

Current Practices in Program-Related Investing

by Francie Brody, Kevin McQueen, Christa Velasquez and John Weiser, 2002

Although in existence for more than thirty years, program-related investments (PRIs) were used initially by only a small number of the thousands of foundations in the United States. Only in the last 10 to 15 years has the PRI tool been embraced by foundations of all sizes and programmatic focus. The Foundation Center's most recent PRI study shows continued growth with a 31% increase in new program-related investments, from \$203.4 million in 1998 to \$266.5 million in 1999. Since 1997 annual PRI distributions have increased by more than 80%.

The Foundation Center survey attributes the recent increase in PRIs to two factors: the stock market boom of the late 1990s, which increased the value of foundations' endowments, and the long-term PRI education campaign supported by the Ford and MacArthur Foundations, two of the PRI pioneers and most active PRI-makers. Now that the stock market has taken a significant downward turn, the recycling of charitable dollars through PRIs should be even more appealing to foundations looking for ways to stretch their assets in ways that would further their philanthropic goals.

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IRS Definition

The term "program-related investment" was created by Congress in the Tax Act of 1969, which also created many of the rules concerning private and corporate foundations. As currently defined in IRS Section 4944(c), a "program-related investment" is any investment by a foundation that meets the following three tests:

- 1) Its primary purpose is to further the exempt objectives of the foundation.
- 2) The production of income or the appreciation of property cannot be a significant purpose (i.e., a prudent investor seeking a market return would not enter into the investment).
- 3) It is not used to lobby or support lobbying.

In addition, as with any grant, a PRI may not be used to generate "significant private inurement" for any individual or corporation, generally defined as economic benefit beyond ordinary and usual compensation for services.

The IRS allows private foundations to count PRIs as part of the required 5% charitable distribution in the year that the PRI is made. PRI principal repayments count as “negative distribution”, adding principal repayment amounts to the 5% payout requirement in the years that the principal repayments are made. Interest and dividend payments are considered regular income. The IRS exempts PRIs from the “prudent man” rule on other investments.

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purpose deposit,
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A PRI transaction can use any type of investment instrument. A PRI can be a loan, social purpose deposit, loan guarantee, line of credit, asset purchase, equity investment, or recoverable grant. Loans are the most common PRI instrument, making up more than half of PRIs made. Some of these loans are secured by real estate, but many of them are unsecured.

Rates of return on PRIs by definition must be below market on a risk-adjusted basis, and most often are set at very low interest rates (1-4%). There are no set requirements for PRI loan structures, which vary considerably, based both on the needs of the borrower or project and the needs and expectations of the foundation lenders. Terms can range from periods of a few months to more than 15 years, with the longer terms typically associated with capitalizing community development finance institutions and real estate development projects.

Programmatic Focus of PRIs

When the term “PRI” is mentioned, the first image that often comes to mind is often “loans for facilities or housing”. While there is some truth to this—PRIs are an important component of many facilities and housing projects—PRIs can and have been used to fund almost every conceivable type of project. Program interests often supported with PRIs include: education, health, human services, arts and culture, and the environment. The Foundation Center also reports some PRIs have even been used to support religious organizations, science, social science, international affairs and public affairs.¹

Foundation Use of PRIs

The use of PRIs varies widely across the field of philanthropy. Some foundations use this tool frequently and have a significant portion of their assets invested in PRIs, while others have no PRIs at all. Foundations that have made PRIs range in size from less than \$1 million in assets to more than \$10 billion. Of those foundations that regularly make PRIs or have a PRI program, most have 1% to 5% of their assets invested in PRIs. The table on the next page provides a profile of a sample of foundations that regularly make PRIs, showing their asset size, the percent of assets held in PRIs, and typical PRI term and interest rate.

A Sampling of PRI Activity, 2001

Foundation Social Investors	Foundation Asset Size	PRIs as % of Foundation Assets	Annual PRI Budget	Avg. PRI Size	Avg. PRI Interest Rate	Avg. PRI Term
Cleveland Foundation	\$1.6 B	NA	No formal budget	\$125K - \$2 M	3%	7 years
Fannie Mae Foundation	\$250 M	12%	\$30 M total pool	\$200,000	1.5%	5 years max
Ford Foundation	\$12 B	1.4%	\$17 M	\$1-2 M	1%	9 years
Heron Foundation	\$283 M	3.6%	No formal budget Averages \$4 M/yr	\$375,000	3%	6 years
MacArthur Foundation	\$4.5 B	5%	\$12-20 M	\$1 - 1.5 M	3%	7 years
Metropolitan Life Foundation	\$200 M	6% **	\$25 M*	\$2-3 M	4-8%	7 years for debt 15 years for equity
Packard Foundation	\$9.8 B	1.2%	No formal budget	\$2 M	3%	3-5 years
Prudential Foundation	\$156 M	7% **	Foundation: \$6 - 11 M Corp: \$50 M	Foundation: \$1 - 1.5 M Corp: \$3.5 M	4.7%	7-10 years

M = million, B = billion

*Combined PRI budget for Foundation and Company.

** Foundation dollars invested in PRIs as a percentage of total foundation assets. The percentage excludes the bulk of the social investments portfolio, which is comprised of mostly PRI-type investments using corporate funds.

PRI Examples

The following examples provide a glimpse of the diversity of the field, in program areas, size of projects and PRI structures:

Loan for Sustainable Development. The Moriah Fund, a mid-sized family foundation based in Washington DC, began making PRIs in 2000. The first PRI it made was a \$100,000 loan to capitalize the loan fund of Ecologic Enterprise Ventures (EEV) a “green” loan fund that offers fair credit to support small-to-medium-scale environmental enterprises whose production activities foster biodiversity, conservation and socially equitable development in Mexico and Central America.

The PRI was structured as a \$100,000 loan with the purpose of providing financing for community-based enterprises engaged in production

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or processing activities that foster environmental conservation and socially equitable development in Guatemala. The term of the PRI is five years at an annual interest rate of 2%. EEV will make semi-annual interest-only payments and two \$50,000 balloon payments in years four and five. Funds for repayment of the PRI will come from repayments of loans EEV makes to local enterprises.

Bridge Loans for Arts Organizations. The Greater Miami Community Foundation used \$50,000 in proceeds received from the gala opening of the Miracle Center (an entertainment complex in Miami) to create the Revolving Arts Fund. Half of the \$50,000 is kept in market-rate investments. The other half is made available as working capital loans to non-profit, tax-exempt arts and cultural organizations in Dade County. Loans are available in amounts up to \$5,000, with interest at 2% and a specified loan term of three to nine months. Loans are used to:

- Advance funds for organizing a benefit
- Pay a marketing, development or public relations consultant
- Finance the preparation of a grant application
- Provide the advance needed to start a federally-funded program
- Guarantee a short-term loan from another lender
- Serve as bridge funds between the close of one season and the income from subscriptions for another season

Loan for Education. Success for All Foundation, Inc. (SFAF) is a not-for-profit 501 (c) (3) corporation spun off from Johns Hopkins University in July 1998 and is headquartered in Baltimore, Maryland. Success for All's program is based on the premise that all students can and must succeed in the early grades. In the belief that reading is fundamental to other skill areas, the program targets Title I schools for students in lower elementary school grades, providing students with intensive instruction in language arts. Through contracts with public schools, the program delivers curriculum materials and extensive professional development for teachers.

The MacArthur Foundation made a \$1.5 million loan at 3% interest for an eight-year term; the Ford Foundation made a \$2 million loan at 1% interest for an eight-year term; and the New Schools Venture Fund made its first PRI for \$1 million at 3% interest for a term of five years. The purpose of the PRIs is to support SFAF's growth to national scale through its program of establishing public school reform models that have a measurable success in promoting student achievement in mostly high-poverty, Title I schools. PRI loans are being used for SFAF expansion working capital, for material production costs and other expenses. Repayment of the PRIs is projected from profits. Since receiving PRIs, fi-

nancial results have been strong. Net asset and sales increases are ahead of budget.

Equity Investment for Economic Development. The Reinvestment Fund (formerly Delaware Valley Community Reinvestment Fund) is a Philadelphia-based nonprofit development finance corporation with a wealth-building agenda for low- and moderate-income people and places through the strategic use of capital, information and market systems/innovation. TRF specialized in housing lending and lending to nonprofit organizations (facilities, cash flow, and social purpose nonprofit business venture lending). Always strong in its market research, TRF determined that the financing gap in the Philadelphia area was venture capital for smaller, slower-growth companies that hire low-income people or are located in the inner city. TRF created a community development venture capital fund to meet this need and links its small business investments to its workforce development program. The fund was formed as a limited liability corporation (LLC) with a ten-year life and an optional two-year extension.

The Ford Foundation made a \$1 million equity investment directly into the venture fund. Currently, the venture fund has made all of its first-round investments and is retaining its remaining funds to use as follow-on investments in its portfolio companies. At the end of the ten years (or twelve years if the two-year extension is taken), the fund will dissolve and the equity investors will share the proceeds of the fund. Success in this first fund also has drawn the interest of a private sector venture capitalist, which is assisting with the financing of a much larger second fund.

Loan Guarantee/Human Services. Children's Services International (CSI) is a long-established nonprofit childcare provider in Monterey County, California. CSI came to the Packard Foundation in 1998 with an opportunity to support the construction of a new childcare facility for 150 children in a severely underserved population of East Salinas. CSI did not have the financial capacity to qualify for a construction loan on its own for the \$2.6 million building construction project. CSI raised city and county funds for the land acquisition and a grant from the Harden Foundation for \$250,000 for equipment and furnishings. CSI was planning to launch a capital campaign to raise the funds for the construction project, but had to commit to the project or lose the window of opportunity.

Packard chose to guarantee a \$2.6 million bank construction loan. The loan would be repaid by private sector mortgage financing after the construction and capital campaigns had been completed. CSI had the childcare center constructed and conducted its campaign to raise \$2.6 million. After CSI successfully raised about \$900,000, Packard decided

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to make a \$1 million grant as part of a special group of large grants in childcare facility finance. Three years later CSI obtained a \$700,000 mortgage and Packard's guarantee was released.

As these examples show, PRIs can differ widely in size, type of project supported and investment structure. As the field of program-related investing has matured, innovations in all aspects of PRIs continue to be developed and disseminated. Some foundation boards have gone as far as requesting that every grant application be carefully reviewed by staff to see if it can be recast as a PRI opportunity. While this is the exception rather than the rule, it does point out how diverse the opportunities for PRI activity truly can be.

Benefits of PRIs

An investment of foundation funds in a PRI, by definition, is expected to earn less income than a market-rate "corpus" investment of the same amount. Less income can mean less money available for grants. So why make PRIs? There are several answers:

1) **A grant won't do.** There are sometimes situations in which a loan or a guarantee is what is required to enable a project to succeed. A grant may be inappropriate or insufficient alone. This is most frequently true for housing, economic development, conservation land acquisition and facilities—all of which require large sums of capital, and generate a stream of rental or operating income. This income stream can be used to repay a loan, which makes a PRI a viable option to consider.

2) **A PRI's principal as well as its income is working to achieve charitable ends.** A PRI is expected to earn less income than a market-rate investment. However, funds used to further a charitable goal are not limited to the interest income, as is the case of a "market-rate" investment, earning interest to generate the funds for charitable giving. Instead the entire principal amount of a PRI is used to further the charitable goal. There are times when the total dollar amount of funding is more important than whether it is a grant or a PRI, because the program impact is obtained through the use of large sums of capital. This tends to be particularly true for charitable financial institutions such as loan funds and community development banks, credit unions, and venture capital funds.

3) **A PRI may be "a recyclable, interest-bearing grant."**² A key question here is whether the PRI is being made as part of the foundation's grant budget, or in addition to the foundation's grant budget. To the extent that the PRI is made with funds that otherwise would have been distributed as grants, it becomes, in effect, a recyclable, interest-bearing grant. In the long term, making PRIs from the grant budget in-

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creases the total asset pool available for grant-making because the interest is received annually and the principal is returned and recycled over time. Making PRIs with funds in excess of the 5% distribution requirement slightly reduces the total assets available for grant-making. However, it also increases the annual charitable activity, because PRI dollars are charitable dollars, and continue to recycle through the foundation to become grants or PRIs as they are repaid.³

4) A PRI can leverage other funding. A PRI can help attract other investors in three ways. First, if a foundation is the first investor, the PRI may be seen as a signal to other potential grant makers and investors that the organization is a worthwhile investment. Second, PRIs by definition have below-market returns, and if combined with a market-rate investment, the “blended” rate on the investment package is still below market and more affordable to the borrowing organization. Having a foundation PRI as part of a financing package to “buy down” the interest rates allows other investors that may have higher return hurdles to participate in the deal. This practice is particularly important for affordable housing, where interest is a significant cost, and in development finance institutions where interest income is needed for operations and to provide technical assistance to borrowers. A third way a foundation can leverage other funding is to allow its PRI investment to guarantee private sector dollars or to be subordinate to other investments. The foundation may take on more of the risk involved in an investment by permitting the other investors to get paid back in full before the foundation gets repaid.

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5) A PRI builds the internal capacity of the borrower. Having to repay a loan requires many borrowing organizations to strengthen their financial management systems. The PRI application and negotiation process includes long-term planning and financial analysis. An organization must be able to show the foundation how it will be able to operate its business and repay the PRI. In addition to the up-front financial work, once the organization receives a PRI, it must develop financial and management systems that enable it to manage its business on an ongoing basis and plan for cash flow needs both for operations and for repayment. Often foundations make a PRI package that includes a loan or other type of investment, together with grants for operations, for technical assistance and/or for building the borrower’s net worth—all things that help develop internal management capacity.

Future Trends in Program-Related Investing

PRIs are more popular now than ever in their 30-year history. Not only are very large foundations making PRIs, but also mid-sized and even

small foundations are making PRIs in ways that are appropriate for their size and resources. The intensive review of a PRI and the ensuing long-term relationship fit well with the popular “venture philanthropy” approach to supporting and strengthening organizations, which would indicate that we will see an even greater increase in the use of the PRI tool.

There is a wide range of interest in and ability to make PRIs in both the nonprofit sector, and at times to support program interests in partnership with for-profit social purpose activities. Some foundations and some borrowers/investees have become quite sophisticated with their PRIs. For example, we are seeing an increase in the use of equity investments. There also has been an increase in financing of nonprofit social purpose ventures, which are inherently more risky than housing, facilities, or capitalization of loan funds.

PRIs can provide an exciting way to stretch the impact of a foundation’s charitable dollars. They can enable a foundation to be effective in situations where a grant may be inappropriate or insufficient alone. They also may enable a foundation to increase its total charitable distributions over time without changes in its asset base. For these reasons, PRIs merit careful consideration as an addition to the toolbox of philanthropy—a toolbox that is always in need of additions, given the complexity and diversity of the problems that philanthropists are called upon to solve.

1 The PRI Directory, *Charitable Loans and Other Program-Related Investments by Foundations*, The Foundation Center, 2001 Edition. The directory can be purchased from The Foundation Center. An excerpt summarizing the major PRI trends detailed in the directory is available online at http://fdncenter.org/research/trends_analysis/pdf/01pri_ex.pdf

2 This term was coined by Paul Lingenfelter of the MacArthur Foundation.

3 The article Program-Related Investments: “Do They Cost, or Do They Pay?” by Paul Lingenfelter of the MacArthur Foundation is available from BWB.

Brody · Weiser · Burns helps complex nonprofits develop strategic and business venture plans, assists foundations with structuring and managing program-related investments and facilitates partnerships between businesses and nonprofits. Clients have included the Ford Foundation and MacArthur Foundation PRI Programs, Prudential Insurance Social Investments and The Moriah Fund. Brody · Weiser · Burns partners have served as faculty of the MIT Project on Social Investing, teaching PRI workshops for foundations throughout the United States for nearly 20 years.

Brody · Weiser · Burns also works with PRI borrowers and other socially motivated businesses, developing strategic and business plans, preparing for growth, facilitating internal changes, and evaluating program impact and financial strength.