VC and philanthropy: A vital joining of forces

Some institutions want to make money while others want to help society. Both goals can be achieved through philanthropic venture capital firms (PVCs), an innovative way for investors and philanthropists to achieve financial and humanitarian aims. **BY HARRY EDELSON**

VENTURE CAPITAL — the investment of "sweat equity" and money to invent or discover something that enhances the well-being of individuals and society — is virtually as old as civilization itself, although it didn't evolve into an industry until about 40 years ago. In 450 B.C., the Greek researcher and storyteller Herodotus opined that "All men's gains are the fruit of venturing." Given that practically every invention or service ever created has stemmed from venture capital, it is logical that venture capital can be leveraged to help society achieve its humanitarian goals.

Charitable giving in 2002 rose to $241 billion, according to the "Giving USA" report issued in June 2003 by the American Association of Fundraising Counsel. Charitable contributions continue to increase, but by a smaller percentage than in previous years: While philanthropy grew by large percentages in the 1980s, in the 1990s it increased by only about 5% per year (2002's increase was only 1%). Social problems are now outpacing philanthropy's ability to deal with them. Three innovations can reverse this trend: greater funding for social causes, a more productive use of funds, and new technologies designed to cure rather than just alleviate social ills. All three can be achieved through the establishment of philanthropic venture capital firms (PVCs). These firms can draw on the discipline, incentives, and success of venture capital to solve some of the world's leading social problems. Here's how this can happen:

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• *Greater Funding for Social Causes:* The leverage implicit in venture capital can be of enormous benefit to those interested in solving nettlesome social problems. For example, a $2 million investment by a PVC in an early-stage company developing a cure for AIDS or cancer can ultimately generate hundreds of millions in additional funding from both private and public sources. Investors and philanthropists can enjoy the benefits of leverage by funding PVCs that focus on solving the same social problems that they are addressing. The PVCs can return both principal and profits to philanthropic-minded investors, who can recycle the money into additional social endeavors.

• *More Productive Use of Funds:* Venture capital firms have strict requirements for the companies they fund, including oversight, transparency, frequent financial reports, and a focus on results. Nonprofit donors often encounter fuzzy definitions of "results." But one key metric of venture capital — financial results — is easily measured. Good financial results are a reliable indication that a company is achieving its goals. See accompanying chart for the annual returns for early/seed venture capital firms over long periods.

• *Technology:* Most venture capital investments involve new technology, which helps cure diseases, reduce pollution, and develop innovations like electric vehicles and educational software. Technology holds the promise of solving or greatly alleviating serious social problems instead of merely coping with them (as does the nonprofit community). PVCs and community-based charities can work as a team to identify social problems for which technology can have the greatest impact. The PVCs can focus on investment opportunities in these areas; after the technologies are developed, nonprofit or government organizations can apply them in needy communities to help solve social problems.

A proven model

Venture capital is a proven operating model that will have an immediate and dramatic impact on achieving the goals of philanthropy primarily because of the focus on results. Results are achieved through strict oversight, financial incentives, and good business practices.

Accolades given to donors are usually based on the quantity of their contributions rather than the quality of the results achieved. The donor's conscience is often assuaged by the feeling that duty has been served once the donation is made. Today, this attitude is changing, with donors demanding more accountability for their contributions.

Some charities exert a reasonable measure of oversight, but many do not. Often the focus is more on meeting required annual disbursements (5% of assets) rather than on providing the discipline and oversight necessary to achieve specific goals. Another complaint is that many nonprofits are more interested in perpetuating their own existence than in achieving social results. An article in the *Harvard Business Review* of April 1997, "Virtuous Capital: What Foundations Can Learn From Venture Capitalists" stated: "Foundations generally face little risk when making grants. Far from worrying about losing money, foundations are more likely to worry about not spending enough. In venture capital the all-important metric is profitability, hence results."

The U.S. government has also provided massive funding to develop beneficial technologies, but usually the private sector has done a better job at far less cost. For example, the National Institutes of Health proposed a 13-year plan to decode the human genome. Officials at a private, venture-backed company, Celera Genomics, declared that they could do it in three years — and did. Eventually, the government and Celera Genomics combined forces.

U.S. Private Equity Performance

Net return to investors*
Investment horizon ending 12/31/02

Fund Type	**1 yr**	**3 yr**	**5 yr**	**10 yr**	**20 yr**
Early/Seed VC	-27.6%	-4.7%	51.4%	34.9%	20.4%
Balanced VC	-22.8	-8.0	20.9	20.9	14.3
Later Stage VC	-15.7	-8.5	10.6	21.6	15.3
All Venture	-23.3	-6.8	28.3	26.3	16.6
All Buyouts	-5.5	-5.6	1.1	8.7	12.3
All Private Equity	-11.0	-5.4	7.8	14.8	14.3
Nasdaq	-31.6	-31.0	-3.2	7.0	7.1

* After management fees and carried interest. Data from over 1,600 U.S. venture capital and private equity partnerships with a capitalization of $534 billion.

Source: Thomson Venture Economics/National Venture Capital Association

Needed: More transparency

Many leading philanthropists now recognize that the nonprofit world could benefit by adopting methods used by venture capitalists to ensure that grants are not just spent but *well* spent. Foundations and corporations are certainly more vigilant than individuals about their donations, but more transparency and oversight are clearly desirable. Mario

Harnessing the profit motive

It makes sense from both 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 (make money) rather than amorphous (help society).
- Orientation towards results rather than sustainability.
- Solves rather than copes with problems (e.g., 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 major 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.

Says Alan "Ace" Greenberg, former head of Bear Stearns: "Commonly, VC funds specialize in market segments such as telecommunications, software, and biotech. It is a brilliant idea to have VCs focus broadly on solving the problems of society by investing in life sciences, energy, education, and the environment."

The profit motive helped make America great. It should be applied to solving social ills.

— *Harry Edelson*

Morino, founder of the Morino Institute, a nonprofit organization that explores opportunities to leverage the Internet to advance social change, is a pioneer in this field. Morino recently said: "The way we fund nonprofits prevents them from doing these things well, or, too often, at all. Executives must focus too much on fundraising, not management. Their horizon is often the next grant cycle, not the next performance goal. The standards they are forced to follow deal with programs and process more than outcomes."

The Morino Institute and others — including the Philanthropic Initiative, 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 good 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 highly commendable efforts to improve nonprofit organizations' results are an acknowledgment of the validity of venture capital methods.

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The nonprofit sector lacks a profit motive and has suffered for it. As David Rockefeller has 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 into good causes. Based upon historical venture capital results, PVCs should achieve annual returns of 10% to 30% after expenses.

A powerful elixir

When a major donor makes a grant to a nonprofit organization for a one- to three-year period, the project may not receive additional funds. The venture capital process, on the other hand, is built on many rounds of external financing, including seed, startup, first and second round, mezzanine, and IPO. Each successive financing attracts new and larger investors. This kind of leverage can be a powerful elixir when applied to philanthropic goals.

More than 99% of venture capital firms receive 2.5% or less of committed funds for annual expenses. By way of comparison, the American Institute of Philanthropy, which maintains a charity rating guide, states that it is acceptable to spend as much as 40% on fundraising and administration. Some charities spend less than 5% on desired services, others more than 95%. There is no standard. In contrast, a venture capital firm cannot spend more than its allocated management fee. In some cases, venture firms spend less than the allocated amount. Every year Edelson Technology Partners has voluntarily returned approximately one-third of its expense allocation to its partners.

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

A rewarding alternative

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. PVCs can be an exciting and rewarding alternative for investors and philanthropists who want to make a difference. PVCs will invest some funds 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: PVCs will create technologies that will be applied by more traditional nonprofit organizations. The challenge for philanthropists is to find venture capitalists who 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 make major progress toward solving many of the world's problems.