that the Gates Foundation is pursuing, for example, trying to bring agriculture technologies to small-holder farmers in Africa, or working with companies to develop breakthrough scientific discoveries that would translate into products for global health. So at the outset of the program, our focus was on addressing the issue: Are these instruments useful in terms of identifying private-sector partners and creating the incentive to get them to work with us on some of these really hard problems? That is what I would call phase one.

In phase two we started to think in a lot more depth and with more nuance about market failures. What are the market failures that prevent experimental, innovative biotech companies from focusing on global

health problems? How do we solve those market failures using these tools? Looking at all of the challenges that poor people face, how do we use investment tools to develop low-cost innovative products and make them accessible and affordable to poor people? We talked a lot about how we could make markets work better for the poor.

In our latest phase, we're thinking a lot about what we call "betting on believers," finding those great partners who want to work with us and using PRIs as tools to make great things happen in the world. So it's been an evolution to figure out what we can do to empower great innovators, great companies, and great entrepreneurs to focus on the problems we're trying to solve.

Is there an overarching pattern to market failures, what causes them, and what cures them?

We're not delusional about the private sector and about capitalism. We know that markets don't work well for the poor for very, very good reasons. It's not theoretical. The reality is that the poor don't have much money and therefore profit margins are slim. The only way that you can create good business models to serve the poor is to get to high volume and large scale with small margins.

We know that the transaction costs of selling to the poor are high. We know that to serve poor people, if you have to actually go out and do last-mile delivery and interact with them directly, it costs a lot. We know that the distribution channels and the infrastructure to reach these populations are underdeveloped. We know that there's not a lot of information about these markets. And we know that we're often operating in what are perceived to be very high-risk markets from a political and business environment standpoint.

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So there are a lot of constraints to overcome for good, rational companies that may want to work in these markets. Whenever we look at the sectors in which we work—health care, agriculture, education, and financial services for the poor—we’re very realistic about how challenging it is for companies to work in these markets and try to find ways to solve some of those market failures.

We believe that the way to do that must involve innovation, whether it is technology or business model innovation. We’ve seen how leapfrog innovation enables you to lower

The theory being that if you can tackle some of those obstacles then the market can work without the subsidies that you provide?

Absolutely. We’re not interested in supporting unsustainable businesses or business models. What we’re really interested in is using subsidized capital or the other tools that we have—whether it’s regulatory change or ways to de-risk upfront innovation—to try to solve some of those market failures. The expectation is that over time

market failure.” We want to think about how the underlying economics of a market evolve over time and what role we can have to address some of those market failures, and help that market evolve toward something that doesn’t need us anymore.

Let’s turn to the tools themselves. Are PRIs just grants by another name, or are they something different?

We sit within the foundation and we’re the only investment group within the Gates Foundation proper. [The endowment is outside of the foundation.] So at the outset we narrowed our scope to program-related investments and thought of ourselves as the strategic investment arm of the foundation.

We really did want to push the envelope in terms of the tools we wanted to use. Many of our colleagues in other foundations had focused on low-interest loans to address housing, or charter schools, or working capital for their NGO partners. We wanted to look as well at different types of partners such as biotech companies, multinationals, and innovative entrepreneurs.

In the first couple of years of the pilot we did everything. We worked within global health, agriculture, financial services, and US education. And we also used a full range of financial instruments. We used direct equity investments into companies. We used equity funds. We did traditional loans to nonprofits. And we used guarantees, which have turned out to be one of the most extraordinary tools that we’ve used and that are truly leveraging the foundation’s balance sheet.

I won’t discount the challenge of pushing the envelope in terms of using those instruments and developing new legal structures. The legal team at the Gates Foundation has been our partner hip to hip in terms of helping build these new investment structures.

We have to make investments for a charitable purpose and we have to define metrics within all of our investment criteria that are consistent with the charitable purpose. Those two constraints have actually been a powerful tool to hold ourselves accountable to the purpose of the investing, and to negotiate in a very straightforward way with our partners. We’ll walk away from a negotiation if we find that we can’t get alignment with our partners around the charitable purpose. We often describe this as “Global Access”: ensuring that knowledge and information gained



transaction costs and achieve high volumes with products that can change people’s lives.

One of the greatest examples of this is bKash, a company in Bangladesh that uses mobile payments and has created an incredible digital infrastructure that allows poor people to access financial services with very low transaction costs. It’s pennies for a financial transaction. In a few years, we’ve seen bKash grow from zero customers to close to 20 million, if not more than 20 million by now.

The answer to the question of how do you solve market failures is specific to the sector in which you’re working. We’re betting on innovation. We’re betting on business models that can achieve a large scale. We’re betting on partnering with companies that have the appetite to take on risk and build distribution and delivery models that work.

these markets will work for the poor. We will have low-cost, affordable products that the poor can access. That’s the theory.

We don’t want to be ahistorical here. We know that you don’t just turn a switch and solve a market failure. What we want to think about is how markets can evolve over time. Again, I go back to the bKash example. We’re pretty confident, given the economics of using digital payments to reach poor people and what we’ve seen happen in East Africa with M-Pesa, that it will be a functional market once you de-risk some of that early upfront infrastructure building and innovation.

Other sectors, like agriculture, are much more complicated and people have been trying to solve those market failures for a long time. It may be a longer path toward a market that works for the poor. So we don’t just say, “Hey, you go out, you do a PRI and you solve a

from a foundation investment is promptly and broadly disseminated and products funded by the foundation are made available and accessible at an affordable price to the poorest populations. We have very specific metrics that define how our partner reaches those global access requirements.

The second thing that's important about PRIs is that no significant purpose can be financial return. Their primary purpose has to be charitable. We've found that within that constraint there's a lot of room to structure investments. We've worked with our legal team to be careful about how we both maintain that financial discipline but also make it clear to our partners, to ourselves, and to the organization that the primary purpose of a PRI is the foundation's strategic charitable purpose.

Do you consider yourself an impact investor?

I count myself as an impact investor. I'm investing for impact. My purpose is to achieve impact. I'm very clear on that and I'm very aggressive in negotiating with companies to ensure that I get that impact.

Within the context of the impact investing community, we're very, very clear-sighted that in most cases, especially in the sectors in which we work, there are trade-offs between financial return and impact. And we're very clear about the subsidy that we provide in order to generate that impact. So we sometimes get pushback from some of our impact investing partners on two levels.

We know that if we're investing in an early-stage company, we're taking risks that purely rational financial investors wouldn't take and there is an inherent subsidy in that. If we're providing a low-interest loan to one of our partners to expand into Africa, it's a lower interest rate than market interest rates and there's a subsidy there. If we provide a guarantee and we don't charge a guarantee fee, and there's a risk of loss, there's a subsidy inherent in there.

So with every single investment we make, we want to be clear about the subsidy we are making and we want to measure and be held accountable for it. We think about how much impact we get for providing that subsidy. That's built into the DNA of this program. We're very aggressive in negotiating with our partners and our companies to deliver on the metrics to show that they've created that impact.

We've gotten pushback from some of our impact investment colleagues, "Oh, there's no trade-off." In other sectors maybe there isn't a trade-off between financial and social returns; you can have your cake and eat it too. In the markets in which we work—where we're focused on the poorest populations and we're trying to solve market failures—we're pretty conscious that we should be providing a subsidy and that the subsidy is valuable and enabling us to get toward impact.

The other pushback we get from partners is that we're too hard-nosed, that we should be softer and be more open in supporting social entrepreneurs and social entrepreneurship and not be so worried about invoking financial discipline. Our feeling is if you don't have a good company that can generate cash flows and that can be financially successful in the long term, then we're also not going to get to our impact goal.

So we get pushback from both sides that we're not hard-nosed enough in believing that you can have social and financial return, that we shouldn't provide subsidies, and that we shouldn't be distorting markets. And we also get pushback that we're too hard-nosed and that we should be more supportive of social entrepreneurs that may have more questionable business models.

If you're getting pushback from both sides, you figure you must be doing something right?

We're right where we should be. Or we're completely wrong! Could be either way.

Tell me more about how you think about subsidy.

Nobody likes the word "subsidy." It's a scary word. Economists cringe, everybody cringes. So we re-coined it as "Risk Share." Our entire investment review process is structured to look a lot like a typical private equity or venture capital due-diligence process. But instead of just focusing on whether this is a good or a bad investment, we are focused on pricing the inherent subsidy, or Risk Share: how much of the investment do we think the foundation is unlikely to ever get back, and then make sure that risk share is worth it in terms of the impact that we're trying to get.

If we had a very high-risk, early-stage \$10 million investment that other investors wouldn't go into because it's too high-risk, we

might say that 50 percent is more risk than a rational financial investor would take and are funds that the foundation is likely to never get back. Therefore, 50 percent of the total investment, or \$5 million, is subsidy, what we consider the risk share, which we account for from our program team's grant budget. We account for the other \$5 million from our PRI balance sheet allocation. All of these investments are funded fully from the foundation payout, and all of these investments have an explicit charitable purpose for all elements of the investment, but this clever way we account for them internally does a few things.

First of all, it means that whenever we do an investment, we've got skin in the game, both from the program team and from the investment team. Second, we've got deal teams that include both the investment and programmatic professionals. Third, what we're trying to achieve is to make sure that the \$5 million contribution, that Risk Share, is tied very explicitly to the impact it's going to get for the program team's grant budget. Program officers have hundreds of millions of dollars in grants that they're putting out, and by looking at that subsidy and comparing it to an equivalent grant, they can say "Yes, it's worth doing. I'm going to get as much outcome from doing that investment as I would if I were doing a grant."

That allows us to have a rational conversation with both our investment committee and our leadership around what a good investment is for the foundation. Instead of saying, "Hey, is this too risky? Is it not risky enough?" we're saying, "We know how risky it is and we know that it's worth it." The internal pricing and funding allocation mechanism allows us to have creative and productive conversations about those trade-offs between impact and financial losses and allows us to still maintain discipline around the use of the foundation's resources.

Where do your deals come from?

The foundation has world experts in education, in some fields of vaccine development, in immunology. I've got a great team of 10 investment professionals but we're primarily generalists. We do not have the expertise in these sectors but we get to work with these amazing people who deeply understand what is needed by the people that we're trying to serve. They're the ones that understand the theory of change that gets the impact and

what we need to do to make markets work for the poor, and also have the ability to validate the underlying technology.

In some cases, our program colleagues will bring us investments, bring us companies that they've identified through their strategy process and through being out in these markets. In some cases, we'll go out and find them. We've been doing this for seven years, and we now understand some of the sectors and some of the problems that we're trying to solve. We can go into the venture community and the biotech community and say, "Hey, this is what we're trying to solve. Do you have potential technologies or platforms or solutions to those problems?"

With all those scientists and experts, you have market expertise that other investors would kill for.

I don't know if they'd kill for it, because we're working in some pretty hard sectors. If I were an investor that wanted to make money, I don't know if I would focus on agriculture in Africa or financial services in Bangladesh. We're in some pretty unique sectors because we're focused on underserved populations.

That being said, we're identifying some amazing companies because of that technical expertise. Even though we're not at all focused on financial returns and it's not our objective and not any purpose of our investments, we are able to identify great entrepreneurs, great platforms, and great technologies. Our focus is getting to that impact and if we're successful, they may also be able to generate financial returns.

We have a hypothesis that because of that technical expertise, because we're investing on the back of giants, because our program colleagues have gone in and understood these markets better than anyone, because we have access to great deal flow and great ideas and the pull of our leadership, we actually may get more of our funds back than we expected. But you have to put that in context and understand that our expectations are to generate a loss. We currently only expect to generate a return of 90 cents on the dollar, which is much lower than what many of other foundation PRI colleagues expect.

In typical investment funds you are criticized if you have flops. In the impact world you can also get criticism if you have suc-

cesses. There may be such a thing as doing too well.

We're very conscious that for every single one of our investments we need to define the charitable purpose of that investment and make sure that the companies and our partners understand that it is very much an investment for a charitable purpose. But it's possible for people who don't look closely at what we do and why we do it to say that the Gates Foundation is trying to make money off the backs of the poor. That is absolutely not what we do or why we do it, so I don't know how to defend against those critiques except to go back to the extraordinary creativity and results that we do get on the impact side.

How do you tote up the impact returns?

When we think about impact, we think about it by sector. Within our financial services, our digital payments investments, it's about the population that we can reach with low-cost product. When we think about our biotech investments, we think about a pathway of innovation and moving along that innovation cycle from early-stage idea through to a product, from proof of concept to clinical trials. That's a decade-long cycle to get from a breakthrough scientific idea to a low-cost product for the poor. Within our agriculture investments we think about yield improvements and income improvements for smallholder farmers.

For every investment we do, we're thinking about the theory of change and the pathway to impact, and then defining metrics around those. We're still early, but if I look at the returns from our portfolio on the impact side I'm really pleased. For example, within our volume guarantee portfolio where we've gone out and worked with multinationals to lower the price of key health commodities, we know that we're on track to save a billion dollars of donor money. That's freeing up a billion dollars that can then be used for other life-saving products for poor people. That's a clear impact metric result from that portfolio that's easy to measure and quantify. We know we're getting results there.

How would you sum up the lessons you have learned?

First, I think this is hard work. I'm a big believer in impact investing and I'm a big be-

liever that companies and entrepreneurs and innovators can make a huge difference in the world. When I lived in Africa, the most inspiring people for me were always these entrepreneurs trying to make things happen, fighting against unbelievable odds in business environments that most Silicon Valley entrepreneurs wouldn't even remotely be able to function in. But it's not easy to do this well, so I think that one of the important lessons is to bring all the tools of good due diligence and good investment decision making and try to make the absolute best decision possible. And then once we make the investment, to be tough with our partners to ensure that they are being disciplined themselves, to ensure that their companies are successful and that they are accountable to our impact goals.

The second lesson is the concept of aligning incentives. A lot of the investors in companies we work with do have a social responsibility mindset. They want to make the world a better place while building a company. How do we create incentives and how do we enable the most overlap between our objectives and the objectives of the company? If there's not enough overlap, then we shouldn't do the deal. If there is a lot of overlap and we can de-risk or we can provide capital in creative ways to enable them to do the things that they want to do, those are our best deals.

A third lesson is the importance of understanding your markets and understanding the economics of your markets and the theory of change for how you get to a functional market. In a lot of cases, to gain that knowledge we'll also do grants alongside investments. Often, that work on regulatory issues, market research, R&D, or product development—that is supported with grants—is as important as our PRI investment.

The fourth lesson is the importance of finding great people and giving them the tools they need. We've found some fantastic people to partner with in these companies and those are the ones that we want to double down on, the great innovators and the great entrepreneurs. Within multinationals, we meet people who are committed to bringing the capabilities of those companies to these markets. All of these committed, visionary people are a joy to work with. And that's probably my most important lesson—finding great people to work with and enabling them to do great things is where we've been most effective. ♦