PRIorities : The Sweet Spot Between a Grant and an Investment

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Can a foundation fund a social program and get its money back to use again, maybe even earning a healthy return in the process?

It sounds too be good to be true, but it´s legal. In the US and the UK foundations are increasingly dipping their toes into **Program-Related Investing**.

When the Gates Foundation took an equity stake in Visterra, an innovative biotechnology company that develops drugs for infectious diseases, it joined an A list of venture capitalists. But the Gates´ investment came through the programmatic arm, not the investment function of the foundation. On a smaller scale, the Lora L. and Martin N. Kelley Foundation Trust was furthering its charitable purpose when it provided a low interest loan of $200,000 to the nonprofit Craft3. Craft3 will use the investment to finance improvements for homes and schools in poor neighborhoods in Oregon. After five years, Craft3 will return the capital plus a minimal interest charge. The Foundation will be required to pay out 100% of the capital that gets returned to other charitable projects within 12 months; the interest generated by the investment can go into the foundation´s endowment.

According to the United Kingdom´s Charity Commission, a Program Related Investment or PRI is "an investment by a non-profit organization to advance its mission and involves the potential return of capital within a set period. " The IRS uses a similar definition and classifies PRI as grants. Both the investment capital and the transaction costs of PRIs count towards the minimum of five percent that US foundations must disburse each year.

The founders of Clif Bar made their first PRI in March 2013 through the relatively new Clif Bar Foundation. A $100,000 low interest loan seemed like the most appropriate tool for conveying the board members´ faith in a MBA in Sustainability being launched at Bard College. The director of the new MBA program, Eban Goodstein, agrees, "As an MBA focused on building a sustainable future, PRI start-up financing provides a great lesson for our students. They are learning to scale profitable solutions to environmental and social problems."

Thanks to a 2012 proposed IRS ruling, US foundations are increasingly leveraging PRIs to fund programmatic activities. PRIs can be made in non-profit entities or in private companies to achieve specific social objectives.

In its new draft ruling, the IRS clarified this point with examples of permitted investments:

- An equity investment in a commercial pharmaceutical company which is creating a vaccine for a disease that affects predominately poor people in developing countries when the expected Internal Rate of Return (IRR) is less than the market rate.
- An equity investment in a company that reduces pollution through recycling in a developing country. Because it is a risky investment, the deal can be considered a PRI despite the potential to achieve a high return rate if the company is successful.
- A concessionary loan to a company which employs low-income people in a rural community when traditional sources refuse to provide the capital needed to repair damage caused by a natural disaster.

The Heron Foundation, a pioneer in the field of impact investing, has embraced this broader range of options. The Foundation states clearly that it is "less interested in an investee's tax status (e.g. non-profit, for-profit, cooperative, etc.) or industry than the results of the investee with respect to our (mission) objectives."

PRIs differ from other forms of impact investment because their primary purpose is to accomplish a social good. Expected financial return is secondary and must be less than what would be expected from a non-PRI investment with similar risks. According to the IRS, for an investment to qualify as a PRI, the decision-makers would not make the investment if were it not for the social benefit likely to be created by the investment.

The John S. & James L. Knight Foundation uses PRIs to fund both commercial projects and nonprofit entities. A simple requirement summarizes the difference between the Foundation´s PRIs and its other forms of impact investing. In addition to a commitment to repaying the investment, PRI recipients must agree that the first release of a PRI funded project will be "open-source". In contrast, portfolio companies in the Foundation´s Knight Enterprise Fund, which does not use PRIs and seeks competitive returns, have no such obligation.

Foundations can benefit immensely from the potential to use PRIs to recoup their capital and redeploy it, plus any earnings, to fund mission activities. Trillium Asset Management has modeled conservative scenarios which show that a $100M foundation that allocates 4% of its assets for grantmaking and 1% for new PRIs each year could reasonably expect to deploy $23M (combined PRIs and grants) or 16% of its corpus for social purposes, whereas traditional grantmaking of 5% per year assuming equal administrative costs, would only lead to $9M in grantmaking.[1]

According to a recent study by the University of Indiana, *Leveraging the Power of Foundations-An Analysis of Program-Related Investing*, most PRIs fund local economic development, affordable housing and education, and a high percentage of PRIs go to nonprofit financial intermediaries, such as community development finance institutions, which have long histories of efficiently lending to businesses and individuals in low-income communities.

SIX GOOD REASONS TO USE A PRI

- To be able to **re-use capital** to fund new projects once the money is returned.
- To **access additional public or private funding** for projects which advance your mission.
- To **take on greater risk** than permitted with typical investment assets (In the US, PRI investment decisions are exempt from the standards of the "prudent investor").
- To fund worthwhile projects without losing the **potential to increase your foundation´s asset base** with competitive returns.
- To promote activities that **aren´t suitable for traditional grant funding**.
- To **strengthen the recipient** ´s financial management capacity and reputation.

When making direct PRI investments, foundations tend finance groups they have supported successfully in the past. For example, the Meyer Memorial Trust PRI felt comfortable coupling an $800,000 loan with a $200,000 traditional grant to a new regional food bank because the Trust already knew the community initiative well.

Since making its first PRI of $6,000 in 1980, a loan to the Natural History Association Yosemite to publish a coffee table book, the Packard Foundation has invested $250 million in PRIs. Among these is a $2.5 million loan to fund the launch of the "Roundtable on Sustainable Biofuels Services Foundation" (RSB). RSB worked with multiple stakeholders to develop "sustainable" certification criteria for the entire value change of biofuel production and the European Commission recognized its standards in a Directive on Renewable Energy In 2012. According to Packard, RBS´ first certification, of the Australian company Manildra, demonstrated that sustainable production of commercial-scale biofuels is viable and has motivated other companies to work toward this standard, fulfilling the foundation´s mission objective.

PRIs often catalyze additional funds, private or public for the recipient. For example, a low-interest loan of $1.2 million from the Packard Foundation to the Food Bank of Santa Cruz, California for a new warehouse led to other funders donating another $5 million to improve the Food Bank´s logistics and

[1] Trillium Asset Management, *Mission-Related Investing for Foundations and Non-Profit Organizations: Practical Tools for Mission/Investment Integration* (2007) p. 7

efficiency and provide more fresh fruits and vegetables to their customers. In the case of the Alfond Family Foundation, a $20 million PRI guaranteeing a state bond for the construction of a new hospital enabled the hospital to leverage $276 million in public funding, more than 13 times the value of the foundation assets being held as security and earning interest for the Foundation.

As the supply of PRI funding is starting to increase, nonprofit demand for PRIs is expanding as well. A 2013 report by the Nonprofit Finance Fund revealed that 23% of the cross-section of US nonprofits surveyed planned to seek some form of loan or investment next year, a 20% increase over the previous year. In addition to financing buildings and infrastructure purchases, PRIs typically help organizations access new revenues, which allow them to repay loans, generate royalties, or increase the value for their equity investors, or enable them to handle timing issues for receiving public or private capital that is committed but not yet in hand.

The Packard Foundation has offered PRIs for 30 years and has lost less than 1% of its capital. How have they achieved this enviable record?

Packard´s criteria are similar to the principles the Meyer Memorial Trust uses for making PRIs:

- The purpose of the PRI must be consistent with the strategic plan or business plan of the recipient.
- The recipient has demonstrated financial soundness.
- Multi-year financial projections forecast sufficient cashflow to be able to return the funds.
- Board and/or staff have proven their ability to manage debt and cash.
- A PRI is an appropriate tool for financing the project.
- The PRI is likely to lead to additional new sources of capital.
- There are collateral or secondary sources for repaying the investment.

Although the vast majority of PRIs are funded out of Foundations´ program budgets, some foundations go one step further and use PRIs to have greater mission impact with their investment dollars as well. For example, the Jessie Ball DuPont Foundation´s first PRI, a loan of $500,000 for the construction of new affordable housing, was part of a larger $10M portion of the family foundation´s endowment the trustees set aside to deploy in impact investments. The trustees wanted to use more of their assets to achieve the foundation´s mission. That being said, the Foundation President Sherry Magill clarifies, "our goal is not to make loans. Loans are a tactic. Our goal is to help create a system to ensure there is affordable housing." ***PRIorities***: ***It´s all about the social mission***.