

THE LEMELSON FOUNDATION

PROGRAM RELATED INVESTMENT (PRI) STRATEGY PAPER

July 2006

A program-related investment, or PRI, is an investment that can be made to a nonprofit or for-profit entity that brings with it the expectation of both social and financial returns. To be classified as a PRI, the primary purpose of the investment must be to further an organization's philanthropic goals, and the generation of income or interest cannot be a significant purpose. The investment must also not be used for lobbying. PRIs generally take the form of loans, but can also be loan guarantees, equity investments, recoverable grants and other financial tools. Rates of return are typically lower than market rate and the terms can be anywhere from a few months to more than 15 years.

The purpose of developing a PRI Strategy for The Lemelson Foundation (TLF) is to further define how to employ PRIs as grantmaking tools that efficiently and vigorously achieve TLF's mission to support inventors and entrepreneurs. We anticipate that implementation of such a strategy will enable us to:

- Significantly increase our impact by making PRIs that are larger than grants, by recycling repaid PRI funds, and by leveraging support through co-funding;
- Assist in strengthening the management of institutions to which we provide support through better knowledge of their administrative and financial systems, and in some cases supplementing PRIs with capacity-building grants that strengthen PRI repayment ability;
- Contribute to the institutional sustainability and long-term viability of these organizations by helping to strengthen their internal revenue generation activities;
- Provide targeted, tangible support for the commercialization of inventions.

This strategy paper proposes that TLF pursue a conservative approach to consistently integrating PRIs as a part of our grantmaking toolkit by investing approximately \$10 million over the next six years in PRIs that align with our organizational mission.

The first section of the paper describes the growing opportunities for social investment and lessons learned by PRI practitioners.

The second section provides examples of how PRIs have been employed historically and more recently by peers in the foundation world.

The third and final section provides a detailed recommendation for how TLF should move forward in implementing a PRI strategy.

1. SOCIAL INVESTMENT OPPORTUNITIES AND LESSONS LEARNED

Various external and internal factors suggest that PRIs can provide new opportunities for TLF to creatively support invention and innovation.

Globally, the majority of the world's capital does not flow to the poor, making it more difficult to support the commercialization of inventions that address the needs of the "Bottom of the Pyramid."¹ While over the past thirty years microfinance has stepped in to fill the gap, the funds available do not nearly meet the need. Market demand for small-scale credit is estimated at more than US\$300 billion, while the supply is only US\$15 billion.² There is ample room and need for additional social investment outside of the bounds of the burgeoning microfinance world.

Throughout this period of microfinance development, the poor have proven to be a good investment, with excellent payback rates. Study after study demonstrates that average microfinance payback rates are 97% or higher. What used to be a niche market is starting to attract large banks such as Citibank, Deutsche Bank, HSBC, ING, ABN-AMRO and others, as they note that investing in the poor can reliably pay market or above-market returns. Thus the risks associated with social investment have, in general, been proven to be smaller than once perceived.

As the demand for social investment has increased, TLF notes that several of its existing grantees have revenue-generating activities that could support loan repayment. Technology Dissemination program grantees including Kick-Start, IDE-India, EnterpriseWorks and Benetech have, or plan to establish, for-profit activities as part of their non-profit operations. These revenue-generating programs may benefit from PRI support while at the same time strengthening the non-profit arms of the organizations.

In addition, we note that while TLF has encouraged grantees to push for commercialization of innovations, commercialization can be expensive, entailing larger amounts of money than we normally give through grants. Assuming that the product aligns with our organizational mission, PRIs may be an appropriate vehicle for commercialization support, providing funding at this later stage of the Idea to Impact framework. It is most likely that an investment in support of commercialization would take the form of loans to grantees that they would in turn use for commercialization purposes, rather than a direct investment by TLF in a business.

¹ The term "bottom of the pyramid" describes the four billion people living on less than \$2 per day, but recent scholarship has focused on the proposition that the fastest growing markets, largest future buying power and most impressive entrepreneurial activities are taking place in this arena. See especially C.K. Prahalad's "The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits" (Wharton School Publishing, 2004) which posits that the continuation of traditional aid work, grants, subsidies and government support will not successfully eradicate poverty, and that the most promising — and profitable — approaches to poverty reduction involve investment in grassroots level entrepreneurs.

² Quoted by Grameen Foundation USA from de Sousa-Shields, Marc & Frankiewicz, Cheryl, "Financing Microfinance Institutions: The Context for Transitions to Private Capital."

Staff also notes that while the Foundation is not short of grant funds currently, making PRIs can enable TLF to increase its development footprint by making larger investments and recycling funds to increase long-term impact.³ In addition, partnering with more experienced PRI makers can help us develop relationships with organizations that can enhance our learning and program impact. Indeed, social entrepreneurs comment that in order to have a greater impact they need more than grant money, and simply need larger sums of money than are generally provided through philanthropic giving.⁴ Such entrepreneurs state that they need risk capital, loan guarantees, and bridge funding in addition to grants.

Lessons learned by PRI practitioners over the years indicate that PRIs can be costly in terms of transaction costs and due diligence, but that costs generally decrease over time and are worth the extra investment because of the larger size, potential impact, and effect on the strength of the investee organization which PRIs can engender.

PRIs are generally the most costly in the initial stages when an organization is learning how to make these investments. PRIs require financial and business reviews and legal advice that are not generally as necessary with grants. Still, some foundations have standardized the process. The Alexander Gerbode Foundation worked with outside counsel to create a “master agreement” that it uses as the basis for all its PRI contracts. The agreement is simpler than the type used by many large foundations and is not meant to cover every possible contingency. Gerbode also has chosen to structure many PRIs as recoverable grants.

Some foundations have chosen to establish loss reserves to account for unpaid or failed investments, but organizations interviewed by the Foundation Strategy Group for a January 2006 study on social investing⁵ reported that significant losses are rare. “Most had begun with the expectation of substantial losses, but found instead that their loss experience was more often in the range of 1% to 3% of the portfolio. Those organizations that have deliberately sought to minimize losses have been able to do so. Other funders may embark on a program with a much greater appetite for risk, deliberately setting loss targets of 10% to 30%, yet several of them reported that their actual loss was substantially below the authorized level.” In addition, “several interviewees found that they had obtained better returns on their (social investments) than on their conventional investment portfolios.”

Loss rates generally relate to the risk level of the investment itself. In the 1970s and 1980s, the Ford Foundation chose to pursue somewhat riskier investments through its early PRIs and maintained a loss reserve of 15% although its loss rate generally did not reach 10%. The MacArthur Foundation pursued less risky options, maintained no loss reserve and did not

³ Most PRIs are at least twice the size of a foundation’s average grant, and often they are ten times larger. For example, the Packard Foundation estimates that their average PRI of \$2 million is approximately 10 times the size of their average grant.

⁴ Social entrepreneurs receiving Skoll Foundation awards for social entrepreneurship in March 2006 commented that risk capital in the form of equity financing can be less burdensome even than grant funding. These entrepreneurs described grants as a transaction in which investors/donors purchase a commodity called a project. Like most consumers, these donor/investors want low overhead and the best price available. Conversely, when providing risk capital in the form of equity financing, donors/ investors are investing in people to create more impact and greater social change, with fewer restrictions.

⁵ Kramer, Mark and Cooch, Sarah. “Investing for Impact, Managing and Measuring Proactive Social Investments” January 2006.

write off any PRI investments in its early years. (The two organization's strategies grew less distinct later on, with MacArthur taking on some riskier ventures as well.)⁶

While PRIs may entail more staff time, the size of PRIs are generally much larger than grants, so staff time per dollar disbursed may not be disproportionate in terms of "per transaction" or "per grant" cost.

In addition, working with a partner organization may reduce costs as partners share the cost of due diligence and drafting legal agreements. Ultimately costs will be reduced as we gain more experience and perhaps the capacity to conduct due diligence and draft agreements internally.

Experienced PRI makers commonly state that an indirect benefit derived from PRIs is the rigor of grantee organizations having to develop financial and management systems that can support revenue-generating activities which strengthen the organizations they invest in and render them more successful in achieving their programmatic goals. Social investment can also enhance the organization's credibility with commercial lenders. Investee organizations themselves acknowledge that the long-term planning needed to support repayment of loans or structuring of equity finance has helped to instill financial and managerial discipline in their organizations.

Finally, PRIs have often resulted in organizations achieving a level of self-sufficiency and financial sustainability that had not previously been achieved. Some of TLF's existing, long-term grantees, such as NCIIA, have the potential for greater financial sustainability, and greater independence from grant-led organizational support. It is possible that newly configured activities in a future NCIIA grant could support the commercialization of inventions addressing sustainable development activities while also resulting in revenue that will contribute in modest ways to NCIIA's own financial sustainability.

2. PRI HISTORY AND BEST PRACTICES

PRIs were initially pursued in the 1970s and 1980s by large foundations such as the Ford Foundation and the MacArthur Foundation. Many early PRIs focused on the development of low-income housing and provided loans or loan guarantees to banks that considered this lending risky. Low-income housing and community development-related PRIs continue to constitute a large percentage of US-focused PRIs.

The Ford Foundation and MacArthur Foundations continue to have large, discrete PRI funds. The Ford Foundation maintains a \$200 million PRI fund that makes loans in amounts ranging from \$1-3 million, typically for ten years at an interest rate of one percent. The MacArthur Foundation has over \$100 million invested in PRIs and makes about \$10 - \$20 million in new PRIs annually, with approximately \$5 million of this going to international grantees. The typical structure of MacArthur's PRIs is a long-term, unsecured loan with a three percent interest rate. The Packard Foundation has a total of \$124 million in its PRI portfolio.

⁶ Brody, Frances; Weiser, John and Miller, Scott, "Matching Program Strategy and PRI Cost," BWB Social Investing Series, 1995.

An increasing number of smaller foundations are giving PRIs internationally, and in sectors that are more akin to TLF's program areas.

Shell Foundation

The Shell Foundation, with an endowment of approximately \$400 million, invested \$2.5 million in Uganda, matched by \$2.5 million from a local bank, to support increased access to modern energy services by small enterprises. The project provides funds to purchase energy equipment for various forms of off-grid electrification efforts including liquid, gaseous, solid fuels and renewable energy — filling a gap where funding was not flowing. Microfinance and large loans were available, but there was nothing in the middle — a market gap in the \$10,000 to \$500,000 range. Within three years of launching, the fund has financed over 50 small to medium-sized enterprises, generating over 5000 new jobs. The portfolio has been delivering a 20% internal rate of return in the local currency. The PRI was supplemented by grants for technical assistance, and the local Shell office provided ‘value added’ and no-cost support in the form of training and business development services.

Sainsbury Family Charitable Trusts

The Sainsbury Family Charitable Trusts consists of a number of independent grantmaking trusts. One of these, the Ashden Charitable Trust, with an endowment of approximately £20 million, made an interest free loan of £100,000 to Tropical Wholefoods. Tropical Wholefoods is a fair trade company which purchases dried fruit and vegetables from small scale producers in the developing world. It builds partnerships with small businesses in Africa and Asia to provide them with improved access to expertise and markets. In lieu of interest payments, the Trust took a one percent (equivalent to £25,000) stake in the enterprise, which it has given to another of its beneficiaries, the Ashden Awards for Sustainable Energy. The loan enabled the Trust to avoid the issues that arise from holding equity and enabled Tropical Wholefoods to grow its business and thereby work with significantly more entrepreneurs in developing countries.⁷

⁷ Bolton, Margaret. “Foundations and Social Investment. Making money work harder in order to achieve more.” October 2005.

The Solar Electric Light Company, or SELCO, was founded in 1995 on the conviction that it is possible to run a profitable business while achieving the social objective of bringing energy services and enterprises to underserved and un-served areas of South India. SELCO has provided reliable energy services (mainly solar lighting) to more than 60,000 rural clients. SELCO's revenues have grown from \$25,000 in 1996 to \$3million in 2005.

SELCO operated on a budget of US\$30 for its first 18 months. The first capital infusion came in 1996 in the form of a "conditional grant" of \$150,000 from Winrock International. The condition was that SELCO only need to repay the grant if the organization succeeded in meeting specific milestones. The grant was repaid with interest by 2001.

From 1997 to 2000 SELCO received \$850,000 in private investment capital and in late 2003 took a loan of \$1million from the IFC. By 2006, however, the organization had run into financial difficulties due in part to the fact that the IFC loan was tied to libor (the London Interbank Offer Rate) + 300 basis points. The loan's interest rate in 2003 was 4.5%. However, libor increased between 2003 and 2005 from 1.5% to 5.22%, resulting in a new effective interest rate of 8.22%.

As Harish Hande, SELCO's Managing Director, states:

"Still much more financial inflow — grant, debt, equity — is required by SELCO to prove models for reaching the bottom of the pyramid. The learning experience of 11 years has helped SELCO to leverage money many times over — thus PRI funds make perfect sense for SELCO's growth. The loan from the IFC (at 8.22%) is killing us and we are looking at ways to replace it by other PRI funds."

SELCO would likely be in a stronger financial position in 2006 had loan capital in the form of a PRI been available in 2003 at below-market interest rates with no additional conditions.

3. PROPOSED TLF PRI STRATEGY

a. Overall Strategy

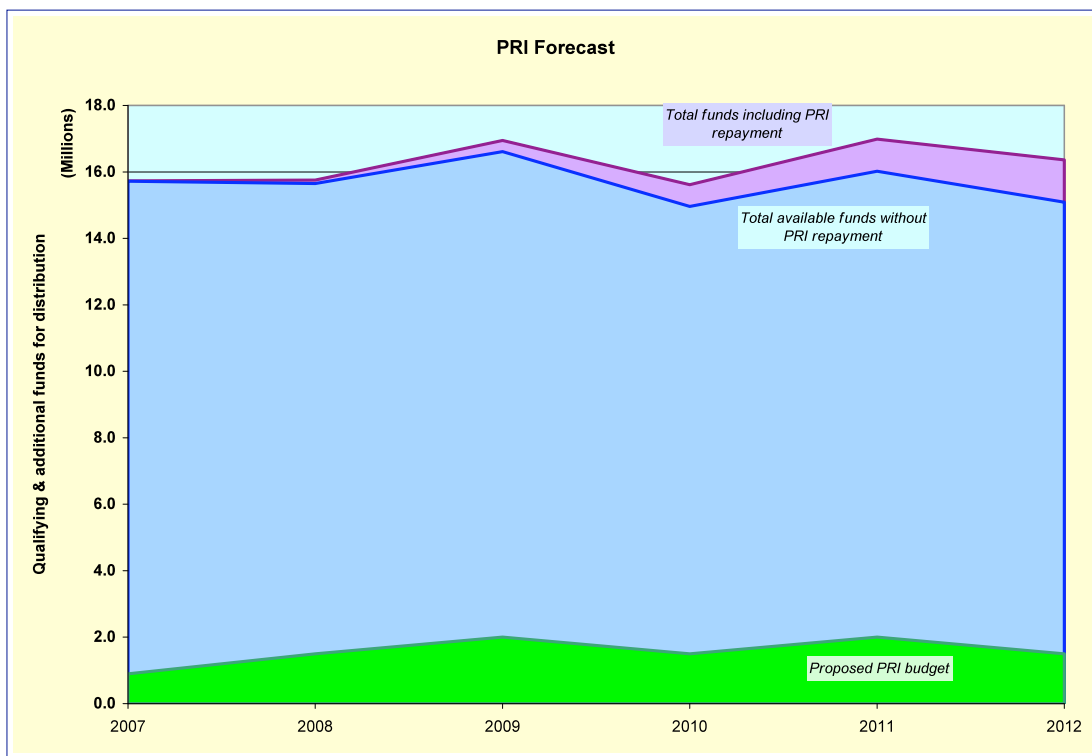
TLF's goal as an organization should be that our partners will have self-sustaining post-grant or post-investment activities — that something will remain after our funding is no longer available. This result is more likely to be achieved by organizations that rely less on grants and more on earned income, revenue generation or other activities that are self-supporting. Investing in social change through PRIs can help TLF to achieve these sustainability goals.

While encouraging the development of institutional sustainability in all longstanding partners, TLF should primarily consider PRIs in the form of loans for any grantee or prospective grantee that has a percentage of their budget derived from income-generating components or that has shown evidence of having borrowed and repaid on loans.

It is proposed that TLF seek to make PRIs for a total of approximately \$10 million from 2007 – 2012, investing conservatively in programs that have proven revenue streams, reasonable expectations for repayment, and where organizational capacity to fulfill the repayment obligation is present or can be easily developed.

The source of PRI funds over the short, medium and long-term is proposed as follows:

1. Short-term: funds from existing grantmaking budget (2007 PRIs) and additional grant funds approved by Board in March 2006 (2008 – 2009 PRIs)
2. Medium-term: possible additional payout after successful experience with initial PRIs (2009 – 2010 PRIs)
3. Long-term: combination of grant funds and repaid PRI funds (2011 and beyond)



	2007	2008	2009	2010	2011	2012
Total qualifying + additional distributions	\$15,721,510	\$15,651,101	\$16,610,948	\$14,958,848	\$16,021,407	\$15,088,033
Proposed PRI budget	\$900,000	\$1,500,000	\$2,000,000	\$1,500,000	\$2,000,000	\$1,500,000
Sample repayment: fixed principal + interest *	\$7,500	\$105,188	\$336,271	\$655,806	\$967,424	\$1,275,292
Estimated number of PRIs	1 - 2	2 - 3	3 - 4	2 - 3	3 - 4	2 - 3

*Assumptions:

2% interest, 6 year term

All PRIs paid on July 1 of each year

Interest payments begin the month following the PRI

Principal payments begin one year following the PRI

b. Selection Criteria

Staff shall establish a “Required PRI characteristics” checklist: a profile of characteristics that PRI recipients must have, including:

- i. **Mission alignment:** Ensure that potential PRI projects are aligned with our mission and programmatic priorities in the same manner as grants, with particular emphasis on the effort being demand-driven, creating both jobs and enterprises, and being financially sustainable.
- ii. **Repayment potential:** Target partners that have the potential to produce earned income from services or products. PRIs will target situations in which market gaps, as opposed to market failures, exist.⁸ All program staff will be more cognizant of PRI opportunities during their grantee evaluations, focusing on organizations that we believe have the ability to generate sufficient income to repay loans.
- iii. **Institutional strength:** Staff will conduct initial assessments of the institutional strength and management capacity of potential PRI recipients through grantmaking relationships. Alternatively, staff will consider supplementing PRI support with capacity-building grants — PRI/grant packages — for organizations that demonstrate PRI potential. Such packages may employ grants to enhance organizational effectiveness, such as supporting staff training or the development of improved internal management systems, or may be used for market development for new technologies.

c. Implementation Plan

TLF should employ a “blended approach” of “building and buying” the expertise needed to make PRIs⁹ by taking the following actions:

- i. **Chief Financial and Administrative Officer:** The Chief Financial and Administrative Officer (CFAO) will take primary responsibility for financial analysis, managing due diligence, contract negotiations and underwriting related to PRIs, although the CFAO may employ consultants for parts of the process.

The CFAO will be responsible for contracting, reviewing, and potentially, over time, conducting due diligence related to financial and organizational performance. The CFAO will work with legal counsel and/or consultants to draft legal and financial agreements. The CFAO will also be responsible for establishing systems to measure the financial return on the investment.

⁸ “Investing for Social Impact: Managing and Measuring Proactive Social Investments” January 2006 distinguishes between *market failures* and *market gaps*. Where grants may be used to address market failures, investments may be an appropriate tool to address market gaps wherein “a viable financial model is possible, but has not yet been developed. Once a viable solution is developed, conventional capital markets may also begin to participate...”

⁹ “Program-Related Investing Skills and Strategies for New PRI Funders” April 2006, Grantcraft.org states that “most investors use a blended approach — buying market analyses, for instance, but building in-house managerial expertise” including training program staff for the credit function of program-related investments.

- ii. **Program staff:** Program staff will be trained in early identification and evaluation of PRI opportunities. Program officers should have basic skills in financial analysis which will enable them to better scout potential PRIs (and will also assist in their assessment of grants). Program staff will also be involved in developing evaluation measures for PRIs that enable easy comparison to the societal measures used to evaluate grants.
- iii. **Board, advisors and experts:** The Foundation may consider forming a subcommittee of interested board members, advisors, and outside experts to guide the initial stages of PRI making, including comparison and evaluation of early PRI opportunities and helping to develop a standard PRI process and protocol.
- iv. **Consultants and legal counsel:** Legal due diligence will be conducted by the Foundation's legal counsel. Financial and management due diligence will likely be contracted in early PRIs to obtain independent analysis of the financial and managerial capabilities of potential investee organizations and to establish initial standards for due diligence. (Over the longer term, the foundation may build in-house due diligence capacity.) The foundation should approach firms with experience in PRI consulting to assist with decisions on how to structure the PRI including establishing detailed financial documentation and milestones.
- v. **Seek opportunities for co-funding and "safe bet" PRI opportunities:** The Foundation will need to determine the degree of risk we want to undertake, both as to the recipients and the investment amounts. It is suggested that we attempt to work with partners, co-funding PRIs in cases where our mission aligns well with others. We should seek partnerships with knowledgeable PRI makers, benefiting from the capacity and expertise of those with prior experience, or, as in the case of PRI opportunities possibly to be considered in November 2006, provide PRIs to organizations with a track record of receiving and repaying PRIs.
- vi. **Measure and analyze:** Staff must develop systems to rigorously measure impact in terms of both social and financial returns from the beginning in order to assess if PRI impact is greater, less, or the same, as with grants. Information on social returns will include data gathering and evaluation of the number of enterprises/jobs created to manufacture/disseminate new technologies, the number of jobs created through adoption by end users, the number of households that adopt the new technology, the number of jobs created through adoption by end users of the technologies, and the amount of income earned by the investee organization as a percentage of its organizational budget and a reflection of its financial sustainability. After two years, staff will also incorporate analysis of our PRI work as part of the already-planned 2008 portfolio review.

4. SUMMARY

It is proposed that the board authorize the further refinement and standardization of a PRI program through its implementation at the funding levels previously described, with initial PRI proposals up to a 2007 limit of \$900,000 prepared for Board consideration in November 2006.