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Money to Grow On

By William Foster

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By William Foster | Illustration by Andy Martin

In the for-profit world, the term "investment" has clear meaning and investors have sophisticated techniques for spotting and growing the most promising companies. Yet foundations and other nonprofit donors have not developed similar clarity or approaches. As a result, the nonprofit sector's greatest gems often languish well below their full potential. By better translating for-profit concepts, donors can learn how to scout out and grow the best nonprofits. Likewise, certain nonprofits can take a page from business's playbook and learn how to attract cash for expansion.

Over the past decade, the nonprofit sector has been increasingly abuzz with talk of strategic philanthropy, venture philanthropy, growth capital, and other forms of nonprofit investing. Among the Web sites of the 100 largest U.S. foundations, for example, 77 tout that they are involved in some type of "investment," "leverage," or "venture activity." As entrepreneurs turn into philanthropists, they want to have the same outsized impact with their giving as they did with their business ventures. At the same time, institutional foundations want to leverage their dollars to do the most good.

Although many nonprofit donors are talking about strategic investing, few are actually putting these ideas into practice. Most make grants that are too small to have a big impact. In 2005, for example, the 100 largest U.S. foundations made (usually multiyear) grants whose average was approximately $200,000. These same foundations' assets, meanwhile, average some $2 billion.[1]

In addition, outside of gifts to universities, hospitals, and foundations, all U.S. individual donors and foundations made fewer than 150 grants of $5 million or more to the nonprofit sector in 2005. Only 25 of these went to human service organizations.[2] By contrast, in 2005, U.S. venture capitalists alone made 3,100 investments averaging $7.2 million each.[3]

What's more, most philanthropic donors restrict their gifts to specific programs, so grantees cannot use the money to grow their organizations as a whole. In 2006, only 19 percent of U.S. grants were either unrestricted or for general support.[4] The rest of the grants—81 percent—could be spent only on designated activities, such as tutoring services for youth in a particular high school or for the construction of a particular building. By contrast, most venture capital investments are not restricted to a specific product, department, or program. Instead, companies can use the money to grow—for example, opening offices in new locations, expanding the company's information technology system, and hiring sales and marketing staff.

"Only a handful of funders are making grants that function like investments to growth-oriented nonprofits," says Harvard Business School professor Allen Grossman. "I doubt


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that the total amount nationwide exceeds $100 million per year."

This handful is worth watching—and emulating. These funders are awarding grants that are becoming known as "growth capital"—large investments that are used to increase the size of an organization's operations and that are not needed to sustain the organization once it has gotten larger. The recipients are themselves trailblazers, using the funds to increase their impact dramatically.

Growth capital is for nonprofits that have demonstrated that their programs work and that have identified a steady source of funds that can support their ongoing efforts. It is not for small, innovative, but still untested nonprofits or for organizations that do not have a sustainable funding model. (See "When Should a Nonprofit Seek Growth Capital?" on p. 53.) If one were to draw an analogy to venture capital funding, nonprofit growth capital would be the equivalent of later stage funding, not early stage funding.

There's great potential in nonprofit growth capital investing. To realize this potential, however, funders and nonprofit leaders alike need to understand the differences between growth capital and grants for ongoing operations—in essence, the difference between investment and revenue. They must also develop the ability to identify the limited number of nonprofits that can benefit from growth capital.

Over the last several years, the Bridgespan Group has worked with and studied both funders that provide growth capital and nonprofits that receive it. We have helped two of the most promising candidates for growth capital develop their business plans—Youth Villages, a Memphis-based organization that helps emotionally and behaviorally troubled youth and their families, and Alexandria, Va.-based Communities in Schools, which helps students stay in school. We have also helped one of the largest providers of growth capital, the Edna McConnell Clark Foundation (EMCF), develop its strategy, identify potential grantees, and assist its grantees with business planning. And we were part of the business planning for a particularly promising new growth capital intermediary, SeaChange Capital Partners, whose founding donor is the Goldman Sachs Group Inc.

Through these experiences, we have honed due diligence processes that funders can use to identify promising nonprofits that can effectively use growth capital to go to scale (and those that cannot). The common deal breaker? A sustainable funding model. Nonprofits can likewise use this process to figure out whether and how they can attract growth capital.

GROWTH CAPITAL

Nonprofits and funders alike often blur the important distinction between investments that help an organization grow (growth capital) and investments that fund ongoing programs (revenue). Some of this blurring is intentional. When nonprofits ask foundations for grants, they routinely highlight onetime, growth-oriented uses for money, knowing full well that in reality the money will be needed to fund ongoing operations. Both parties talk as if they're making a deal on Wall Street when it is really a transaction on Main Street. Of course, funders are willing participants. Only a small minority of grant opportunities can really function like investments and help nonprofits grow, but that is what many foundation staff, management, and board members routinely set as objectives. This dynamic has been called "the dance of deception."

The good news is that some funders are beginning to be much more rigorous about differentiating between growth capital investments and other donations; they're also increasingly focusing on the potential impact they can have through growth capital. These philanthropists make grants large enough for nonprofits to invest in capacity-building activities, such as hiring more managers, training new staff, buying new software, and covering short-term losses as the organization expands its operations.[5] In general, these are investors with a deep commitment to organization building and an uncommon self-discipline about measuring results. Over time, they have found the need to be more selective about their grantees and to provide better forms of support. (See "Growth Capital Funders and Intermediaries" on p. 54.)

One of the leading growth capital investors is EMCF. For the past year, it has been raising $120 million from a group of institutional and individual funders to provide growth capital to three nonprofits: Youth Villages; The Nurse-Family Partnership, a Denver-based organization that helps low-income teen mothers with parenting and planning; and Citizen Schools, a Boston-based nonprofit that provides after-school programs and expanded learning time to middle school students.

EMCF committed $39 million of its own funds to this campaign and has publicly announced an additional $49 million from donors including the Picower Foundation, the Samberg Family Foundation, and the Atlantic Philanthropies. When completed, this will be the largest investment of philanthropic growth capital to date.[6]

"To help disadvantaged youth on a national scale, we must raise much more capital and direct it more effectively," says Nancy Roob, president of EMCF. "Each of these grantees has proven its program, is poised for growth, and has a business plan with an increased emphasis on financial strategies that will lead to sustainability. Ultimately, this infusion of growth capital from the private sector will leverage significant public investment, aligning philanthropic and government resources to provide truly effective remedies to serious social ills facing our nation's youth today."

On the other side of the checkbook, several additional nonprofits are using such investments to pursue their growth. In 2005, for example, Washington, D.C.-based College Summit, an organization that helps schools and districts increase the number of students enrolling in college, raised $15 million from 10 investors and is using the money to quintuple its size.

Similarly, in 2006, New York-based Teach for America, a nonprofit that trains outstanding recent college graduates and places them in teaching positions in urban and rural schools, raised $60 million in growth capital. It is using this funding to more than double the size of its teacher corps and to increase their impact.

And in 2007, Boston-based Year Up, a national nonprofit that trains urban young adults and helps them secure living-wage jobs, closed an $18 million growth capital campaign and plans to use

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this money to build the infrastructure needed to serve four times as many young adults.

The increase in growth capital investments is a positive trend, but it will pay off only if grantees are able to sustain their new size and scope. And therein lies the challenge: How can a philanthropist tell if an organization has what it takes not only to get bigger, but also to stay effective? More than unraveling an accounting dilemma (although it is that too), the key to making a successful growth capital investment lies in finding the few nonprofits that can use the funds to achieve important and lasting social impact.

SPOTTING POTENTIAL

Before venture capitalists invest in a company, they conduct a thorough review of the company's management team, business model, and strategic plan, along with an analysis of the company's competition and market. More often than not, they walk away from deals that are in many respects attractive. Few nonprofit donors undertake such rigorous due diligence. But they should.

We have identified seven criteria that nonprofit donors should use to choose recipients of their growth capital investments. To be sure, there is no magic in the number seven. We could condense these criteria into six or expand them into eight. The important point is that nonprofit donors need a due diligence process to guide their investments.

The first three characteristics are important for many kinds of funding and can be found in a wide range of nonprofits. The next three characteristics relate to the readiness of an organization for growth and narrow the pool of candidates considerably. The seventh and last characteristic is the most difficult to find, but also the most important, because it identifies those nonprofits that can sustain growth and are therefore ready for growth capital.

First Round of Due Diligence

1. *The organization addresses a critical need.* No investment can succeed in a big way if the nonprofit is tackling a small or unimportant problem. Of course, determining this is a matter of opinion and values. Philanthropists should fund the issues that they themselves view as critical. If the philanthropist believes that the nonprofit will need to attract funding from other donors, however, she should assess whether broader society views the problem as a critical unmet need. Some issues (for example, failures in the education system) are more widely viewed as such than others (for example, increasing youth soccer skills[7]).

Citizen Schools, College Summit, and Teach for America all focus on educational inequities—a top priority of most local governments, politicians, and many philanthropists.

2. *The organization has strong leadership.* Philanthropists need to look beyond charisma to the management strength of both the executive director and the overall leadership team, including managers and board members. As with any successful venture capital investment, nonprofit growth capital investments succeed because of the leadership more than the specifics of a plan. Circumstances and conditions will change, and the team will need to react. In the nonprofit world, moreover, boards of directors often play a significant role in helping executive directors and management teams adapt. Although part of a growth plan may include augmenting the team, the core members should be in place.

It is worth noting that the leadership of the organizations that have raised or are raising growth capital are widely acclaimed. For example, Patrick Lawler, the CEO of Youth Villages, was named one of America's best leaders by *U.S. News & World Report* in 2006. Bill Milliken and Dan Cardinali of Communities in Schools are recognized for having created an exemplary pairing of an inspirational founder and results-oriented CEO. And the leaders of Year Up, College Summit, Citizen Schools, and Teach for America have all been recognized by *Fast Company* among the social entrepreneurs of the year.

3. *The organization has strategic clarity.* The management team must be able to state clearly what it wants to accomplish. Its approach for accomplishing these goals must be compelling and credible, and must logically lay out the sequence of steps necessary. Before initiating growth capital campaigns, all of the organizations mentioned above had completed rigorous business plans that laid out the objectives and steps that they would take. Most secured outside consulting assistance to test and refine their plans.

Second Round of Due Diligence

4. *The organization's programs are demonstrated successes.* Many nonprofits have a compelling vision but little proof that what they are doing is actually working. Because the return on the investment into a nonprofit's growth is increased social impact, investors need some evidence that the nonprofit is having an impact in the first place. Different investors have different standards of evidence, but all should require some substantial proof.

Consider two examples: Communities in Schools is trying to keep students from

When Should a Nonprofit Seek Growth Capital?

The idea of raising lots of money gets most nonprofit leaders excited. But growth capital is not for everyone. In fact, it is not for most organizations. To determine whether your nonprofit might be a good candidate for growth capital, first answer these questions:

1. **Does our organization address a critical need?**
2. **Do we have a strong leadership team?**
3. **Do we have a credible approach to the problem we are trying to solve?**
4. **Can we demonstrate our results?**
5. **Is our solution cost-effective?**
6. **Have we grown successfully in the past?**

If you can answer "yes" to these six questions, then ponder the deal breaker:

7. **Do we have a clear and logical funding model that provides core ongoing funding?**

Then ask two very pragmatic questions:

Is there a likely anchor funder who can provide a substantial percentage of the desired funding?

Do our board members and senior executives have the personal relationships needed to connect with promising additional funders?

dropping out of school. Before exploring a growth capital campaign, Communities in Schools' leaders invested in a rigorous, multiyear study of the organization's impact, the first phase of which showed that the promotion and graduation rates of entire schools improve where the program was implemented with fidelity.[8]

The Nurse-Family Partnership conducted three randomized controlled trials that showed that, even 15 years later, mothers in the program earned more money than did ones in a control group who did not participate in the program; they were also less likely to be involved in criminal behavior. Children in the program have greater school readiness and fewer adjudications, even when they reach their teenage years.

5. *The organization's programs are cost-effective.* Not only must organizations prove that their programs are successful, they must also show that they get the most value out of their funding. Youth Villages is a good example of a cost-effective organization. It is difficult to make a sweeping generalization, but as a general rule, for $8 million, the national child welfare system, which relies heavily on residential institutions, can serve 100 youths, only 40 percent of whom are likely to be successful (defined as being in school or working and not back in state custody) two years after being discharged. For the same $8 million, Youth Villages can serve 550 youths, 80 percent of whom are likely to achieve long-term success. Youth Villages achieves these results with a research-based, in-home support service it calls "intercept." Each of the organization's counselors focuses on supporting four or five children and their families in a highly structured environment, 24 hours a day, seven days a week. Intensive? Yes. But it is much less costly and more successful than institutionalization.

6. *The organization has grown successfully.* Growth can strain every aspect of a nonprofit organization. Its cultural fabric can fray as the number of employees grows. Tensions can arise between program-oriented founders and outsiders brought in for functional expertise. The demands on a leader's time increase dramatically and require new skills. And so investors should look for a track record of successfully adapting to the demands of growth—even modest growth—before making large investments in further growth.

Consider the example of Year Up. Before beginning its campaign to raise growth capital in 2007, Year Up pursued a very deliberate strategy of phased growth. First, the organization honed its Boston program in a proof-of-concept phase, and then it demonstrated that the program could work elsewhere by expanding to Providence, R.I., Washington, D.C., and New York. In each of these sites, its program, operations, and partnerships were up and running, helping Year Up to make the case to growth capital investors that its model was truly replicable.

The Deal Breaker

7. *The organization has a sustainable funding model.* Conventional wisdom says that nonprofits do not have sustainable funding models—that is, they cannot develop predictable, ongoing financial support that covers core operating expenses. The common image of nonprofits is that they are often led by an executive director who is not sure how he will find enough money to meet the year's budget and is perpetually pulling rabbits out of his hat to do so.

Yet sustainable nonprofits do exist, and there are more of them each year. In fact, almost every nonprofit that has grown large in recent decades has cultivated sustainable funding. And the larger a nonprofit becomes, the more it needs a well-developed funding model. Large amounts of dollars cannot be consistently raised without identifying and building expertise in highly aligned sources of funding.

Unfortunately, not all causes have equal opportunities for securing ongoing financial support. For example, advocacy groups—those giving voice to the voiceless—have a notoriously hard time attracting significant amounts of ongoing funding. Yet many types of nonprofits are able to raise substantial amounts of money, and

Growth Capital Funders and Intermediaries

A small but growing number of organizations are involved in providing growth capital. They can be divided into funders that provide growth capital and intermediaries that help secure it.

—THE EDITORS

FUNDERS

Edna McConnell Clark Foundation, New York. A foundation that advances opportunities for low-income youth ages 9 to 24 in the United States.

The Jenesis Group, Irving, Texas. A family foundation that supports nonprofits focused on youth development, education, and social entrepreneurship.

The Kresge Foundation, Troy, Mich. A foundation that supports nonprofits around the world in the areas of health, the environment, arts and culture, education, human services, and community development.

New Profit Inc., Cambridge, Mass. An organization that provides financial and strategic support to social entrepreneurs and their organizations.

NewSchools Venture Fund, San Francisco. A venture philanthropy firm that seeks to transform public education.

REDF, San Francisco. A venture philanthropy firm that invests in organizations that employ people who would otherwise remain in long-term poverty.

Robertson Foundation, New York. A foundation that makes grants in the areas of the environment, education, medical research, and religion and spirituality.

Surdna Foundation, New York. A family foundation that makes grants in the areas of the environment, arts, community revitalization, effective citizenry, and the nonprofit sector.

Venture Philanthropy Partners, Washington, D.C. A philanthropic organization that invests in nonprofits that improve the lives and opportunities of low-income youth in the Washington, D.C., area.

INTERMEDIARIES

Bridgespan Group, Boston. A nonprofit consultancy that advises nonprofits and foundations on growth capital.

Nonprofit Finance Fund Capital Partners, New York. A broker that helps nonprofits raise equity-like capital.

SeaChange Capital Partners, South Norwalk, Conn. An organization that creates connections between wealthy donors and high-performing nonprofits.

their sources are familiar. (For these sources, see "How Nonprofits Get Really Big" in the spring 2007 issue of the *Stanford Social Innovation Review*.)

Youth Villages, for instance, has secured a steady stream of funding from the government. Because state governments view taking care of emotionally and behaviorally troubled children as a core responsibility, and Youth Villages has partnered closely with government, 95 percent of Youth Villages' ongoing costs are covered through government reimbursement. The organization currently has more than 15 contracts across multiple states. Still, most government agencies won't pay for nonprofits' expansion, so Youth Villages has sought and secured foundation grants to expand into new states.

Many educational nonprofits likewise rely on government funding. For example, the fees that College Summit charges schools and districts for its services nearly cover the organization's variable costs. Teach for America has shown across many cities that it can secure funding from a mix of local sources—individual donors, foundations, and corporations—to cover the vast majority of a location's ongoing expenses.

Ironically, an organization with a solid fundraising base often looks unattractive to funders, who wonder whether the organization is already too rich and well established. Yet this kind of financial health is what a philanthropist must demand if a grant is truly going to fuel substantive and sustainable impact.

IMPACT ON FUNDER

Having examined the finer details of good growth capital candidates, funders must then turn the lens on themselves. Nonprofit growth investors need a set of processes and skills different from other types of philanthropists.

Growth capital funders must devote more time and attention to finding the right nonprofits to invest in, and less time to current grantees' board meetings, annual galas, and site visits. Like private equity investors, who spend as much as two years looking at companies before investing in them, nonprofit growth investors must be careful and choosy. In this way, they can assess whether potential grantees meet all seven criteria. They must also be willing to say "no" much more often than they do now, even turning down existing grantees that are doing fine work.

Donors will also need to co-invest with other donors—something done too rarely. Co-investing differs from simply giving a grant to a nonprofit that already receives grants from other philanthropists. In co-investing, a group of funders invest at the same time, on the same terms, using the same reporting, and share credit for the impact. Donors need to co-invest because the amount of funding many growth capital candidates need often exceeds what any one funder is able to provide. To date, the most notable growth capital campaigns have raised more than $10 million, some have raised more than $50 million, and all have been backed by groups of multiple funders.

Once funders identify and invest in a suitable nonprofit, they need to make sure that the influx of money does not distort the organization's ongoing funding model. Large amounts of money can do so a number of different ways. The unaccustomed influx of large amounts of money can weaken an organization's financial discipline and undermine part of what made the nonprofit attractive in the first place. Even with a well-developed funding model, core ongoing support may be able to grow only at a certain rate. If the growth capital plan calls for unrealistic levels of growth, nonprofit executives may fail to meet their goals. And even compelling nonprofits may find it takes longer than expected to attract growth capital. If anchor funders encourage a nonprofit leader to set too large a goal for their growth capital, the time it takes to secure the philanthropic investment could undercut the time they need to do their work.

At the same time, nonprofit growth investors have to be less restrictive with the terms of their grants than are other kinds of philanthropists. They must eschew many common practices, such as restricting dollars (explicitly or implicitly), giving only short-term funding, or demanding specialized reporting, as these undermine the long-term success of a growth capital investment. The whole point of growth capital is to support the leaders of the highest-potential nonprofits—leaders and nonprofits who are chosen precisely because they can be trusted. These organizations need to spend their time and resources growing, not fundraising. The philanthropist's source of satisfaction needs to be in the results.

Only a few pioneering donors are currently pursuing growth capital investments. And only a few nonprofits have the funding models and other characteristics to use these funds successfully. The art is in matching these funders and nonprofits, and in increasing the numbers in both groups.

Nevertheless, these matches are possible because remarkable nonprofits do exist. Equivalent organizations in the for-profit world would attract large amounts of money from great investors. Why, in the nonprofit world, shouldn't these organizations attract large sums from the greatest philanthropic investors? If these organizations did attract growth capital, the most vulnerable people and places in our country would be the big winners. Perhaps one day soon, a $5 million philanthropic donation won't be notable simply because of its rarity, but rather because it enables the nonprofit to be more effective in tackling one of society's big problems. ■

This article has benefited from the thoughtful and ongoing insights of my fellow Bridgespan partners, especially Alan Tuck and Kelly Campbell.

Notes

1 "Subject Focus of Grants Awarded by Size of Foundation," FC Stats: The Foundation Center's Statistical Information Service, 2005. www.foundationcenter.org/findfunders/statistics/.

2 Bridgespan analysis, conducted in 2006, drawn from research conducted by the Center on Philanthropy at Indiana University.

3 PricewaterhouseCoopers/National Venture Capital Association MoneyTree Report, August 2007.

4 FC Stats: Foundation Center's Statistical Information Service. http://foundationcenter.org/findfunders/statistics/pdf/07_fund_tos/2006/15_06.pdf.

5 To explore the role of philanthropic investors, see Christine W. Letts, William Ryan, and Allen Grossman, "Virtuous Capital: What Foundations Can Learn from Venture Capitalists," *Harvard Business Review*, March 1997, which brought this topic squarely into nonprofit discussions. In more recent years, George Overholser has made vital contributions calling for much clearer measurement and accounting of such differences; see Overholser, "Defining, Measuring, and Managing Growth Capital in Nonprofit Enterprises: Building Is Not Buying," Nonprofit Finance Fund; and Clara Miller, "The Equity Capital Gap," *Stanford Social Innovation Review*, Spring 2008.

6 *The New York Times*, December 21, 2007.

7 I am a first-grade youth soccer coach, and I believe that the sport is great for kids.

8 CIS completed the first two phases of a five-year study with the Caliber Group in 2007.