



CENTER FOR CIVIC INNOVATION
AT THE MANHATTAN INSTITUTE

Going to Scale: A New Era for Funding Nonprofits

George Overholser of NFF Capital Partners, a division of the Nonprofit Fund, and Robert Steel, Senior Director, Goldman Sachs, believe that good nonprofits can “go to scale” with a new perspective on nonprofit finance. They argue that an effective capital market can be created for promising nonprofits, with help from financial intermediaries similar to those that encourage growth in the financial marketplace.

INTRODUCTION:

Howard Husock, Director of the Social Entrepreneurship Initiative, Manhattan Institute

For the past five years, the Manhattan Institute has sought to identify new and effective not-for-profit social-services organizations around the country. Our social entrepreneurship award program has recognized twenty such organizations, which are effectively taking on some of the most important and challenging tasks that American society faces: preparing poor children to succeed in school, helping the homeless become part of the economic mainstream, helping prisoners prepare for freedom, and helping new immigrants make the most of their talents.

As satisfying as it has been to identify and recognize these social entrepreneurs, our work raises a fundamental question: If such organizations are effective, how can they grow? In the jargon of the nonprofit world, can good organizations go to scale? How can they serve larger numbers of people who are in need? For many years, there was a widely accepted answer to this question. Donors would support new programs as demonstrations, or “pilots.” It was widely assumed that grants would come with a time limit, beyond which they would probably not be renewed and after which programs

would have to find the means to be self-sustaining. Implicitly or explicitly, that often meant government support.

Today we are in a different era. Many question whether programs that are publicly funded and operated can match the effectiveness of the private social entrepreneur. At the federal level, at least, we face budget deficits as far as the eye can see. The possibility of scaling up through government has been sharply diminished. At the same time, an unprecedented flow of new wealth is coming in to the philanthropic sector. By some estimates, \$6 trillion will be donated by the year 2050. How can we match the effective social entrepreneur and organization? How can nonprofits be held accountable for their performance as they grow?

Two social entrepreneurs have begun the hard and cutting-edge work of thinking through these problems. George Overholser and Robert Steel came to the nonprofit world from Wall Street, and now they’re adapting to the nonprofit sector some of Wall Street’s methods for directing capital to those who can effectively use it.

In the pages that follow, adapted from presentations in New York City on January 18, 2006, they share their views on structurally innovative ways that this might happen.

GEORGE OVERHOLSER

I was recently reflecting about an old friend who has been in the world of social entrepreneurs and capital markets for nonprofits for a while. She described to me what it was like some years ago when she was talking about using private-sector methods in the nonprofit sector. At that time, there was an immunological response along the lines of, “The nonprofit sector exists precisely because markets fail. You are bringing market concepts as if that is going to be a solution. What you’re really doing is injecting business ideas where they ought not to be.”

This conversation has been going on for years. On one end of it are many people who, like me, perhaps went through years of training in business and then washed up on the shores of social-purpose work, clueless about many aspects of what it takes to truly have social impact. On the other end of it are people with long-term careers in the social-purpose realm, entertaining business practices for the first time, which, if adapted appropriately, perhaps can get us all on more sound footing. What an amazing contrast there is between these two worlds.

My buddy Earl Phalen, with the BELL Foundation, based in Boston, underscored this contrast when he told me what it was like launching BELL. He said, “There were two of us. Me and this other guy.” The other guy also had an after-school program that he was trying to launch. They would occasionally check in with each other. For many months, each would report no progress. Then one day, Earl ran into the other fellow and asked, “How’s it going?” and he replied, “Oh, it’s going great. I got ten million bucks.” Earl said, “Tell me what happened,” and the guy replied, “Well, I finally just gave in. I went for-profit. I had a success earlier, so I went to my old funders and in two weeks I got \$10 million all lined up. Now I’m able to build my tutoring organization.”

Both these fellows had something compelling that they wanted to build. They knew that it was not going to work the first day and that it was not necessarily going to work for a number of years. Yet it was so compelling that funders would simply say,

“Please do more of what you’re doing, and we’ll pay you to do what it is that you do.” But in the nonprofit sector, there wasn’t a turnkey source of financing available for Earl. His buddy became so frustrated that he “went to the dark side,” so to speak: he went for-profit. I don’t know what happened with this other guy’s program. I suspect that he may have migrated in the end toward tutoring markets that were able to pay him. Perhaps he is not as mission-focused as Earl, who has been focused for years in the most low-income, needy communities.

That story conveys the fragmentation that exists for social entrepreneurs who are trying to run nonprofits. Here are some interesting statistics on fragmentation. There are three important numbers: 63 percent, 67 percent, and 88 percent. The first number, 63 percent, represents surprisingly good news. It’s the growth over the past ten years in philanthropic giving, adjusted for inflation. There really is acceleration in the amount of private giving in this country. In a world where resources are allocated toward the programs that work the best to accomplish social change, one might expect that there would be some type of consolidation, which is, after all, the name of the game in the for-profit world. In many industries, that’s the natural course of things.

The second number, 67 percent, is the rate of growth in the number of nonprofit organizations. So during this period of rapid growth in giving, we’ve had an even more rapid growth in the number of organizations. In fact, we now have a million nonprofits in this country. The third number, 88 percent, is the increase over the last ten years in the number of foundations with sources of money for these nonprofits. The number of foundations reflects the number of conversations it takes to raise money—and it has gone up most of all!

There is a sense of bewilderment when I speak with folks who run nonprofits. How many \$10,000 checks will I have to raise? All these relatively small checks, instead of \$10 million that I could raise all at once. How many hundreds of funding conversations am I going to have to have in order to get the same \$10 million? In the absence of turnkey, large-

scale infusions of capital for organizations that are trying to grow, senior management teams are distracted by never-ending fund-raising, which precludes the team from building an enterprise that would be compelling enough to attract sustainable sources of funding. So it's a catch-22. Lacking focused sources of capital, the organizations lose the opportunity to become compelling enough to have focused and sustainable sources of funding.

I do venture capital work in the for-profit world, although most of my time is in the nonprofit world. One morning, I was meeting with a for-profit organization that had just received venture capital financing. In the boardroom, everyone was high-fiving, because we got our \$10 million and we were ready to build this organization. But very soon into the meeting, the CEO gulped and said, "Now we're in trouble, because our revenues are zero and we're on the hook to get our revenues to go up." It was a bracing experience to receive this growth capital.

That same afternoon, I went to a nonprofit that received its growth-capital check. It was one-tenth as large—a million-dollar grant, but that's a very nice grant, particularly for an organization that is trying to get going. Everyone was high-fiving, and then something extraordinary happened. The CEO said, "We've raised all the money that we need for the year." His revenue was now \$7 million, and he was already showing a surplus. He said, "I'm reluctant to continue chasing revenues now for the rest of the year because I don't want to show a big surplus in this organization. That would give me problems next year when I go out to do fund-raising. People would say, 'Obviously you're in good shape. You don't need to raise an awful lot of money.'"

What is going on here? In the morning, growth capital is a bracing experience that says, "Let's go grow our revenue-generation capacity," and in the afternoon, growth capital, in a sense, is doing the exact opposite of what it is designed to do. There was a perverse incentive to systematically dismantle the revenue-generation capacity of this nonprofit organization so that it would atrophy. To add insult to injury, those million dollars were used to expand the program and to build a cost structure that was

larger than before. So after the time period of that grant ended, we had the terrible one-two punch of a larger cost structure and a development capacity that had atrophied.

This episode underscored for me that accounting is different in the nonprofit sector. In the for-profit sector, there is a clean distinction between revenue and capital. In the for-profit sector, when you get that \$10 million, the accounting system doesn't call it revenue. The company puts it on the side. It is like getting your battery charged. The metaphor I like to use is that we're going to charge up the battery while the company learns to build a combustion engine, and we hope that the battery won't run down before the combustion engine is ready to vroom. What keeps the combustion engine going are the customers who say, "I like what you do. I want to pay you to do what you do."

In the nonprofit sector, when money comes in—whether it is for capital purposes or whether it is money just to pay the organization to do what it does—it is called revenue. In the nonprofit sector, it's all just money, as far as the accounting is concerned. This masks one of the primary goals that we need to have in place. Capital builds the capacity of the firm to please philanthropic customers so they will say, "I'd like to buy some tutoring from you on behalf of these kids in Dorchester." As a provider of capital, what I'm looking for is: Did we sustainably enhance this firm's ability to do good in the world? For example, here is \$5 million. Can you become so compelling in the eyes of other people that instead of serving 100 kids a year, you're serving 1,000 kids a year?

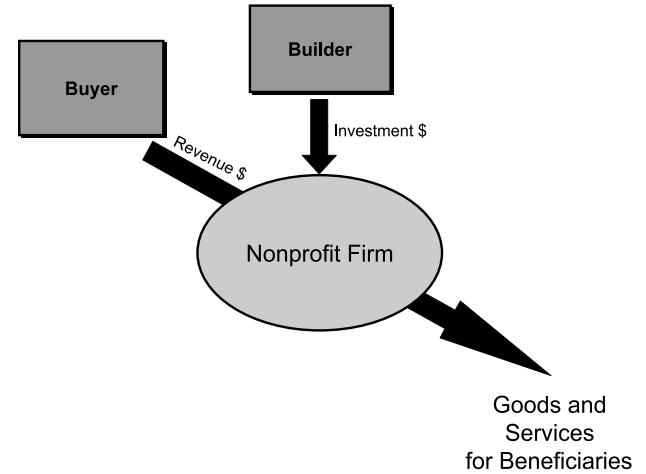
There are stories about what many of us think of as capacity-building grants versus what I view as the role of growth capital. Aside from paying for things like bricks and mortar, computers, and so on, growth capital pays for mistakes. In both for-profit and nonprofit worlds, growth capital goes into the operating budget and pays for the learning process. As a result, it is very difficult to categorize growth capital in terms of the exact use of proceeds.

One story I want to tell is about David Olds and the Nurse-Family Partnership. David Olds is

one of the real gems of people in the sector whom I've met over the past five years. In 1977, he came up with the idea that if we could get nurses to visit the homes of low-income, pregnant teenage girls, perhaps we could help the girls cope with this disruption and achieve better outcomes in their lives. David was able to raise some money to start testing this idea. He is an academic social scientist who said, "I'm going to do this right. I'm going to do a tremendous amount of evaluation work." So for nearly thirty years, David tested the program scientifically in three different cities, over three time frames, in three different types of populations. He discovered a number of things. For example, when he tried to replicate a program that worked in one city, it didn't work in the other city at first. He discovered that not all the young women were benefiting from this idea; he was able to determine which of them had a psychological profile that made the support from the nurse more efficacious. He created a screening methodology so that when money was spent on the program, it would really make a difference. It took almost thirty years and a lot of money—growth capital.

Even though he had proved that the program worked, he had not yet learned how to tap in to sustainable funding. In his case, the sustainable funding was government. Showing me a binder, he said, "It took me years to create this binder. It lists thousands of pots of money that exist throughout state and federal government—the labyrinth out there. It took me years to learn, first, how to identify these sources; second, how to approach them; and third, how to persuade them to write checks that would simply pay us to do what we do." Even though he had a program that worked and science to prove it, he had not yet learned how to go to market.

But he did learn, because David now has over \$100 million reliably coming from a diverse set of primarily public sources. He serves 11,000 young mothers each year by this program. Because he has such good science behind it, he can show that although \$100 million is spent on this program, the taxpayer has a relieved burden of \$288 million due to lower incarceration rates and fewer emergency-



room visits. He has the return on investment well spelled out, and he has a sustainable source of funding that is highly diverse and bankable. Let me name the funders, because we should always applaud patient capital: the Robert Wood Johnson Foundation, the Colorado Trust, the W.T. Grant Foundation, and the National Institutes of Health provided the \$28 million of growth capital over the nearly thirty years that it took for him to become compelling enough to actually roll this program out.

How do we do this faster, instead of in thirty years? How do we make funding more turnkey? There are many answers, but the approach that I have been using is one of a private placement agency function. This is something that exists in the for-profit world that we should be adapting. At the Nonprofit Finance Fund, we're launching something called NFF Capital Partners. For our clients, we're trying to raise money up front and do capital campaigns, which is not a new idea. Perhaps what's new is to position the capital campaign as growth capital. We'll say that the growth capital is \$15 million and that it wasn't to pay for this truck, this training program, or this brick and mortar; its purpose was to pay for the deficits incurred en route to sustainability.

For one of my clients, I had to work with the board to do this, but we got there. For internal accounting purposes, we broke out the revenues associated with the \$15 million. We called it extraordinary revenue and carried it below the line,

as they say, so that we could expose that, in fact, we had zero revenues in each of several newly-launched branches in other cities. We will measure success toward our goal of sustainability as the rise in these recurring revenue sources in each of the respective cities. We will measure the depletion of the \$15 million as the difference between what we are able to raise locally in the cities and what it cost for us to be in those cities, so that in the end the lines will cross. The operations in the cities will pay for themselves, and we will no longer be depleting the \$15 million.

This is just how venture capital works. You get this battery charged, and you draw down on the capital through what's called a burn rate, betting that eventually the customers will end up paying for what it is that you do so that the capital will no longer be paying for what you do. The positioning was very successful. We did raise the \$15 million, the launches are happening, and the progress is continuing. We have quarterly reporting.

Let me describe how this can work in general and how it is perhaps different from the old world. We've shifted the financing for a nonprofit from the program level to the enterprise level. We've gone from raising growth capital in small increments, in many small checks, to one large capital campaign up front. For a nonprofit, it is hard not to listen acutely to a funder's agenda and then try to modify what you're doing to become more attractive to that funder. But we said, "This strategy is so sacred that we're going to have a single strategy and we're going to ask multiple funders to sign up for the one strategy." We went from multiple contracts to a single

contract that was shared. We created a syndicate. The NFF Capital Partners is in the business of trying to surface deals like these. We call them deals. A sustainable source of revenue is usually accomplished through a combination of fee-for-service orientation as well as diversification, so that even though the funders in the diversified world may be one-time funders, collectively they are reliable.

We are finding organizations that have a great social purpose, combined with a vision of sustainability that they just haven't reached yet. We then structure an investment opportunity in the form of a capital campaign. We work with these organizations to tap in to networks of receptive funders. We coordinate the mechanics, but then—very importantly—we also have an accounting treatment that monitors progress toward sustainability, compares it with the original amount of growth capital, and asks, "Is the growth capital gone? If so, have you accomplished the goal of sustainable enhancement?"

ROBERT STEEL

When I left Goldman Sachs a couple of years ago, I went to see my good friend John Whitehead and we began to ruminate on the fact that the not-for-profit world had a financial market that was inefficient and expensive. We thought that this was not dissimilar to the financial markets in our country if one looked back several decades. As George Overholser notes, it costs a lot to raise money. Depending on which organizations you examine, as much as 20 percent of the capital raised is chewed up by the expenses of raising the capital. My first

INVESTMENT	REVENUE	GROWTH CAPITAL
Flow of money	Flow of money	Pool of money
Episodic	Perpetual	Episodic
From financial partners who seek to build the firm	From paying customers (often "third-party payers")	Fed by investments, loans, and surplus revenue
Expands the pool of growth capital	Purchases the provisions of goods and services	Covers the deficits incurred en route to sustainability

reaction was, “I wish Goldman Sachs could charge those rates. We’re stuck at 4, 5, and 6 percent.”

John and I also reflected on the fact that ongoing management time is required for fund-raising and for rebuilding a nonprofit capital base, which doesn’t seem to be a good use of executives’ time. An executive should be able to get on with the business of running his or her organization. We started to think that there should be an entity, which could be a financial intermediary, to encourage the growth of a financial marketplace, not dissimilar to what intermediaries like Goldman Sachs, Morgan Stanley, and others have done in the capital markets. What would this entity be like? What skills are needed that such a financial intermediary could produce?

My lens on this issue was Goldman Sachs. Inside Goldman Sachs, we do advisory work, we do research, we advise on mergers and acquisitions, and we do capital-markets work. We could imagine any one of these activities or skills being valuable in the not-for-profit world. People talk about the need for rating agencies or the equivalent thereof, and they talk about the need for consolidation. We thought that any of these skills might be needed, but the one that we started to work on right away was what I would call a capital market’s activity—that is, something that involves getting capital from suppliers of capital to users of capital in an efficient way so that these organizations that can put the capital to use in the best way have the highest odds of getting the capital.

John and I invited four or five colleagues of ours, former Goldman Sachs people, who were involved in the not-for-profit world to a dinner, and we started to brainstorm on this idea. The next thing we did was hire Bridgespan, the nonprofit specialty arm of Bain Capital, to help us think about the idea. Tom Tierney, a good friend, took this on personally and helped us think about this marketplace and how we might approach it. After several months, we became interested in certain types of institutions in the not-for-profit world: organizations that had the potential to grow, but were limited by access to capital.

In my Goldman Sachs world, I spent decades finding companies that had good ideas that had been

proved, finding them capital so that they could grow to a great degree. We can all think of an example, and it doesn’t matter which one is your favorite—Restoration Hardware, a restaurant, or any type of retail idea. There are lots of people who, once you have proof of concept, are excited to support you because you’ve proved that you have a business model.

The number of nonprofit organizations that I decided fit this pattern is surprisingly small: probably substantially fewer than 100. Among this small number are organizations like College Summit, City Year, JumpStart, and Teach For America. I believed that if they had access to capital so that they could grow, then they could expand their business model and there wouldn’t be a dilutive effect to the growth; rather, there would be a complementary effect. These organizations were spawned in cities, in local areas, and applied their skills in those very narrow areas. But if they could be liberated to think about growing in a more national way, that was something that should be fueled. There was opportunity for these organizations, if they had access to capital, to scale dramatically.

So I had identified and started to talk about the users of capital. But then I had to walk to the other side of the equation and think about the suppliers of capital. Who are they? This is where Tom Tierney’s work was helpful, because this is the area I’m least certain about. There are a large number of people who are quite philanthropically minded but are unsure of how to spend their dollars. They are in a muddle as to reporting and success, and they would like an intermediary that could be a kind of a screen for them.

What are the characteristics in an intermediary that these wealthy individuals would like? They want a defined mission and a clear business model. The organization’s leaders know what they do; they can describe it to you, and they are very sharply focused. They’re not adjusting their mission for the next funder. It’s codified, described, and anyone can read it: Like it or not, this is what we do. The second vital thing is good governance, in the sense of a board of trustees, chairs of boards, and auditing. The third

key factor is good management: an executive director and a staff that you have confidence in and that can run the organization. The fourth is a commitment to metrics and measurements of outcomes and a declaration in advance of what these measures are. It does not matter so much what they are—only that they are identified and don't change and that people are committed to them. The last thing that these nonprofits need is an interest and an enthusiasm for regularly reporting to stakeholders about how they're doing, relative to their previously declared measurements and ambitions.

We decided that if we could find that cocktail in an organization, we're interested in raising tens of millions of dollars for it. This would not be about envelopes with hundreds of dollars. Instead, you go into the marketplace, you identify individuals, you invite them to meet with management, you present them with a business plan, and you invite them to invest a million or a half-million dollars over several years. These philanthropists should then receive reports and information. The financial terms and conditions would be similar to what George describes. One closing, one set of docs, and everything organized in that way.

Basically, the idea that we were investigating was whether there is a marketplace and whether the philanthropists would respond. But there's a big difference between saying this and doing this. Our test is to get in the field with an organization to see if we can raise tens of millions of dollars, and the declared purpose for the organization is to execute an expansion plan that has the characteristics that I mentioned: mission, governance, management, outcomes, and communication.

If organizations are willing to do that, are there funders who will respond? My hunch is yes. Clearly, some of them are going to be people like me, who have a background that's related to markets, measurements, and outcomes. There are many people who, in the last decade, have been successful. If you look at the creation of foundations among them, there is an interest in being philanthropic that exceeds the opportunities. In other words, people want to do more than just give to their local library.

My goal is to develop a group of people who view the intermediary as a screening technique. For instance, an individual, a family, or a couple might say, "We're really interested in early-childhood education." It's quite imaginable that the privilege of providing growth capital to JumpStart, or a similar organization, would be exciting to them.

I have been working on this with a colleague of mine, Chuck Harris, who has been the chairman of College Summit. In the next few months, we will do a test run, or a proof. The goal is not to tap cronies who will give because we ask them to. That's not a real test. Instead, we're going to places where we don't know people. We might get access to them because of who we know, but in the end we want to get in front of people and do a more objective study to see if this really can engender giving.

As Tom Tierney often says, an amazingly large amount of money is "gifted at death." There are many younger philanthropists, or potential philanthropists, with large net worths and good consciences. If presented with ideas that they have confidence in, with the characteristics I mentioned, will they respond? We're betting that they will and that this will be a real spur of growth for the whole not-for-profit area.

QUESTIONS AND ANSWERS

MR. HUSOCK: What if the shoe were on the foot of the potential philanthropist, rather than you thinking, "How am I going to market College Summit?"—which, by the way, is one of five organizations profiled in a recent article in *City Journal*, so the Manhattan Institute thinks very well of it, too. It's one thing for you to market their proved concept; for example, if I have some money and want to buy stock, I know how to do that: I go to my broker. What if I don't know you and I've never heard of College Summit? What is going to be the stock-market equivalent that will bring in the unorganized money?

MR. STEEL: In the last decade, we've watched the equivalent of new marketplaces being created, often to the benefit of technology, but people want

to have access and feel part of a group of people who are seeing these types of opportunities. Most networks, once they get to a critical size, begin to grow. So the question is, do you begin with 500 people whom you might build as a list of potential philanthropists? And as those 500 people have access and see these opportunities, will there be a spreading of that network by word of mouth? These people have much in common, and they traffic with one another. It's no different from the client base of people who are buying high-end financial services.

Assuming that we're successful, our business model won't look that different from any other financial intermediary, where there are certain people within the firm who focus on the investor and investing side. Over time, you develop relationships, and people look at you as the source of either capital or ideas. Tom Tierney started Bridgespan. I think that they provided initial help but are not connected in any legal way today.

MR. HUSOCK: What about the psychology of givers? We all know that foundations like to discover things themselves and nurture those things from seedling to tree. Are you, in effect, asking them to change their psychology and accept a group report? That implies that they're not as central to the universe of the recipient.

MR. OVERHOLSER: Jim Andreoni, an academic, wrote, I think, a seminal paper that looked at Christmas gifts for children. He interviewed many children and discovered that children got far less value out of the Christmas gifts than their parents did. He called this the "warm glow" theory of philanthropy. He explained that philanthropy is just as much about pleasing the giver as it is about accomplishing the social goals that are more antiseptic. If Jim Andreoni has the "warm glow" theory of philanthropy, maybe George Overholser has been espousing the "cold shower" theory of philanthropy.

I remember meeting with a venture capitalist one time—actually, I was with Rob Waldron, the CEO of JumpStart. He had spent years trying to get a meeting with a prominent man who is an active philanthropist in the Boston area. Rob finally scheduled the meeting and said to me, "George, I

want to bring you to this meeting because you can talk the lingo. You can talk about the venture-capital framework as applied to JumpStart." About four minutes into the conversation, this very nice gentleman said, "Just stop, please. I'll tell you what. I just want to help the kids, and when you get this capital-market thing out of your system, why don't you come back and we can talk about helping the children."

Clearly, it was not a great experience, and at first I was a bit chagrined because I was thinking, "You, of all people, a financier, should understand this. We need you to understand this." I thought about an article that I had read in the *New York Times* about the Legal Aid Society here in New York, which, with a \$150 million budget (I think), had terrible financial problems. It had a \$29 million bailout, which is shocking, but even more shocking was the comment from the board chair, which was, "We never discuss deficits in the boardroom. We never review financials in the boardroom." Why? Because it would mess up the giving experience of serving on the board. It would be a cold shower on the warm glow. This is a problem that we need to overcome. Item number five on Robert's list is communication: I hope that people will get pride in bragging rights out of having given rise to the most prominent household-name organizations that serve this nation's social needs. I'm hoping that that's going to provide quite a warm glow.

MS. SARAH HOROWITZ: I am executive director of Working Today. Mr. Steel, what you're doing is compelling, because the market itself exists in small places: Fidelity, for instance, where people are parking their C3 status contributions, not yet deciding where they want to put the money. As a nonprofit person all my life—and also a legal aid lawyer for several years—I am very suspicious of altruism being the only motivation for giving. There's some economic reason to believe that something can be sustainable.

The nonprofit sector isn't only about the 501C3 deduction so that people can make a charitable contribution and then take a deduction; it's actually looking up the market chain. So if you could think

about foundations doing program-related investments, for which they will give you a loan at 1 percent, you can imagine that there is a vast amount that you could be doing.

I think of College Summit, which has the fees; at Working Today, we generate fees from providing health insurance; Fair Trade Coffee certifies labor and organic standards.

MR. STEEL: If you look at this marketplace, there is a great need for skills and efficiencies. It is a question of where you start giving advice and best practices to organizations that would benefit from shared activities and those kinds of things. If you would ask John Whitehead, he would tell you that there should be organizations that do all the things that Goldman Sachs does for the for-profit marketplace, helping the not-for-profit marketplace over time. It is merger advice, it's research, it's corporate-finance work, and it's finding the cheapest place to get debt. We're starting with one specific aspect of the financial markets for one specific type of client. It's a beginning; it's not very many people; it's far fewer than 100. But if we can help these people, this would be a big bang that would accomplish a lot in a relatively short time.

MR. OVERHOLSER: It's far fewer than 100, but I see many social entrepreneurs, as well as organizations that have been around for a long time, who are positioning themselves now for this type of financing. If I have an early-stage organization in my venture world and we're thinking about going public, someone from Wall Street will show up with a checklist and say, "Here's what you need to look like to have access to the public market." We're busy working backward from those checklists, and I'm watching several organizations in the pipeline, so my hope is that while it might be a handful today, five years from now there will be more.

We've been talking about playing the role that equity plays in the for-profit capital market, which doesn't exist in the nonprofit world. I joined up with Clara Miller at the Nonprofit Finance Fund because she has some of the other pieces already in place. She has \$50 million in debt already out there—these PRIs, for example—and we also have an advisory

business that I am responsible for, where we advise 200 nonprofits a year just on financial matters. So it's a very similar concept to the one that Robert is talking about. It's creating, in a sense, the investment bank that the nonprofit sector has not had.

MS. NANCY TRUITT: I am from the Tinker Foundation. How do you evaluate the organizations to which you give? Do you use such things as Give.org and Charity Navigator? If so, how useful are they?

MR. OVERHOLSER: I love Robert's list of five. It starts with a crisp definition. That's what I do, and I've done it enough so that I know I can execute it. I've shown people not only that I can execute it here, but also that it can be replicated: great governance, proven management team, outcomes that are measured, and the willingness to communicate. I hope Robert will permit me to use that list with attribution in the future. But one of the benefits of writing large checks—I don't write the checks, but I assemble investors who do—is that we can afford to conduct due diligence in an in-depth way.

One problem we have, as a sector, is that we're stuck in the middle. The size of the checks that even foundations write are relatively large compared with the retail side of individual gifts, which are still too small to allow for deep due diligence. So I believe in separating the capital funders who do very high-engagement types of due diligence from all the others, who are simply saying, "Well, what do you do? Tutoring? That looks great. I'll buy some tutoring, and I'm not going to do deep due diligence."

MR. HUSOCK: Charity Navigator would be one relatively basic metric of operating cost versus administrative overhead, which might tell you something, but you wouldn't call that deep due diligence, would you?

MR. OVERHOLSER: No, and one of the roles of capital is to pay what it takes for a nonprofit to become good at communicating what it does. Right now, we have a system of proxies. The overhead rate is a very misleading proxy. Rolls Royce has a lower overhead rate than Saturn. Does that mean that it's thriftier to buy Rolls Royces than it is to buy Saturn

cars? I don't think so. So we have to be very careful about automated arm's-length ways of drawing conclusions. I much prefer having a high-engagement proxy, having an intermediary who can actually do the work and understand things more in-depth.

MR. ANDY FISHER: I am from the Lavelle Fund for the Blind. Have there been any broad studies of social entrepreneurship to date—not just of a few high-profile spectacular successes but of the broad field of social entrepreneurship and venture capital?

MR. OVERHOLSER: There has been broad debate and discussion. I don't know of formal studies. I will speak for one portfolio that I know intimately: the New Profit portfolio.

MR. HUSOCK: New Profit is a funder based in Boston and in Virginia.

MR. OVERHOLSER: Well, no, it is just in Boston and is earlier staged. These are organizations that have not yet accomplished the five points on the checklist that Robert described, but they are still moving toward that checklist. This New Profit portfolio has done fabulously well with, I think, nine organizations, where each has grown tremendously and has improved the diversification of the revenues. It has not only grown but has sustainably grown and is on a sure footing, with better management, stronger government, and stronger outcomes measured than before. It's not a systematic look, but when they're hitting nine for nine, I would love to have a portfolio like that in my venture-capital work.

MS. JESSICA STANNARD-FRIEL: I am writing an article for *onPhilanthropy*, an e-newsletter aimed at professionals in the nonprofit and philanthropic sector. Mr. Steel, you said that in your current project you're looking for people like yourself, with backgrounds in markets, measurement, and so on. Would that suggest that you think that corporate funders are a potential source of capital funding? What are the advantages and disadvantages to the corporate funders as well as to the market at large?

MR. STEEL: In general, our view of our suppliers of capital are not the corporate marketplace but wealthy individuals who are people whom you can connect with and have a relationship with. Your

ideas or the organization's resonate with them personally. The data suggest that large numbers of people have had very successful financial situations in their lives and are interested in finding a way to scratch their philanthropic itch. This is one that we're going to have to figure out. I've seen lots of examples for which you have to push a lot of doorbells to find the people—and that just might be the case here—but they self-identify over time.

I don't think that the corporate philanthropic world or the very organized large-scale program-officer-led foundation is likely to be of interest. We're doing something different from what they do. I don't know if people agree with that, but that's how we're thinking about it.

MS. PATTY CALABRESE: I am chief financial officer of the Wildlife Conservation Society. What both speakers said certainly resonated with our experience at WCS. We had an extraordinary opportunity: we were approached by a high-net-worth individual who wanted to give a major grant to conservation, and he had the funding to provide his own due diligence. He hired a group of experts in the field to kick our tires and spent about three weeks with us. He came up with a report that, on the one hand, was wonderful in that it recommended the donor put his capital into our organization. On the other hand, it also gave us an outsider's view of all the things we needed to address, which were mainly management and infrastructure issues. So it became one of the guides to how we would use a portion of this individual's gift. This individual was also willing to allow a portion of his gift to be used for administrative services—administrative recovery, overhead, whatever you want to call it; it gave us an infusion of cash to do the kinds of things we needed to do in the field to better manage our organization.

This individual was also willing to make this gift unrestricted, so that the gift was for our international conservation activities. He didn't care, frankly, where we put it. He was expecting us to make the judgments as to which places we thought we could do the most good. He also told us that the gift was "X amount and after that, you guys are on

your own, so you'd better come up with a plan to become sustainable." This has been both a challenge and a joy, and it has generated the capital on the administrative side to help me better manage my organization and, of course, has provided a lot of program growth.

It has been our experience that it's the high-net-worth individuals, rather than the foundations, who have that kind of mind-set to make it relatively unrestricted, not particular to a particular project. It is they who are willing to recognize that there are administrative costs that are part of running good programs, so that has been a great opportunity for us. Those people are absolutely out there. As a consequence of this gift, in our capital campaign we began a global conservation venture-capital fund along the lines that you've described. The ticket will be half a million dollars-plus a year, and we already have the beginning of it. So far, we have three donors who are, again, high-net-worth individuals who have signed up. It is working.

Ours is a 100-year-old institution that had never accessed the capital debt market, and our trustees were loathe to cross that line. Again, since we had to go to rating agencies, we wanted to have a ratable borrowing, using that as another way to learn how to express what our business model was all about, and test it in the bond market, as another way of looking at our governance and our management and having to make that story to rating agencies and bondholders.

MR. HUSOCK: George, Patty used an interesting phrase: "After that, you guys are on your own." I wonder if that scares or emboldens you. You have made a distinction in the past—build versus buy—and you're talking on the build side. Could you talk about the buy side a bit and what happens after someone says, "After that, you're on your own."

MR. OVERHOLSER: The donor whom Patty spoke about sounds like a very nice guy; I'd love to meet him sometime. By my nomenclature, he would be a builder. He's providing equity-like capital. I'm amazed that he said, "You are on your own." I would have expected him to say, "We are on our own," in the sense that he has joined the team at that point.

He has joined the team in building a firm, which will live or die based on its ability to be compelling enough to attract the types of folks who will want to continue to fund where it goes. It's the battery power for you to build the combustion engine. Very often, low-engagement folks pay for you and that's the only way you can live; if everyone were high-engagement, it would be hopelessly chaotic.

MR. STEVE FELDMAN: I am president of Green Demolitions, a donation program for a charity called the Answer to Addiction. We raise money by taking items from houses that are being demolished or renovated. We then sell those items and use the proceeds for our charitable projects. This program began in Greenwich, Connecticut, five years ago. How important, when you look at a charitable program, is sustainability, where you're putting that capital money in, knowing that the charity is looking to raise its own money? When I started the program, I wanted it to be sustainable and self-funding in the long term. How important is that when you look at a charity?

MR. OVERHOLSER: It's of vital importance. I'll use the David Olds example. Here's \$28 million, all intended to make the organization attractive enough so that there will be a sustainable \$100 million per year forever. Think of the return on investment there. The \$28 million creates perpetuity of \$100 million. You could ask, "What throws off \$100 million a year? Ah, a \$2 billion foundation." So \$28 million gets you something that is equivalent to \$2 billion. That's a very nice return on investment. Many organizations last forever, and you could say that they've been sustained. But do they have a healthy financial setup, or do they have a hand-to-mouth existence? It's more than just sustainability; it's having a business model that lends itself to the continued focus toward excellent execution and toward the continued growth in the number of lives that can be affected by what can happen. So what we really look for is a business model that is aligned beautifully with the work.

MR. HUSOCK: I suppose if we were to take the capital-market idea further, then New Profit would be investing in—

MR. STEEL: Early stage.

MR. HUSOCK: It might be investing in organizations that fail, too. The steady stream of funding might eventually run out because the organization has fulfilled its purpose. That is part of the creative destruction of the real private sector if we were to take the analogy even further.

MS. EMILY MENDLEMARKS: Many venture-capital growth firms put someone on the board of the organization that they invest in. Is that part of your plan? There are many not-for-profits, even the very successful ones and the growing entrepreneurial ones, that need strong board members, particularly with a financial background.

MR. STEEL: What we're interested in would not include that. It might be imaginable that we would have a representative of our group on the board—that could be one of us or it could be one of the investors—but it wouldn't be an automatic assumption.

MR. OVERHOLSER: I would say the same thing for the earlier-stage work, the type of work that the venture philanthropy folks are doing. That work does require a lot of problem solving and a lot of changes in strategic direction, so board involvement can be very helpful there in stewarding the investment on behalf of multiple investors. We're really working with later-stage organizations for

which one of the conditions for an investment is that this governance is very strong. The other condition is that there is a feedback loop, so it's possible to not have a board member but still have information rights. The information rights say that we need to have access to all the information that the board has about the progress that is being made relative to the goals of the investment. We need to feel confident that the accounting system is up to the task, which is often one of the toughest things to find out there. That's why there are not a hundred organizations on the list. It is short.

MR. STEEL: The point that Ms. Mendlemarks just made about the need for good board members should be highlighted. It is something to which we should all be committed. You could have another session in this room about the need for stewardship and for good board members. At Goldman Sachs, we've created a program for younger successful professionals—thirty- to thirty-five-year-olds who are doing well at Goldman Sachs. We've developed a two-day program at Harvard to teach them how they might find and connect with organizations, and we give them the skills that they need if they are on the audit committee of an organization. That's a big contribution that these organizations would like to do better. They need people to help them do better, and that is what good board members can do.

CONTRIBUTORS:

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George Overholser is one of the founding partners of Capital One Financial. He is today the founding managing partner of NFF Capital Partners, an arm of the Nonprofit Finance Fund, which provides analysis and capital financing for nonprofits on behalf of some 170 funders. For the past five years, he has worked almost exclusively with nonprofits, collaborating with a wide range of organizations to help them manage difficult transitions. He has worked as well on a theoretical framework for how to adapt traditional financial concepts to the nonprofit sector.

Robert Steel retired as vice chairman of Goldman Sachs in January 2004 and currently serves as a Senior Director of the firm. He has moved full throttle into the nonprofit sector, serving today as the chairman of the Board of Trustees of Duke University, his alma mater, and as a senior fellow at Harvard University's Kennedy School of Government. He also chairs the After School Corporation and is chairman-elect of the Aspen Institute. His writing has appeared in the *Washington Post* and the *Financial Times*.

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