THE CHRONICLE OF PHILANTHROPY
NEWS AND ANALYSIS
MAY 31, 2017
PREMIUM

Mission Critical

Nonprofits and foundations making impact investments believe their dollars are vital to solving tough problems.

By Nicole Wallace

AARON MINNICK/WORLD RESOURCES INSTITUTE
ROOTS OF CHANGE: The World Resources Institute, which replants forests in Ethiopia, has invested more than two-thirds of its nearly $40 million endowment for environmental sustainability.

The numbers were daunting. More than 1.6 billion people worldwide live in substandard housing, yet Habitat for Humanity International was putting up only about 100,000 homes annually. Even 100 years of home building would address only a fraction of the need.

Habitat concluded it had to do more. Its answer? Impact investing.

Several years ago, the organization began experimenting with for-profit approaches to boost housing production, particularly strategies to improve access to credit. In some developing countries, less than 2 percent of the population can obtain mortgages. As a result, many people build their homes in stages, often one room at a time, completing each as they can pay for it.

Habitat created the $100 million MicroBuild Fund to seed new microfinance loans that borrowers could use to pay for phased construction. With such financing, it hopes to encourage others to put up money. Generally, investors don't bet on housing loans to poor borrowers in the places where Habitat works, says Patrick Kelley, who heads the nonprofit's Terwilliger Center for Innovation in Shelter. "We really want to break down those walls of perceived risk so that other investors will follow us."

One of the fund's first investments put $2 million into housing microloans at Imon Tajikistan, a microfinance institution. That was back in 2012. Imon has since attracted an additional $10 million — exactly what Habitat hoped would happen.

Habitat isn't alone in its epiphany that charitable dollars by themselves won't solve society's toughest problems. Pioneering nonprofits and foundations have experimented with harnessing markets and investments to catalyze social change for more than a decade, and the Ford Foundation's embrace of impact investing, announced in April, pushes the idea further into the mainstream.

The challenge, one expert says, is to push as close to the edge on social impact as possible and not lose your shirt.

But powerful players in the finance industry are also getting behind investments that aim to tackle social and environmental challenges *and*generate a monetary return. Multinational companies and equity firms are racing to offer advice and products to mission-minded investors.

Their money and resources dwarf what philanthropy can offer; indeed, some might wonder if it's best to leave impact investing to commercial entities. But the work of Habitat and other nonprofits and foundations offer a counterpoint, suggesting that philanthropy remains vital — both to open up new areas of investment and to attract capital to take on the world's toughest problems.

Big Announcement

There have long been people and organizations that believe in the power of markets to do good, but the idea of impact investing only gained widespread attention with the rise of microfinance in the 2000s. Pioneers like the Heron and Annie E. Casey foundations experimented with endowment investments that advanced — or at least didn't conflict with — their grant-making agendas. Charities like the Local Initiatives Support Corporation and the Nonprofit Finance Fund marshalled investment to build affordable housing and child-care centers.

Today the term "impact investing" covers any number of things. It can mean putting money in a stock fund that chooses companies based on their carbon efficiency. Or making low-interest loans to a nonprofit health clinic. Or investing in a fledgling education-tech company. Or backing a social-impact bond to reduce homelessness.

Pinning down numbers is difficult, but such investments appear to be gaining momentum. A Global Impact Investing Network survey of 208 leading fund managers, foundations, development-finance institutions, family offices (which manage the wealth for a single extended family) pension funds, and insurance companies found that they held more than $114 billion in impact investments at the end of 2016, with the total likely to climb to nearly $140 billion by the end of the year.

The number of large foundations with impact investments has grown slowly but steadily. In recent years, grant makers like the Kresge, MacArthur, and McKnight foundations started or expanded efforts. Nonprofits getting into the act include the World Resources Institute, which is two-thirds of the way to its goal of investing its roughly $40 million endowment for sustainability. The Calvert Social Investment Foundation runs a new service that plays matchmaker between impact investors and social-purpose businesses in need of financing. Catholic Relief Services made its first impact investment late last year, a $500,000 loan to Lafaza, a company in Madagascar that buys vanilla at fair prices from local farmers.

5 TO WATCH

These are some of the foundations that have made the biggest commitments to impact investing.

Heron: **$280 million**

Kresge: **$350 million**

McKnight: **$460 million**

MacArthur: **$500 million**

Ford: **$1 billion**

Not everyone is convinced impact investing can deliver on its enticing promise of meaningful social change combined with attractive financial returns. Ford's announcement is, however, the biggest sign that philanthropic impact investing is on the move. The foundation will allocate up to $1 billion of its $12 billion endowment to investments that are in line with its mission.

"The problems we seek to solve will not be solved through grant making alone," says Darren Walker, Ford's president. Philanthropy has to move beyond its current mind-set and "be more creative about how we achieve our mission."

Activists to Pros

Ford and Habitat are jumping into a field that looks very different than it did just a few years ago. It was activists who galvanized impact investing and pushed its development, says Matthew Weatherley-White, co-founder of the Caprock Group, a wealth-advisory company.

"They were people who wanted to create a different kind of a world, one that is more just and more environmentally sensitive," he says. "They turned to the capital markets, in part, because — well, that's where the money is."

Now impact investing is professionalizing. Responding to customer demand, mainstream financial-services and investment companies like BlackRock, Goldman Sachs, Morgan Stanley, Northern Trust, and U.S. Trust offer clients impact-investing advice and products. In 2015, Bain Capital tapped Deval Patrick, a former governor of Massachusetts, to lead its new social-investment fund.

Mr. Patrick and other proponents say companies and investors increasingly recognize that responsible use of natural resources and fair treatment of employees aren't just feel-good measures; they are signs of a well-run business. Failing to manage environmental and social risks "will come back and bite your financial bottom line," he says.

"If we and others do this right, there isn't going to be a difference anymore between investing and impact investing. We're just going to call it investing."

What Role Philanthropy?

Bain Capital and the other commercial players in impact investing can muster both financial savvy and enormous amounts of capital. Given that, it's fair to ask: Is there still a role for foundations and nonprofits? Can philanthropy do things that the boutique investment houses and financial behemoths can't?

For answers, *The Chronicle* turned to more than 30 nonprofit leaders, foundation investment gurus, financial professionals, investors, and experts. Overwhelmingly, they argued that foundations and nonprofits are critical. Their financial choices can point investors to a good idea and attract other dollars. Yes, philanthropic players have smaller coffers than a BlackRock or Morgan Stanley, but they can take bigger risks and wait longer for returns. Relatively small amounts of money also can prove out promising enterprises or fields of investment.

"If there's not a huge potential market and the margin is uncertain — as it almost always is with new ventures — the private-sector players are not going to step in at the earliest stages," says Cathy Clark, director of the CASE i3 Initiative on Impact Investing at Duke University's Fuqua School of Business.

The nonprofit Prime Coalition hopes to spur philanthropic investment in early-stage environmental ventures. It connects foundations and family offices with start-ups developing promising technologies to reduce greenhouse-gas emissions. Like other start-ups, these companies can stumble in the lean years between angel funding and large-scale investment — what the industry calls "the valley of death."

“We really want to break down the walls of perceived risk.”
"Companies are dying on the vine," says Sarah Kearney, Prime’s founder.

Prime’s first investment was in Quidnet Energy, a company seeking the holy grail in renewable energy: a low-cost means to store energy generated by wind turbines, solar panels, and the like. Quidnet developed an innovative approach using old oil and gas wells for storage, but no one would pay for its $1 million pilot. Prime stepped in, lined up philanthropic investors, and the test was successful. The company has since raised additional money to build a commercial-scale plant.

The Nature Conservancy, meanwhile, has set out to create new kinds of deals that demonstrate the financial payoffs of protecting nature. There’s real muscle behind NatureVest, the charity’s 28-employee impact-investing unit; JPMorgan Chase has committed $11 million since its start in 2014. So far, NatureVest has closed six transactions that have attracted $200 million in capital.

The deals can be complicated. NatureVest, for instance, raised a $20 million fund to buy water rights in Australia’s Murray-Darling Basin, where one-third of the country’s food is grown. More than 80 percent of the basin’s wetlands are in poor health because of climate change and the diversion of water to agriculture.

The fund aims to balance the needs of farmers and the environment while returning a profit to investors. During years of plentiful rainfall and low water prices, the fund uses its water allocation to renew critical wetlands. When rain is scarce and water prices climb, it sells its allocation to farmers. Investors net earnings from water sales and the appreciation in value of the water rights.

NatureVest is pleased with the results so far. It’s looking to raise up to $76 million for the fund in Australia and adapt the model for the U.S. West and Latin America.

When creating new investment products like the fund, philanthropic dollars are critical to paying for the personnel, expertise, and upfront costs, says Taryn Goodman, NatureVest’s director of investment partnerships.

"In areas that are new to investment, the deal itself can’t cover those expenses," she says. "But once you start proving those models, you can scale those deals and build those expenses in."

Absorbing Risk

Sometimes philanthropy paves the way for commercial capital by mitigating risk for other investors. The Healthy Neighborhoods Equity Fund, created by two nonprofits, seeks private financing to invest in mixed-use developments near transit to create walkable neighborhoods. Three grant makers — the Boston, Kresge, and Robert Wood Johnson foundations — committed a total of $5 million that could be used to cover losses if borrowers default on loans. The fund has so far raised $16.5 million from banks, wealthy individuals, and a hospital.

INVESTING FOR GOOD

Innovative nonprofits and foundations are turning to impact investing to attract commercial capital to their causes. But some observers worry the investments that blend social and financial returns could change the way donors think about charitable giving.

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- Nonprofits Innovate to Build Market for Mission Investing **PREMIUM**
- Impact-Investing Pioneers Take Stock and Adjust Course **PREMIUM**

They were willing to invest with a lower expected rate of return (8 percent vs. the 15 to 25 percent real-estate equity funds usually provide) in part because the philanthropic investors and public money provided a safety net.

Without that, the fund couldn't have attracted private investment, says Joe Flatley, chief executive of the Massachusetts Housing Investment Corporation, one of the nonprofits running the effort.

"We would have had to pay a higher return to the investors and then demanded higher return for the projects, which would have made the projects infeasible," he says.

Kresge's commitment took the form of a guarantee, a legally binding promise that's recorded as a liability on the foundation's balance sheet. Guarantees are a powerful but seldom-used tool, says Kimberlee Cornett, managing director of Kresge's social-investment practice. They make up $150 million of Kresge's $350 million impact-investing portfolio. (Kresge is such a fan of the practice, it commissioned the Global Impact Investing Network to write a report about guarantees.) In deals like the Healthy Neighborhoods Equity Fund, guarantees accelerate the foundation's mission goals and spur additional investment, yet Kresge only has to take the money from its endowment if a borrower defaults.

Ms. Cornett and her team do a lot of scenario planning to anticipate defaults. They also manage guarantees to try to avoid the possibility of multiple ones coming due at the same time. So far, Kresge has never had to make good. But it's early. The foundation has been offering guarantees for five years; in some cases, the investment funds will last more than 20 years. "We're barely in inning one," Ms. Cornett says.

Kresge's investment committee is already questioning whether the foundation is taking enough risk. The challenge, Ms. Cornett says, is to push as close to the edge on social impact as possible and "not lose your shirt. If we think it's going to make a difference, we should do it, even if it's risky. And we don't make those decisions casually or quickly."

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