Philanthropic Venture Capital: Its Time Has Come

By Harry Edelson, Edelson Technology Partners

Chalk it up to a new millennium attitude or a post 9-11 reaction. But in 2001, individuals, corporations and foundations opened up their checkbooks and donated $212 billion to charity. Charitable giving then rose to $241 billion in 2002, according to "Giving USA," a report issued last summer by the American Association of Fundraising Counsel.

Unfortunately, accolades given to donors are usually based upon the quantity of their contributions rather than the quality of the results achieved. The conscience of the donor is often assuaged by the feeling that their duty has been served once the donation has been made. This attitude, however, is changing as donors are demanding more accountability for their contributions.

In fact, it is now recognized by many leading philanthropists that the nonprofit world would benefit by adopting disciplines used by venture capitalists to ensure that grants are well spent – not just spent. Foundations and corporations are certainly more vigilant than individuals about their donations, but more transparency and oversight is clearly desirable. The Morino Institute and others, such as The Philanthropic Initiative, the Social Venture Partners, the Roberts Enterprise Development Fund and New Profit Inc., are leading lights in what is becoming known as "venture philanthropy."

They are applying "venture capital like" business practices in their philanthropic activities. Their focus is on providing managerial assistance and oversight to the nonprofit organizations with which they are involved. These commendable efforts to improve the results of nonprofit organizations are an acknowledgement of the validity of venture capital methods.

Now it's time to more fully hook up VCs with the nonprofit world.

Social problems are outpacing philanthropy's ability to deal with them. But there is a solution. The answer is to establish unique venture capital firms called PVCs (Philanthropic Venture Capital firms) that will use the disciplines and incentives of investing while solving some of the world's leading social problems. Such a setup could increase funding for social causes, create a more productive use of nonprofit funds and design new technologies to cure rather than just alleviate social ills. Here's how:

Greater Funding for Social Causes: The leverage exhibited by venture capital can be of enormous benefit to philanthropists who want to solve difficult social problems with relatively limited funds. For instance, a $2 million investment by a PVC in an early-stage company can ultimately generate hundreds of millions in additional funding from both private and public sources as the company becomes successful. Why shouldn't philanthropy enjoy the benefits of leverage by investing in PVCs, whose focus is on solving the same social problems that they are addressing?

Another important feature of PVCs is that they can return both principal and profits to philanthropic investors who can then recycle them into additional philanthropic endeavors.

More Productive Use of Funds: Venture capital has been around since antiquity. It evolved into the industry we know today only about 40 years ago. It has strict disciplines including oversight, transparency, frequent financial reports and a focus on results. The definition of results can be fuzzy, in both venture capital and philanthropy.

But there is a key metric in venture capital that is easy to measure, and that is financial results. Good financial results are a reliable indication that a company is achieving its goals.

Technology: The majority of venture capital investments involve technology. New technologies have already cured diseases, reduced pollution, launched the Internet, spawned electric vehicles and created educational software. Technology holds the promise of solving, or greatly alleviating, serious social problems now being addressed by the nonprofit community.

Why not work as a team to identify social problems where the impact of technology can be greatest, and have PVCs focus on investment opportunities in these areas? Once developed, these technologies can be applied by nonprofit and government organizations to communities where the need is greatest. The combination of socially beneficial technologies funded by PVCs, which are then applied by community-based charities, can bring about dramatic improvements in solving deep-seated social problems.

The PVC Advantage

Nonprofits mostly focus on alleviating problems, while PVC-backed technologies have the potential to solve problems. The United States leads the world in innovation largely because entrepreneurs realize that success will yield financial rewards. The same is true of factory workers, programmers and engineers who flock to small emerging growth companies with the hope that stock options will pay for their automobiles, homes and the education of their children. Capitalism has thrived in the American system of free enterprise largely through the formation of small companies.

Successful capitalists from John D. Rockefeller to William Gates Jr. became major philanthropists and returned a portion of their wealth to the less fortunate. The nonprofit sector has not had a profit motive and probably has suffered for it. As David Rockefeller stated: "There is nothing inconsistent about being socially responsible on the one hand and doing what is right

for the shareholders on the other." Philanthropists should not be embarrassed about making money, especially if their philanthropic goals are achieved while generating more money that can be recycled back into more good causes. Based upon historical venture capital results, PVCs should achieve annual returns of 5% to 30%, even though the focus will be on solving social problems.

One problem with applying the existing venture capital system to philanthropy is that most funding comes from pension funds, which by rule have the goal of making the highest possible financial return. This problem can be overcome by narrowing the charter of a fund so that it invests only in socially beneficial activities while still attempting to achieve high returns. A PVC combines the efficient administration and operating techniques of venture capital with the goal orientation of nonprofits.

Profit does not come without a strict focus on results. Lead venture capitalists maintain strict oversight of their portfolio companies. VC-backed companies are required to provide monthly financial statements, board representation and good corporate governance. Additional money is invested when milestones are met. If milestones are not achieved, additional funding is delayed, withheld or invested at a lower price. Management is held accountable and if necessary, replaced. These actions achieve results as indicated by the outstanding long-term financial gains achieved by the venture capital industry, recent years notwithstanding.

Plus, when a donor makes a grant to a nonprofit organization, there may not be additional grants forthcoming for the project. By way of contrast, the venture capital process is built on many rounds of financing, including seed, startup, first and second round, mezzanine and IPO. Each successive financing attracts new and larger investors. A PVC could invest $2 million in a promising startup and attract $100 million from others if the company is successful. If the company has an IPO, it could attract hundreds of millions of dollars from the public market. Leverage can be a powerful elixir when applied to philanthropy.

Investments in PVCs can revolutionize philanthropy by shifting some of the focus from funding social palliatives to achieving socially oriented technology breakthroughs. In doing so, PVCs can also help leverage more money for social causes, create jobs and provide additional funds to be recycled back into philanthropic activities.

Some of the investments made by PVCs will be in companies that survive and prosper, helping society for decades rather than just a year or two. PVCs and nonprofits fit neatly together like pieces of a puzzle, in that PVCs will create the technologies that will be applied by more traditional nonprofit organizations. The challenge for philanthropists who want to explore investing in PVCs is to find venture capitalists that will use the discipline and oversight inherent in the venture capital system to achieve social goals.

By combining their financial and professional resources in PVCs, philanthropists and venture capitalists will have a major impact on solving many of the world's problems.

Money that is donated to a charity is gone, except for possible tax deductions. Investments in PVCs remain on the balance sheets of donors and can very well double in value over a 10-year life of a typical partnership. This is after deducting all expenses as well as the 20% share of the profits allocated to the general partner. Thus, the principal and the profit can be recycled into additional charitable pursuits.

In 450 B.C. Herodotus opined, "All men's gains are the fruit of venturing." Virtually every invention or service ever created has come from venture capital, the investment of sweat equity and money to invent or discover something to entertain or enhance the well being of individuals and society. Since antiquity, charities have done a wonderful job of helping the poor and those in need, but it was not charity that invented the wheel, steam engine, printing press, automobile, airplane, radio, light bulb, television, computer, telecommunications, pencil, can opener or contact lens.

It is the rare venture capital firm that has not invested in at least several breakthrough technologies.

Harry Edelson is managing partner of Edelson Technology Partners which has made numerous investments in information technology, life sciences, education, the environment and energy.

Harnessing the Profit Motive

It makes sense from a financial and a humanitarian standpoint for investors to join philanthropists in combating social problems:

- A $10 million investment in a philanthropic venture capital fund (PVC) will likely return $20 million, while a $10 million donation will provide a $3.5 million tax deduction.
- Measurement of success is distinct (such as make money) rather than amorphous (help society).
- Orientation towards results rather than sustainability.
- Solves rather than copes with problems (for example, finding a vaccine for AIDS rather than simply providing help for victims).
- Expenses are lower and known beforehand.
- Investments in socially beneficial technologies by PVCs will attract tens of million of dollars from others in follow-on investments.
- Investors in PVCs will make money and gain the approbation of society for achieving victories in the fights against diseases, pollution and other social ills.
- Tax deductions are not enough of an inducement to attract the money necessary to solve or keep pace with the problems of society. Something new is needed — such as the ability to make money while solving the problems of society.

— Harry Edelson

contact: harry@edelsontech.com website: www.edelsontech.com
Edelson Technology Partners, 300 Tice Boulevard, Woodcliff Lake, NJ 07677 • (201) 930-8900