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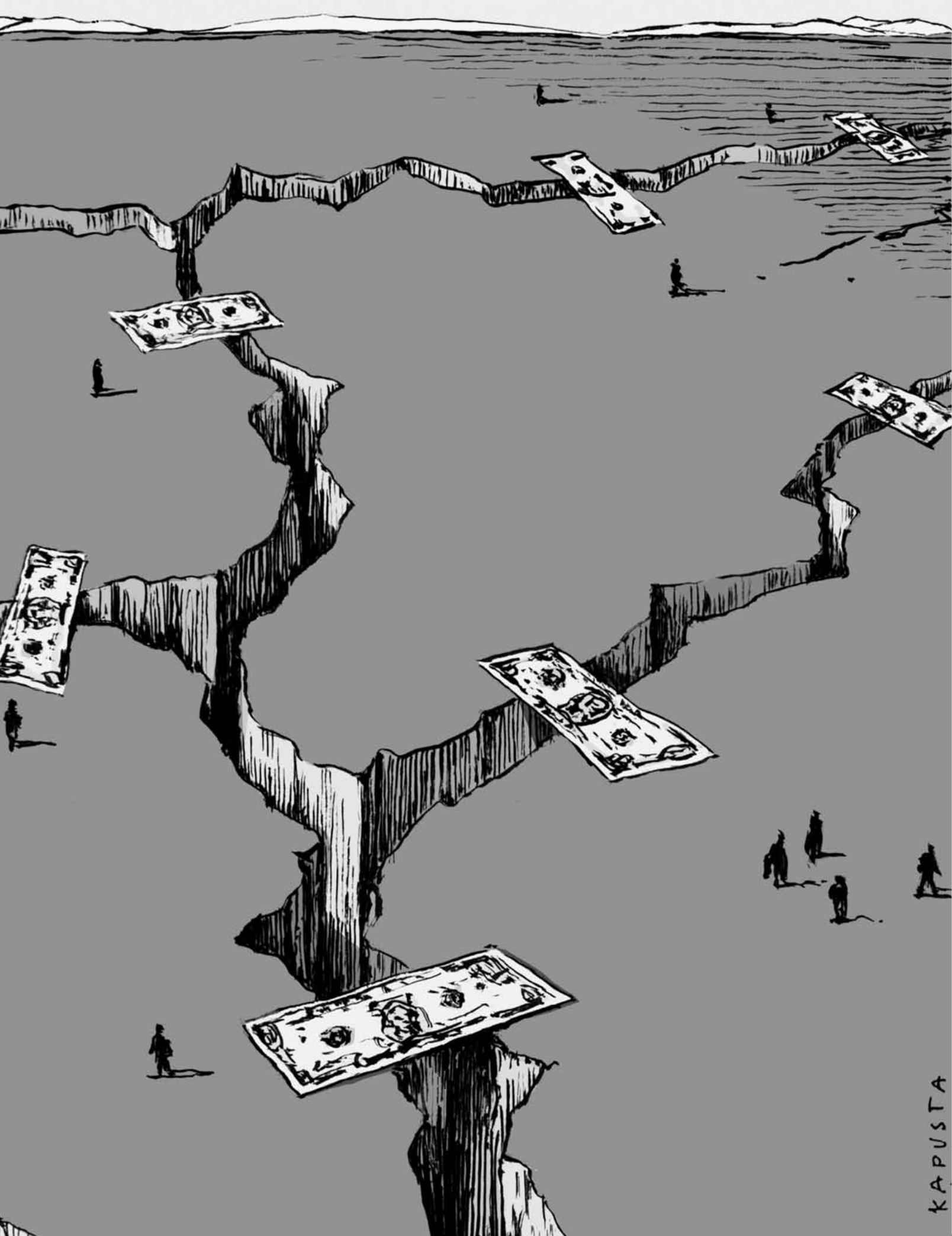
STANFORD SOCIAL INNOVATION *review*

The Equity Capital Gap

By Clara Miller


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THE EQUITY CAPITAL GAP



by CLARA MILLER

For-profit businesses can efficiently and quickly raise large amounts of money to fund growth and innovation by tapping equity capital—money that people invest in a company in return for ownership and a share of profits. The nonprofit world has no corollary, making it difficult, costly, and time-consuming to raise money. In this article the author explores ways that nonprofits and funders can create their own version of equity capital, and, just as important, develop an equity approach to doing business.

IMAGINE FOR A MOMENT THAT OUR 21ST-century economy were transported back to the 15th century. Businesses, by and large, would be tiny by today's standards. Most revenue would be in the form of unwieldy barter rather than standardized currency, and profits would be thin or nonexistent, making it difficult to invest in new technologies or fund growth. Guild elders, the king, and other oligarchs, not consumers or the market, would have sway over the entrepreneur and the success of his business. And equity capital, used today to fund the growth of risky start-ups, promising midsize businesses, and large multinationals, would be unavailable.

Does this scenario seem difficult to imagine in today's world? Not if you're an entrepreneur or manager working in the 21st-century nonprofit sector, where some of society's most daunting challenges are routinely taken on with commercial tools and techniques that could have figured prominently in the 1394 poem *Pierce the Ploughman's Crede*. Although the social, political, and economic environments have changed enormously in the intervening centuries, and entrepreneurial ideas, techniques, and resourcefulness are now common among nonprofits, antiquated commercial habits still dominate the nonprofit sector and undermine its progress.

First among these hindrances is this: Nonprofit enterprises suffer not so much from a lack of money (though reliable revenue is scarce in some subsectors and unevenly distributed throughout), but from a lack of something more fundamental—equity capital, as well as a lack of the managers, board members, and philanthropic investors who know what nonprofit equity capital is and how to deploy it successfully. The classic definition of equity capital is a financial stake in the ownership of the enterprise, the distribution of profits to the owners, and the ability to exchange equity shares with other prospective owners—none of which is strictly possible in a nonprofit. And so the very idea of nonprofit equity capital may be puzzling to many. How can nonprofits issue equity when individuals can't "own" a 501(c)(3) and nonprofits cannot distribute profits?

To explain what nonprofit equity capital is, we must recount why we have a nonprofit sector in the first place. Nonprofits exist to bridge for-profit market deficiencies and thereby provide social value. For instance, when people cannot pay for vital services such as food, shelter, and health care, nonprofits operate soup kitchens, homeless shelters, and free health clinics to bridge the gap. Other enterprises—such as schools, child care centers, string quartets, and dance troupes—often do not take in enough revenue to offset their costs. Still other enterprises—including those undertaking basic scientific research, civil rights advocacy, and butterfly appreciation—lack a predictable or even desirable commercial return.

Nonprofits step into the commercial breach by creating programs that provide these needed services and activities. Most nonprofits depend on some combination of donations, fees, and government payments to fund their work. The indispensable element behind all of these forms of payment is goodwill—the emotional benefit that a person receives in return for his or her money. Accordingly, many people believe that the money they contribute to nonprofits should be used to fund the *programs* that showcase the organization's work, not to fund the organization itself. (After all, not many people get emotional satisfaction from funding a new IT system.) Although programs are important, they cannot exist without strong enterprises backing them. And it is those enterprises that nonprofit equity capital can help fund.

In his seminal working paper, "Buyers Are Not Builders," George Overholser draws a similar distinction among types of funding: Providing the funds to support programs year in and

year out is different from building the enterprise that delivers them. He points out that many so-called investors in nonprofits think they are "builders" contributing to the establishment of a stable organization. In reality, however, they are "buyers" whose money goes to purchasing more services for more users. As he writes: "Building an enterprise is fundamentally different from buying from an enterprise. And yet, standard nonprofit accounting sheds no light on the building vs. buying distinction. I believe that this missing distinction is a major reason why a market for nonprofit growth capital has failed to materialize."

Equity capital plays the same role in the nonprofit and for-profit worlds: to focus a group of committed investors around a common goal. That focus gives rise to creating and maintaining a lasting enterprise that will attract both reliable buyers (such as annual givers, government contracts, tuition, or fees) and, eventually, additional equity holders. Some of the latter will be investors who periodically provide growth capital to do more. Others will essentially own the built enterprise, protecting it from harm or decline in effectiveness so it will be around to deliver on its promises, preserve its goodwill, and fulfill its mission.

And so the concept of nonprofit equity capital does make sense. The concept rests not on notions of strict ownership or share of profits, but instead on notions of the equity ownership ethic and the skills and financial tools it requires. And that equity ethic is what the nonprofit sector sorely needs.

The Role of Equity Capital

To understand how equity capital might work in a nonprofit enterprise, we must first understand how equity capital works in a for-profit business. Imagine a young or growing company about to enter a major new phase of its business strategy. The company might be ready to add a new product line, enter new markets, or expand its existing operations. In any case, it expects to grow and over time increase its profits.

For this to happen the promising enterprise must first go out on a financial limb. The enterprise may need to invest in new plant, equipment, or technology; fund research and develop a new product; or hire more sales staff to grow revenues. As the enterprise proceeds along this new path there will be mistakes, delays, and other assorted glitches. All of this will cost money—more money than the enterprise will earn in revenue in the short term—which is why it needs to raise equity capital.

If the business strategy succeeds, the value of the equity stake will increase because of the growing worth of the profits that the enterprise produces. Not only might the equity holders receive a share of the growing profits, but they also may eventually be able to exchange their equity for cash, possibly worth many times their original investment. If the business strategy doesn't pan out, the equity declines in value or becomes worthless, and the investment is lost.

In the for-profit world these concepts are elementary. But in

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the nonprofit sector most of these concepts are taken as metaphorical at best, or in some cases as simply inapplicable. To be sure, in the topsy-turvy economy of the nonprofit sector, many of the elements that compose the for-profit business growth cycle are missing—starting with profitability in the core business. Perhaps for that reason, in the nonprofit world the powerful role that equity capital plays in funding growth is poorly understood, confusion between “capital” and “equity” is commonplace, and nonprofit business models are often opaque.

In truth, most nonprofits do undertake many of the same tasks as for-profits, such as research and development, field-testing, organizational restructuring, marketing, quality adjustment, and, in the happiest cases, revenue growth. For these nonprofits, the for-profit analog of attracting new customers or generating increased sales is garnering additional public sector contracts, more fees for service, and more donors. The payoff for these nonprofits and their stakeholders, however, is not better financial performance. Rather, the payoff is nonfinancial gains like curing polio, educating young children, or creating a fabulous musical experience. Because nonprofits are driven by a social mission, the equity capital must not only help managers create financially sustainable enterprises but also help them meet their mission.

In contrast to for-profit equity investors, funders in the nonprofit sector (mainly individual donors, foundations, and gov-

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ernment) aren't normally focused on business considerations. Instead, they are looking for organizations that will provide better services or better outcomes for a group of disadvantaged people or for some field of human endeavor. Nonprofit funders rarely see the need to build the enterprise, even though these investors know—or ought to know—that successful outcomes don't normally spring from undercapitalized, thinly managed, fragile organizations teetering on the rim of insolvency.

To remedy this situation, nonprofit funders must understand what distinguishes an equity investment from the usual practice of making project grants or even capital contributions. Grantmakers and other nonprofit funders, even those that call themselves “investors,” often focus on delivering programs or products—in effect, on buying services for a certain number of beneficiaries, or paying for items that are part of an organiza-

tion's existing cost structure. Equity investors, on the other hand, provide general purpose funds—equity—to build and maintain the entire enterprise. If nonprofit equity investors don't have enough capital of their own to build the enterprise, they are duty-bound to find other similarly minded investors with whom to pool their capital.

Funders who take this approach when investing in nonprofits would indeed be providing equity capital—a close cousin of the risk capital on which successful businesses thrive. These investors would cease to be passive purchasers, blind to the enterprise but meticulous about getting exactly what they pay for (or, usually, more than they paid for). These investors would instead be true equity holders—owners charged with protecting the health, success, and durability of the organizations that attract and deploy precious public and charitable dollars.

Traditional Grants Are Not Enough

The small amount of capital that is invested in the nonprofit sector today that could be considered equity capital is mostly grants from individual donors and foundations. In some cases—most notably hospitals, universities, and large cultural institutions that raise significant amounts of capital to fund expansion, real estate purchases, and endowments—charitable donations serve this purpose extremely well. But for most small and midsize nonprofits—particularly those serving disadvantaged communities—there is very little equity capital available to build the enterprise or fund its growth.

Very few foundations, and even fewer individual donors, are willing to make donations to jump-start a fledgling fundraising department or to purchase a new information technology system, let alone to fund the expansion of an entire nonprofit. Even when a funder takes an interest in a nonprofit's core management and organizational development—something more and more funders are doing—the typical grant is still restricted to current expenses. Funding for any part of an existing organization—whether it's the CFO or a teacher—is revenue, not equity capital. These expenses are part of the ongoing cost structure of the enterprise and must be funded with “buy” revenue, not “build” equity.

Nonprofits need not only capital to fund growth, but also growth investment that yields a reliable revenue stream to fund the larger organization for years to come. It is the job of equity capital to build an enterprise that can afford a cost structure that includes the CFO, the financial management system, and other basic business needs in perpetuity. And the major source of this “build” equity is capital campaign grants that are structured to cover the broad list of requirements of a growing enterprise.

When small and midsize organizations do undertake capital campaigns, they tend to be focused on one narrow asset class—such as an endowment or real estate. This is dangerous,

because it forces the organization to cover the unfunded growth demands—expansion of programs and accounting systems, marketing costs, moving expenses—from current revenue. And capital campaigns themselves tend to impose enormous stress on organizations, which lack the built-in fundraising business that can reliably and profitably run these campaigns, raise annual gifts or other revenue year over year, and allow the program personnel to do what they do best: deliver on mission.

Nonprofit Capital Markets

It might seem odd to use the phrase *capital markets* to describe investments in nonprofit organizations, much of whose capital is donated and doesn't yield distributable profits or an ownership stake in the organization. Yet in two respects, it is both accurate and useful to think of the exchange of capital in the nonprofit sector as a market.

First, in some instances, grants are sought and allocated competitively on the basis of the donor's view of their productive potential. Some foundations, such as the Edna McConnell Clark Foundation, explicitly describe their grants as "investments" and seek evidence of a return in the form of measurable social benefit. They understand the need to attract a group of like-minded growth investors, all focused on a common measure of social benefit. Individual donors probably don't think in such quantitative terms, but even they direct their contributions to the places that seem most likely to produce the results they value. Nonprofits are more than aware of these calculations and compete for the available dollars on the basis of their donors' view of return and their fields' particular metrics.

There is a second and more literal way in which the exchange of public interest capital constitutes a market. Outside of grants and donations, much of the rest of the available capital for nonprofit operations and projects comes from for-profit organizations that are, in fact, seeking a financial return. Banks, insurance companies, and tax-exempt bond placement agents and packagers provide the lion's share of capital to nonprofits. The overwhelming majority of this capital is in the form of debt, and by far the greatest source of debt for nonprofits is from for-profit retail banks. Large nonprofits, in particular, have ample access to standard debt from a range of other sources, including credit unions, community development financial institutions, and foundations (in the form of program-related investments, or PRIs).

At the moment, access to debt is not the biggest—or even a highly significant—capital challenge for most nonprofits. In fact, a recent article by Robert Yetman, a management professor at the University of California, Davis, shows that nonprofits use debt in about the same proportion, and at roughly the same level of sophistication, as for-profit companies.²

Banks increasingly tend to treat the nonprofit sector as a regular, albeit peripheral, line of business. Institutional debt, includ-

ing letters of credit for bond issuance, operating loans (including third-party receivables loans), mortgages, and other services abound, although their availability is uneven and sometimes sporadic. In my 25 years as president and CEO of the Nonprofit Finance Fund, encompassing two major economic cycles, I have found that the availability of debt from banks tends to wax and wane. When times are good, nonprofits are among the beneficiaries. When there is a general tightening of credit during tough times, the nonprofit practice is the first to be scaled back because it is not a core business for most banks. Because of the economic uncertainty currently troubling the debt market, there may be shortages of certain kinds of debt for nonprofits and social enterprises during the next year or more.

With small and midsize nonprofits in particular, even in good times banks find many reasons to look warily at their business. For these organizations, annual revenues are typically too small, and the intended purpose of the debt too complex and nonstandard, to make many transactions profitable for most commercial lenders. The revenue picture for a typical community center, for example, is very complex compared with a

Helping a nonprofit grow and helping a nonprofit become sustainable are often in conflict.



similarly sized for-profit business. Obtaining debt financing generally involves a dozen or more different sources of funds, some from highly bureaucratic government programs, and nearly all of them with peculiar and inflexible requirements that puzzle underwriters and imply lack of reliability.

Gaps in debt availability do exist, particularly for unsecured debt for working and growth capital for amounts up to \$5 million. The Nonprofit Finance Fund provides this kind of debt in amounts up to \$2 million; the Rudolph Steiner Foundation is another experienced provider, and the two organizations sometimes collaborate on these loans. Institutions with long experience in PRIs, such as the Ford Foundation, are another source of this kind of capital, offering very low-interest, long-term loans.

Nevertheless, for most growing nonprofits, debt alone does not do the trick. Debt is most successful when it is used to match expenses over the useful life of an asset (such as a facility or residence) or to pay expenses before expected revenue is received (to finance inventory, production expenses on a play, or the staff expenses of a school before all the tuition is received, for example). Debt is of limited usefulness for scaling a business where profitability is marginal or missing altogether.

Closing the Capital Gap

Creating an equity capital market as well as an equity ethic for the nonprofit sector has to start with funders, board members, and managers understanding their financial roles. The entire field will improve if it simply applies Overholser's important distinction: Are they "buyers," providing dollars for nonprofit enterprises to deliver additional services, or are they "builders," providing dollars to expand the entire enterprise? Buying is a crucially important role, and without buyers, no enterprise can succeed. But buyers do not help nonprofits grow or change for the future. For that we need builders.

Although many funders—foundations, government, and individuals—imagine themselves to be builders (it sounds more important and helpful, after all), they are more likely to be buyers, simply because equity investment takes more dollars than most funders can ever give at one time. Those foundations that are taking on the building role—as many have begun to do lately—have had to abandon their illusions about their ability to go it alone. The average grant among the 100 largest foundations is roughly \$50,000, an amount that is insufficient to help a nonprofit grow financially stronger, improve its performance measurements, or achieve any other major steps toward greater sustainability.

To help create and grow a sustainable organization—to become, in essence, an equity investor—the investment must resemble real equity capital as much as possible by being substantial, long term, and undesignated. That means the grant should be large enough—typically in the tens of millions of dollars—to help scale an organization. The grant needs to be available to fund operating deficits, unspectacular purposes such as fundraising staff and back-office management, or new undertakings that may fail or need to be reengineered along the way.

It may be the case that an individual funder does not have enough money or is unwilling to invest enough to provide sufficient equity capital for a nonprofit to expand. In these instances, syndication—getting several funders to join together—may be the answer. Even major funders, with top-end grants in the \$2 million to \$3 million range, could make a significant improvement in the capital market by syndicating their investments. In reality, even these rare seven-figure grants offer a typical midsize nonprofit only a fraction of the total capital that it needs to become sustainable at an enhanced level.

The need for collaboration and syndication among funders also applies when it comes to evaluating and measuring return on equity—in the form of improved or increased mission productivity. Developing meaningful ways to measure a nonprofit's progress is a complex, time-consuming, and often costly endeavor for the funder and the nonprofit. These difficulties are multiplied for the nonprofit when each investor has its own particular approach or adopts a different view of success. Funders and nonprofits would benefit enormously from the development

of simple, practical metrics across subsectors—including shared, self-reporting data platforms available to all recipients—that begin to connect social outcomes with indicators of financial performance and organizational capacity.

The nonprofit equity capital market also needs standard and widely accessible financing products. Growth capital grants, enterprise-building support—call them what you will—should be part of the normal tool kit with which funders approach their mission. Here, too, collaboration among funders would greatly accelerate and strengthen the development of the equity capital market. Funders could jointly invent, test, and deploy nonprofit equity-like products, learning from one another's experience and establishing common expectations for each product.

Funders also need to be aware that helping a nonprofit grow and helping a nonprofit become sustainable are not only different, but often in conflict. Many organizations need to build greater internal strength before they can extend their external reach. And sometimes the goal of expanding a nonprofit's service should not include building a bigger organization. A nonprofit sometimes can expand its services by other means, such as partnerships, networks, or franchising. And in some cases effective nonprofits should not be encouraged to grow, but instead should stay small (and beautiful!).

Finally, the overall business conditions for social enterprise, social entrepreneurs, and innovative nonprofits need to be improved so that they can operate on an equal footing with for-profits. Many human service nonprofits, for example, suffer from a structural disadvantage when they compete with for-profit contractors for government contracts. Nonprofit and for-profit applicants often face different rules on such basic business issues as whether they can legally earn excess revenues on their public contracts. Because of their perilously lean balance sheets, nonprofits find it much harder to cope with the demanding payment terms, required balance sheet diminishments, and sometimes erratic payment procedures that are part of doing business with government.

These concerns, and others like them, do not result from just the occasional peculiarities of individual government agencies or funders. They are part of the general business climate for nonprofits whose work is widely (and correctly) regarded as indispensable, yet whose underlying economics and management systems seem to be almost no one's primary concern. Raising these basic, overarching issues to the surface, and finding ways for funders to tackle them collectively, is a great challenge for small and midsize human service organizations and their supporters. Creating an equity capital equivalent—and an equity ethic—for nonprofits is a critical first step in this process. □

1 Overholser's article was published by the Nonprofit Finance Fund and is available on its Web site.

2 Robert Yetman, "Borrowing and Debt," in *Financing Nonprofits: Putting Theory Into Practice*, ed. Dennis Young (Lanham, Md.: AltaMira Press, 2007).