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Case Study

The Profit in Nonprofit

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The Profit in Nonprofit

Kiva, the first online peer-to-peer microcredit marketplace, is one of the fastest-growing nonprofits in history. But its nonprofit status was not inevitable. Here's why Kiva chose to be a 501(c)(3), what this tax status buys the organization, and how being a nonprofit poses challenges. By Bethany Coates & Garth Saloner

In 2004, Jessica Jackley set out for rural Kenya, Tanzania, and Uganda to perform an impact evaluation for the Village Enterprise Fund (VEF), a San Francisco Bay Area nonprofit that makes modest grants and loans to small businesses in East Africa. A few months later, her husband, Matt Flannery, then a computer programmer at Alviso, Calif.-based TiVo Inc., came to visit her. As the couple traveled around the country interviewing small-business owners, they talked nonstop about the best ways to help Africa's struggling entrepreneurs.

One year earlier, Jackley had heard Muhammad Yunus, the founder of Grameen Bank, give a talk about microfinance. "I reacted with both my head and my heart," she recalls. "My head said: 'Microfinance is effective. It's powerful. It works.' But the most important part was what my heart said. The way he talked about the poor was beautiful, respectful, and dignified. I didn't have feelings of guilt and shame like I did after a lot of nonprofit messaging. Instead, I wanted to be there, listening to people's stories and talking with clients face to face."

Once in East Africa, Flannery and Jackley agreed that they too would facilitate loans rather than donations. After weeks of brainstorming, they soon settled on the basic idea for Kiva. At first, they envisioned a few friends and family members lending money to a handful of entrepreneurs in East Africa. And then eventually, although they weren't sure of the steps along the way, they saw Kiva evolving into a self-regulating online lending marketplace where microfinance institutions (MFIs) could raise loan capital to fund projects for small-business people in developing countries.

Upon their return to the United States, they set up meeting after meeting with contacts in microfinance to discuss, among many other topics, whether the venture should be nonprofit or for-profit. After months of skepticism, disapproval, and rejection from industry insiders, they launched Kiva (which means "unity" or "agreement" in Kiswahili) as a nonprofit. By the end of 2007, Kiva had become one of the fastest-growing nonprofits in history.

Although being a nonprofit presents unique challenges, the organization's 501(c)(3) status has ushered in many unforeseen benefits. Major industry players, such as PayPal Inc. and YouTube Inc., generously bestow goodwill donations on the organization. Some of the best business and Internet talents in Silicon Valley freely funnel their time and energy to Kiva. And both individual and institutional donors help underwrite the costs of the site.

"Although perspectives are rapidly changing, and hybrid social enterprises are cropping up everywhere, people still have a lot of misperceptions about the limitations of being a 501(c)(3)," says Jackley. For the time being, Kiva is content with its nonprofit status. "It's a tax code, not a religion," she says. "We do think like a business wherever it makes sense, and we have tried hard not to get sucked into any sort of false limitations of being a nonprofit."

The Obstacle Course

As Flannery and Jackley first imagined it, Kiva's business plan was quite straightforward: An online platform would allow ordinary people to invest in small and medium enterprises (SMEs) in the developing world. (See "Kiva's Loan Cycle" on page 70 for an overview of how Kiva works.) Users would log on to the Web site to read the personal accounts of Kiva's carefully chosen borrowers and then use their PayPal accounts or credit cards to lend as little as $25 to a borrower. On-the-ground MFIs would then administer the loans to the borrowers. Users would get their money back over the course of a year, with the option of either relending the money or pocketing it. While the loan agreement was in place, users would also receive frequent updates about their borrowers from the MFIs.

Despite the simplicity of their model, Flannery and Jackley ran into a tremendous amount of resistance from microfinance experts. "The criticisms were about both the supply side and the demand side," says Jackley. "On the supply side, critics said that the idea wasn't scalable because of the time and effort needed to vet borrowers and then to post their stories on the Web. And on the demand side, the critics said, for whom is this product intended?" The microloans were neither investments nor donations. "No one knew what to do with this bizarre, in-between product," she says.

Another issue was how much interest (if any) Kiva could charge borrowers and return to lenders. Kiva's founders originally wanted to offer lenders the option of earning interest on their

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loans, both to attract lenders and to transform the usual wealthy donor-poor beneficiary hierarchy into the more egalitarian lender-borrower relationship. Yet returning interest on loans could have turned the loan into a security in the eyes of the Securities and Exchange Commission (SEC). Offering a security to the public would trigger a long list of SEC requirements, including sufficiently collateralizing the loans and investing only in entities that comply with U.S. accounting standards.

Kiva's founders also debated whether to be a nonprofit or a for-profit organization. Establishing Kiva as a nonprofit was the fastest way for the founders to get the site up and running. Yet they could not readily ascertain whether a charitable organization could extend loans rather than donations. They were also unsure what tax implications Kiva and its lenders would face upon the return of the loan principals and, should they charge interest, profits.

Finally, skeptics doubted whether Kiva could actually help lift many people out of poverty. A common theory circulated that, for microfinance to have a significant impact on world poverty, MFIs would need to be integrated into the global economy and to tap into the capital markets. Yet most MFIs did not qualify for commercial-grade investments. Rather, they relied on donations, especially during their early years of operation. Observers questioned how Kiva could find enough appropriate MFIs with a reasonable number of borrowers to help the organization establish a creditworthy track record.

CASE STUDY QUESTIONS:

What benefits do nonprofits enjoy that for-profits do not?

What limitations do nonprofits face that for-profits avoid?

How do social entrepreneurs weather doubts and disappointments in the early stages of their ventures?

JUST DO IT

By December 2004, Flannery and Jackley themselves began to question whether to pursue their idea any further. After so many naysayers and so little progress, they were beginning to feel discouraged, says Jackley. Rather than giving up, though, the founders decided to plunge ahead with the more straightforward plan: become a nonprofit.

After calling 47 law firms, Flannery finally located an attorney who was willing to help establish Kiva as a nonprofit. The founders then worked with Moses Onyango, a pastor they met during Jessica's VEF study, to identify seven Ugandan entrepreneurs who could benefit from small loans.

To avoid potentially running afoul of the SEC, and to focus on the core mission of "connecting people through lending to alleviate poverty," Flannery and Jackley decided that the Kiva Web site did not need to offer interest to lenders. At the same time, the MFI partners who would distribute the loans to local entrepreneurs would still charge prevailing interest rates and earn interest income. In this way, individual lenders, not MFIs, bore the risk of borrowers' defaulting on the loans. Suddenly, MFIs had access to free, flexible, and very forgiving debt capital through a brand-new source—individual lenders around the globe.

PHOTOGRAPH COURTESY OF KIVA

Kiva users can make loans to this woman-owned carpet-weaving enterprise in Kabul, Afghanistan.

In April 2005, the founders e-mailed a description of Kiva, its mission, and the businesspeople it currently sponsored to a list of 300 friends. Within two days, the organization had raised $3,500 and funded all seven enterprises. Kiva had just become the first online peer-to-peer microcredit marketplace.

Onyango used the Kiva Web site as a blogging platform and regularly entered updates and progress reports on the entrepreneurs. His profiles became a reason for lenders to check back on the site, and perhaps to lend again.

By October 2005, the borrowers had repaid the first round of loans. Flannery and Jackley decided to launch officially—"which basically meant having a friend write a press release and removing the word 'beta' from the Web site," says Jackley. Kiva then worked with Onyango to find 50 additional Ugandan entrepreneurs.

For the first few weeks after the press release, the Kiva site was rather quiet. Then, in mid-November 2005, "something happened," Flannery described in the winter/spring 2007 issue of *Innovations*:

> My day started as usual. I took the Caltrain to work and logged into my computer. I had received nearly 1,000 e-mails to my Kiva address. I checked the database logs and saw that we had raised about $10,000 that morning and that all the loans on the site were sold out. Why? We had been featured on the home page of Daily Kos, one of the world's largest blogs. Over a million people had read about Kiva that day and hundreds were actively discussing it online.

In short order, Flannery quit his job at TiVo and began building Kiva as its CEO. Meanwhile, Jackley pursued her MBA at the Stanford Graduate School of Business. "We thought this could allow us to have the best of all worlds—I would still be able to learn and bring resources and new ideas to Kiva while it was growing, and we could live off of my student loans," says Jackley. "Meanwhile, Matt could build out the site because he was the tech genius."

THE CHARITABLE ADVANTAGE

Although Flannery and Jackley had not raised any real start-up capital, Kiva attracted a passionate, talented, and dedicated crew, fueled by Kiva's mission. The team grew quickly to include heads of partnerships, marketing, technology, and public relations. Many of the 23 full-time employees—most of them in their 20s and 30s—worked pro bono for months. "It was easy to feel ownership of the project," Jackley recalls. "When you know that a big dream relies on you, it's inspiring."

In part because of its nonprofit status, Kiva was also able to leverage hundreds of volunteers and to fill its board with well-known Bay Area executives, including Reid Hoffman, CEO of LinkedIn Corp. and the former executive vice president of PayPal; and Jenny Shilling Stein, executive director of the Draper Richards Foundation. Geoff Davis, who was serving as CEO of Unitus, a nonprofit microfinance accelerator based in Seattle, likewise joined the nonprofit's board.

Kiva also attracted Premal Shah, a six-year PayPal veteran who had recently spent a sabbatical in India working for an MFI. Shah stepped away from founding MicroPlace Inc.—an eBay Inc.-owned for-profit online lending company that had a slightly different yet potentially competitive model of making retail investments in MFIs—to become president of Kiva. Although both MicroPlace and PayPal are eBay companies, Shah was able to broker a deal with PayPal for free payment processing on the Kiva site—in large part because Kiva was a nonprofit. Because Kiva's largest variable cost is processing payments, PayPal's partnership allows Kiva to pass on 100 percent of loans to entrepreneurs. (Kiva launched a full two years before MicroPlace because the former did not take the long and difficult path of meeting the SEC's requirements for offering interest-bearing investments.)

Other big-name partners soon filed in, so that the "Supporters" list on Kiva's Web site now reads like a Who's Who of hip corporate America. YouTube, for example, has donated 120 million free banner ads to Kiva. Google Inc. gives Kiva free AdWords, the company's flagship advertising product. Yahoo Inc. likewise donates search marketing keywords, as well as employee volunteers. Microsoft Corp., Intel Corp., Starbucks Corp., Facebook Inc., and LinkedIn, among many others, likewise donate goods and services to the organization.

Kiva's nonprofit status has yielded more prosaic benefits as well. "Our staff eat well," says Jackley. Kiva's first office was located next door to Blowfish Sushi, a well-loved San Francisco restaurant. Kiva staff members frequently met with donors and board members at Blowfish, and so became familiar faces there. Eventually Kiva and Blowfish brokered a deal for big discounts on meals. "It may not seem like much," says Jackley, "but it actually helped a lot. The team worked long hours and could now meet potential donors next door, without worrying too much about who might pick up the bill."

Being a 501(c)(3) has also made Kiva feel comfortable asking its members to help cover the organization's operating costs, which totaled $5.9 million in 2009, according to Fiona Ramsey, Kiva's director of public relations. Jackley zeroed in on the idea of optional transaction fees at the 2007 Net Impact Conference. She was on a panel with members of two related nonprofits—DonorsChoose.org Inc., which allows people to donate directly to United States classroom projects, and the GlobalGiving Foundation, which facilitates direct donations to a wide range of projects around the world. An audience member asked the panel how each organization covered its costs. Jackley learned that DonorsChoose suggested that users make an optional 15 percent donation in addition to their base donation. GlobalGiving, in contrast, automatically took a 10 percent fee out of users' base donations.

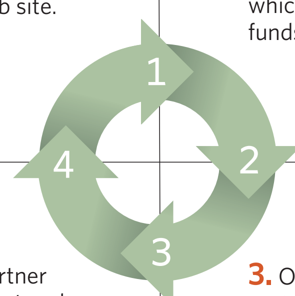
Extracting what she thought was the best of both worlds, Jackley suggested asking users to make an optional 10 percent donation to Kiva, in addition to their base loan to borrowers. A donor who makes a $50 loan to a borrower in Uganda, for example, would be asked to pay an additional $5 transaction fee. Jackley worked with Kiva's staff to implement this idea at the point of purchase online. In 2008, optional transaction fees totaled $2.2 million, says Ramsey, covering some 37 percent of Kiva's operating costs.

For the remainder of its funding, Kiva relies on three other revenue streams: grants, unused Kiva credit (e.g., uncashed Kiva gift

Kiva's Loan Cycle

1. Lender makes loan to business featured on Kiva Web site.

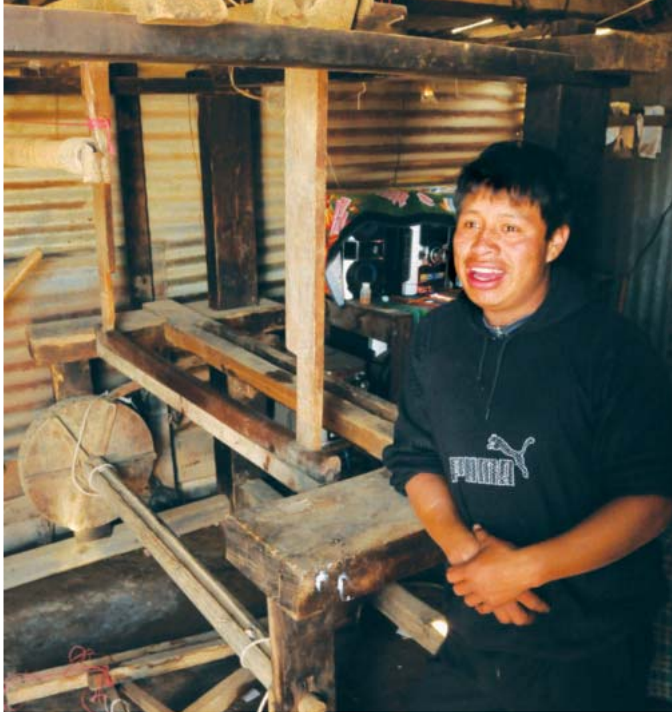
2. Kiva transfers loan to local partner, which then disburses funds to business.



4. Local partner keeps interest and sends principal to Kiva, which then repays lender. Lender may then withdraw or re-lend the money.

3. Over time, local partner collects loan principal plus interest from the business.

Source: Kiva



With demand for his products on this rise, this Guatemalan shoe maker is using his $950 Kiva loan to buy materials.

PHOTOGRAPH BY AUDREY SCOTT

certificates and uncollected loan repayments), and "float"—the interest the nonprofit captures on the capital in its bank accounts. Because Kiva receives loans daily, but distributes the funds to MFIs monthly, its bank accounts earned some $370,820 in float in 2008.

Being a nonprofit also makes Kiva eligible for foundation funding. The organization receives large grants from foundations including Skoll, W.K. Kellogg, and Draper Richards. In 2008, those grants totaled $1,796,000.

THE COSTS OF BEING 501(C)(3)

Although foundation funding has been generous, says Flannery, a major drawback of being a nonprofit is that Kiva has to pass up commercial capital. "Venture capitalists call me up all the time trying to convince me to become for-profit," he says. "I know I could raise a lot of money in a short time." Instead, Kiva must raise its money incrementally, "getting this huge mélange of grants in small, unpredictable pieces."

Flannery indeed considered converting Kiva to a for-profit model. "A couple of years ago, we had trouble capitalizing. I bet that we could raise money from angel investors, so I brought that idea to the board. But the board said no, unanimously, right off the bat."

Over time, Flannery came to agree with the board. "We are building a community based on trust," he says. "We are asking people to concede profit to help a poor person. In turn, Kiva agrees not to profit from people's goodwill. If we did convert to a for-profit model, our users would probably trust us less." Indeed, a 2006 survey showed that 50 percent of Kiva users would not lend on the site if it adopted a for-profit model.

A second possible disadvantage of being a nonprofit is the need to orchestrate the interests of the board, staff, and other stakeholders. "If you're a founder of a for-profit you can just own the business and you don't have to gain the consensus of a large set of people," says Flannery. "The more controlling and entrepreneurial parts of my psyche would like that. But the other side of me is very thankful to be in a community where everyone has buy-in. It's been good for me."

With more stakeholders comes more scrutiny, however—a third cost of being a 501(c)(3). "People hold nonprofits to a high standard," says Flannery. "They scrutinize how you spend every dollar. I'm glad because it makes us stronger. But it can also slow you down," he says. "Everyone knows how much money you make, reads your financials, and questions you all the time."

KIVA TODAY

Since its founding, Kiva has produced a number of compelling results. The site regularly sells out of loans. Most businesses listed on the site are funded within hours. New borrowers are added hourly and potential lenders are urged to check back often to participate.

During times of overwhelming traffic on its Web site, Kiva caps loans at $25 so that more people have a chance to get involved. "Our mission is not to raise money for entrepreneurs at any cost," says Jackley. "Our mission is to connect human beings in a dignified way, through a loan. When push comes to shove, we would rather have more people involved and connected to each other than fewer, especially if the money will come either way."

At this time, the nonprofit has 95 field partners (that is, partner MFIs) in 44 countries around the globe. Average loan repayment rates are above 97 percent, and cumulative loan volume is more than $66 million. Both the number of lenders and the average number of businesses funded by each single lender are steadily increasing.

Kiva has also enjoyed a number of high-profile media successes. President Bill Clinton described the nonprofit in his bestselling book, *Giving*. *New York Times* journalist Nicholas Kristof profiled his experience with Kiva in an editorial piece. Then, in September 2007, Oprah Winfrey featured Kiva on her daytime TV show, thereby attracting an enormous amount of interest from Middle America. Demand was so high on the day the episode aired that it crashed the site.

The Kiva team feels affirmed about the growth of their organization, the positive media attention, and the moving anecdotal evidence of poverty alleviation amongst the entrepreneurs listed on the site. "Instead of sleeping on a reed mat, someone now has a blanket," Jackley notes. "Instead of mud walls, they have concrete. People have mosquito nets and medicine now, where before there were none of these things."

In the future, Kiva wants answers to questions like how many borrowers live on $2 per day now rather than $1, how many can afford to feed their families at least two or three times daily, and how many no longer have to choose between nutrition, schooling, and medication for their children. Yet this plan requires building more technical infrastructure, training MFIs around the world, and even more monitoring and auditing functions—demands that the organization cannot meet at the moment. "But we are planning to in the near future," says Jackley.

Although Kiva can measure its successes in numerous ways, Jackley maintains that the organization's most important impact is on the minds and hearts of the lenders and borrowers who use the Web site. From day one, Kiva's mission has been to connect people through lending. She says that these personal connections are "the most powerful force for change on the planet." ■