

A Basic Guide to Program-Related Investments

By Christie I. Baxter

This article appeared in the Fall '97 issue of *The Grantsmanship Center Magazine*.

<http://www.tgci.com/magazine/97fall/basic1.asp>

<http://www.tgci.com/magazine/97fall/basic2.asp>

<http://www.tgci.com/magazine/97fall/basic3.asp>

<http://www.tgci.com/magazine/97fall/basic4.asp>

<http://www.tgci.com/magazine/97fall/basic5.asp>

To increase the impact of their limited resources, many foundations have added financial instruments collectively known as program-related investments (PRIs) to their traditional repertoire of grants.

PRIs include loans, loan guarantees, real estate mortgages, and stock purchases, among other instruments. They finance affordable housing, education, books prepared by arts organizations, video productions, theater performances, health centers, neighborhood shopping centers, small businesses, microenterprise loan funds, nonprofit financial intermediaries, and land conservation.

Like grants, PRIs have as their primary purpose the achievement of the foundation's programmatic mission. However, as financial instruments, PRIs also produce financial returns and thus share characteristics with a foundation's traditional investments. PRIs sit between traditional grants and investments, offering both financial and programmatic returns.

PRIs include a wide range of financial instruments designed to meet the different challenges that individual projects present to both funders and project managers.

Loans comprise most PRIs. End-use often dictates the term and documentation needs of a particular transaction. For example, a loan to an organization that faces a temporary cash flow problem may be short-term and secured by the revenues that the organization expects to use to repay the loan.

Other loans finance real estate purchases, and lenders may want an interest in the underlying real estate assets to secure their investments. Foundations also lend to financial intermediaries that re-lend the funds to other organizations. A foundation as an intermediary will likely structure the PRI to match the terms of the loan that the intermediary makes to its borrowers.

Documentation needs also vary according to the structure and preferences of the foundation. Simplicity in processing is an overriding goal for some foundations. Others place a high priority on protecting the foundation against the risk of default. Still others see the process of negotiating financial procedures and performance benchmarks as valuable in building the financial expertise of borrowers.

Loan guarantees involve the use of a foundation's financial resources to assure the repayment of a loan made by a third party. In effect, the foundation increases the amount of credit available to the recipient by assuming all or part of the third-party lender's risk. The foundation might pledge to repay all or part of a loan but may not disburse any funds until the pledge is called upon. Alternatively, a foundation may set up a special account to fund the guarantee.

In either case, the foundation's risk is proportional to the amount of the guarantee. The guarantee does not constitute a PRI unless the pledge is called or unless the foundation sets up an account to fund it. For example, the Marin Community Foundation has included a loan guarantee program as part of its Community Investment Loan Fund. The foundation funds the guarantee by setting aside part of each guaranteed loan to cover the risk of default.

Linked deposits and deposits in designated development accounts help foundations induce conventional lending institutions to make particular kinds of loans at favorable terms to particular borrowing organizations. Through a linked deposit, a foundation might agree to deposit funds in the bank for a specified period of time and agree to accept a below-market rate of interest, in effect subsidizing the loan. The foundation would link the loan to an agreement by the bank to pass the subsidy along through a loan to a particular borrowing organization.

South Shore Bank in Chicago used this concept when it created its Development Deposits program in the 1970s. The bank solicits deposits from foundations and other social investors and uses the proceeds to invest in designated low-income and minority neighborhoods in Chicago. Commercial banks, including Wainwright Bank in Boston, Vermont National Bank, and the Sunshine Bank of Wheeling, West Virginia, have created special funds with similar purposes. Investors can make deposits at market rates, knowing the funds will be reinvested locally, or at concessionary rates to help subsidize special community economic development work.

Equity investments include the purchase of stock, charitable-use real estate, and other assets. Foundations make equity investments in venture capital funds that support inner-city businesses, they purchase stock in minority-owned banks committed to investment in disadvantaged neighborhoods, and they invest in products that advance social purposes such as education. Investment returns come in the form of capital appreciation or royalties. Some foundations, such as the Meadows Foundation and the Cleveland Foundation, purchase real estate directly for the benefit of charitable organizations.

In certain situations, foundations combine loans and grants. For example, a nonprofit housing development organization may need to finance land acquisition and schematic design for an affordable-housing project. When the project reaches the point where a bank will provide a construction loan, these predevelopment costs can be repaid. The organization might also want to send staff to a special training program to prepare it to undertake the project. A foundation might provide a grant to cover the training. The Boston Foundation staff has proposed combining a loan and a grant to support the Boston Community Loan Fund. In this example, the grant would improve the financial stability of the fund, thus improving the prospects for loan repayment.

A foundation that makes regular PRIs might focus on a particular kind of transaction, as the The Eugene and Agnes E. Meyer Foundation does with its Nonprofit Advance Cash Flow Loan

Program. Its portfolio would include only one or a few kinds of transactions. Alternatively, a foundation might choose to structure each PRI differently, based on the requirements of different projects. Its portfolio could include a spectrum of transaction types.

Because they primarily serve the foundation's programmatic mission, PRIs may support some of the same kinds of projects that grants do. For example, a foundation might make a seed-money grant to support a new enterprise, or it might make a seed-money loan. A foundation might make a grant to capitalize a community development loan fund, or it might make long-term low-interest loan to serve a similar purpose.

Recoverable grants are closely related to PRIs. They provide for the return of capital under certain circumstances. A primary advantage is the simplicity of the transaction. The documentation may be quite similar to that of a traditional grant and require no more than a modified grant agreement. Because the foundation classifies the transaction as a grant, it avoids confronting the troubling question of "default" if the recipient does not repay. Recoverable grant are not considered PRIs by the Internal Revenue Service; they are treated simply as grants until they are recovered.

Similarly, since PRIs provide financial returns, they may take forms similar to traditional investments. A long-term loan to a well-established nonprofit financial intermediary may perform much like a bond. Real estate mortgages or direct holdings classified as PRIs might be close equivalents to such holdings in the traditional investment portfolio. For example, the Meadows Foundation holds real estate located in the foundation's target area, the Wilson district, in both its PRI and traditional investment portfolios. The primary difference between the two is whether or not the foundation rents the property at nominal rates to a nonprofit organization.

As foundations experiment with and develop PRIs, they are likely to think differently about the very nature of philanthropy. Staff and trustees of foundations steeped in the culture of giving money away may find it difficult to imagine how lending might serve charitable purposes. Conversely, trustees might view a PRI, because it offers a below-market rate of return, as a bad loan. Making good PRIs requires that staff and trustees synthesize their thinking about charity and investment.

This may not be as difficult as it first appears, since foundation professionals are already experts in both areas. However, the expertise may reside in different parts of the foundation, requiring new kinds of internal collaboration.

Capacity Building

Making a loan rather than a grant may change the implicit message a foundation gives a recipient. As Paul E. Lingenfelter, vice president of the John D. and Catherine T. MacArthur Foundation, put it, "When you make a grant, the message you give is that the grantee is supposed to spend the money and come back for more when that money is gone. When you make a loan, you expect the organization to remain viable and financially sound so that it can pay you back." Within the foundation, the focus on the long-term financial health of the recipient may prompt the foundation to look at the financial management systems of the borrower differently than it might if the recipient were a grantee.

The financial characteristics of PRIs may also produce certain management consequences for a foundation, particularly if program staff assume responsibility for monitoring transactions and tracking income over time. Foundations see the need to repay loans as encouraging the development of greater self-sufficiency and more disciplined financial thinking on the part of recipients. As one recipient of a Ford Foundation PRI put it, "Developing a business plan helped us to change our thinking about our organization—from social service provider to self-sufficient economic development entity."

Leverage

A PRI might be part of a financial package that includes grants and loans from other institutions. By taking a subordinate position, a foundation can use a PRI to create an investment opportunity for conventional investors. It also may cause that foundation to enter into partnerships with other institutions and require a kind of collaborative behavior that the foundation finds unfamiliar. Yet the payoffs, in terms of increasing the amount of capital available for particular kinds of projects, can be substantial.

Probably the largest collaboration of this kind is the National Community Development Initiative (NCDI). In 1991, six foundations and one private lender raised almost \$63 million in grants and PRIs to capitalize two intermediaries: Local Initiatives Support Corporation and the Enterprise Foundation. In 1994, seven foundations plus three corporate lenders, participating in a second phase of NCDI, raised another \$88 million. The goal was to leverage a total of \$750 million in community development investment.

Long-term Assets

PRIs can help a nonprofit to finance an asset of long-term usefulness to the organization, such as a building, a revolving loan fund, or an endowment. These assets may improve the long-term financial viability of the organization. PRIs can also build assets for the community in the form of housing, commercial real estate, and improvements to the physical, social, and natural environment.

The Investment Process

Foundations and borrowers go through a series of formal and informal steps in negotiating and closing a PRI, and in managing the relationship during the life of the investment. The most important part of this process never appears on paper—that is, cultivating the relationship between a foundation and a prospective recipient that eventually leads to a PRI.

Although each transaction is different, most PRIs involve the following steps:

- * Identification of an investment opportunity or PRI application.
- * Evaluation of the opportunity and risks (known as programmatic and financial due diligence).
- * Determination of the appropriate investment vehicle.
- * Negotiation with the recipient about terms and conditions.
- * Review and approval of the transaction by the foundation board.
- * Transaction documentation and closing.

- * Ongoing monitoring during term of the investment.
- * Assessment of the foundation's achievement of its programmatic and financial goals.

Christie I. Baxter, Ph.D., is Director of the MIT Project on Social Investing, which has an ongoing conference series on program-related investing funded by The Ford Foundation and the John D. and Catherine T. MacArthur Foundation. This article is excerpted from her book, Program-Related Investments: A Technical Manual for Foundations, ©1997, John Wiley & Sons, Inc.