UNIVERSITY OF SAN FRANCISCO

CHANGE THE WORLD FROM HERE

Designing Sustainable Economic Models
For Impact Investing Organizations

by

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Capstone Research Report Submitted in Partial Fulfillment
Of the Requirements for the
Master of Nonprofit Administration Degree
In the School of Management,
directed by Dr. Marco Tavanti

San Francisco, California
Summer, 2020

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Abstract

The purpose of this project is to contribute to the newcomers in the impact investing sector to guide how to build a sustainable economic model. Private equity is the most commonly used investment vehicle in the for-profit sector, and Venture philanthropy is in the nonprofit sectors. The two sectors experts had different approaches and perspectives on the purpose of doing impact investing and on the financial returns orientation. This research revealed that there are four other purposes of making investment besides making more financial profits to the investors. Those purposes include seeding, filling gaps, Scaling and catalyzing. The research also revealed that the advantages of using nonprofit entities mainly can be focusing on maximization of social impact, and creating a less pressure working environment for the employees. In contrast, the advantage of choosing the for-profit entities, can be regulatory flexibility, and provide compensate employees with more competitive ways, and reach higher opportunity to get large funding. This report will move onto summarizing findings on different investment strategies from different asset classes, such as grant, private equity, and debt to impact themes, market size, and to risk management. Finally, the report will conclude with the five steps of building a sustainable economic model. The five steps are from understanding the purpose of impact capital, building a system that allows capital to flow in the right directions, making good investment decisions to build a good track record, generating and measuring the expected financial and social returns, and finally being able to recreate the investment process repeatedly.

Acknowledgments

I would like to thank each of the professors who helped me with this capstone project, especially by expanding my view and knowledge of the US nonprofit sector: Marco Tavanti, Richard Waters, Louise Carroll, Nicholas Almeida, and David Greco. This capstone project would not have been possible without your support.

Marco, your flexibility and creativity have always given me the power to think big and to move toward bigger dreams. Richard, over the last few months you have taught me frameworks on how to collect, analyze, and produce reports. Without your help, I would never have been able to complete a report. Louise, the standard for strict and meticulous reporting that you instilled in me during the early days of the MNA program taught me how to work hard to communicate well in the English language. Nicholas, thank you for providing your expert perspective during the interview. Your balanced perspective about the nonprofit, for-profit, and public sectors provided a framework through which I could take a neutral view throughout the Capstone project. David, I am incredibly grateful for the guidance and support you gave me during the time we worked together. From the first time I heard you speak in class, I was struck by your passion and expertise regarding nonprofit financing. It is an honor to be able to take a step closer to the field of impact investing with you. Thank you again for giving me an opportunity.

I appreciate the full-time and part-time students with whom I shared various experiences and views during this program. I was able to learn from your experiences and insights in the nonprofit sector. I believe all of you ultimately make the world a better place to live. Especially Megan, you helped make my experience in the MNA program very enjoyable and academically fulfilling. I have no doubt that your intelligence and compassion will positively impact the nonprofit sector.

Also, I would like to express my deep gratitude to the experts, Doug Duckjun Lee, Jed Emerson, Brian Trelstad, Hyunjoo Je, David Lynn, David Samuels, Timothy Freundlich, and Phil K. Yoon, who shared their deep insights and experiences on this project. In particular, Duckjun, the time you dedicated, along with the philosophy and experience you shared, led me to a deeper understanding of the field. I am sure your profound thinking and experience will serve as an example for many people in the future and will bolster your pioneering leadership in the field of impact investing in Korea.

Lastly, I am eternally grateful to my loving family and friends who always care for and support me, taking the time to continually check-in and offer their affection and encouragement.

Foreword

When I worked as a journalist back in 2017, I had the opportunity to visit the beautiful island of Zanzibar located off the coast of Tanzania. During my time there, I made a documentary which explored a social enterprise called Seaweed Center. This enterprise aims to solve the ongoing issue of reduced seaweed production in the region, which is a direct side effect of global warming. Seaweed Center also creates job opportunities for local women who otherwise would not have a chance to get a job because of cultural and religious reasons. However, due to the fact that they still heavily rely on manual labour with limited access to automation, their production costs remain high, and they are located far away from the mainstream capital market and cannot generate high returns. The company has struggled to get attention from mainstream investors.

If they are able to secure adequate funding from investors, this might enable them to boost their impact. In turn, this will lead to an increase in the creation of more job opportunities for women, building a strong infrastructure to increase productivity, growing distribution channels to sell more products, and ultimately resulting in an increase in financial returns which will trickle down to the local community.

With unsolved questions lingering in my mind, I came to the US and started to study nonprofit administration at University of San Francisco. Here, I had an eye opening experience in the class "Nonprofit Finance" with Professor David Greco. When he talked about the concept of impact investing, it was a serendipitous moment for me because this solution aligned with the unsolved questions I continued to grapple with. He said "impact investing can not only help social companies grow up, but also make investors earn money!" I believe that if we can generate financial returns, the mainstream investors might be interested in funding those social companies. With this type of capital, a company like Seaweed Center can have access to enough funding to scale their business.

After expressing my interest in impact investing, Professor Greco gave me an opportunity to work with his organization, All Stars Helping Kids, to design an impact investing fund. The goal of All Stars Helping Kids is to create an impact investing fund to support education and healthcare oriented companies so that underserved children in the Bay Area can access better education and healthcare services through aid from portfolio companies. I was excited to accept his offer and I started to grapple with several questions: What exactly does an impact fund entail? Is it possible for these types of organizations to create sustainable economic models given that "doing good" is not often seen as profitable in business? So I started to dive deeper into research about representative noproprofit impact investing organizations, and I stumbled upon a nonprofit called Roberts Enterprise Development Fund (REDF). REDF is a US venture philanthropy that invests exclusively in the growth of social enterprises focused on employment to provide more job opportunities for low-income communities. Their main instrument is making grants, lending money, and providing technical assistance to portfolio companies. I looked up their 990s form to better understand how their economic model functions.

I found that 98% of their revenue came from contributions, and less than 2% of their total revenue comes from earned revenue. At this point, I wondered whether organizations that solely relied on donations could be sustainable economic models. Then, I looked at their expenses. I soon realized that REDF spent most of their expenses on grant making. From this, I was curious whether grant making activity can be seen as an investment in

organizations that are doing impact investing. These questions led me to come up with three different research questions:

1. How do economic models of impact investing organization function differently in the nonprofit and for-profit sectors?
2. What are the different perspectives on impact investing by nonprofit and for-profit leaders?
3. How to design a sustainable economic model for an impact investing organization?

In light of these, the main purpose of this capstone project is to help newcomers in the nonprofit sector understand what impact investing is and how they can design sustainable economic models for their own organization.

Methods and Approaches

This capstone project is a required component of the Master of Nonprofit Administration degree at the School of Management at University of San Francisco. The total duration of the research is about three months, from June to August 2020. Three main research methods have been used for this research: literature review, data analysis, and expert interviews.

Literature Review

Through literature review, I focused on better understanding impact investing and its development over time, investment funds and their structure, economic models, and investment methods. Given the COVID-19 pandemic, an exceptional situation, all literature was found using offline sources and based primarily on online research. The literature was primarily gathered through Google Scholar and the Gleeson Library at University of San Francisco. When conducting the literature review, I searched using important keywords. For example, when searching for papers about the economic models of impact investing funds, I used a combination of keywords in the search box: “impact investing” AND “investment fund” OR “impact fund" AND “economic model.” The main keywords I used were: “impact investing,” “impact fund,” “economic model,” “venture philanthropy,” “venture capital,” and “program related investment.”

I referenced *The Power of Impact Investing: Putting Markets to Work for Profit and Global Good* by Rodin and Brandenburg as a resource that provides a general view of the impact investing sector, and *Impact Investing: A Brief History* by Trelstad to understand how the impact investing field has developed over time. *The Purpose of Capital* by Emerson helped me maintain an objective perspective to avoid favoring one argument over another. I referenced the report, “From the Margins to the Mainstream Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors,” published by the World Economic Forum to understand various asset classes. I also referenced a report from the Global Impact Investing Network (GIIN) titled “A Guide for Impact Investment Fund Managers: Designing an Impact Investing Fund” to better understand how the economic models of impact funds function. To benchmark the traditional structure of venture capital

economic models, I referenced two books: *Venture Deals* by Feld and Mandelson, and *The Business of Venture Capital* by Ramsinghani. In addition, I refer to articles that provide various perspectives on the overall sector from journals such as the Stanford Social Innovation Review and Harvard Business Review.

Scope

After completing the literature review, I learned that impact investing is incredibly broad in scope, encompassing a range of asset classes, themes, and financial and social orientations. This makes it difficult to specify what exactly constitutes impact investing. As a result, I first focused on specifying the scope of my project, and I achieved this by focusing on three guiding research questions: 1) What are the most commonly used entities in the field of impact investing? 2) Can these entities represent the for-profit and nonprofit sectors? 3) What are the most frequently used asset classes?

Using these questions, I narrowed down the scope to three different entities: impact funds, impact debt funds, and venture philanthropy. Below, I further define these three entities in the way they will be used in this report.

1. **Impact funds** refer to the investment fund raised by an impact investing firm that uses equity as its asset class to make investments. Impact funds can include the private equity model or the venture capital model, and oftentimes it is a for-profit entity.
2. **Impact debt funds** refer to the investment fund raised by an impact investing firm or organization that uses debt as its asset class to make investments. Impact debt funds can be raised by nonprofit organizations or for-profit organizations.
3. **Venture philanthropy** refers to nonprofit organizations that are involved in impact investing and use various asset classes such as equity, grants, and debt. Venture philanthropies are nonprofit organizations that use charitable money to do their investments.

For the data analysis, I focused on about 30 different impact funds and venture philanthropies which are actively mentioned in the various articles I referenced. I contacted each organization directly, hoping to set up interviews with high level employees such as CEOs, CFOs, partners, founders, and presidents. Out of all of the organizations that I reached out to, the following eight organizations were willing to interview with me and were included in the scope of the project: Roberts Enterprise Development Fund; All Stars Helping Kids; Impact Assets,; Mission Driven Finance; Yellowdog; D3 Jubilee; Bridge Fund Management; and Big Basin Capital. I realized that impact funds tend to have similar economic models, regardless of the country in which they are located, so I decided to not focus solely on the US. I included two impact funds and one venture capital firm based in South Korea because 1) South Korea's impact investment industry has been growing rapidly in recent years and 2) Korean impact investors were very flexible and willing to dedicate themselves to support this research. Further, I was able to leverage my Korean language skills when researching and interviewing these Korean impact investors.

Limitations

Through this research, I was only able to interview and collect economic model data from eight organizations over the three month period. This eight company sample does not represent the overall impact investing field. As such, this report represents findings based on only these eight organizations and does not represent the whole sector.

Data Analysis

To research the economic models of the final impact funds and venture philanthropies I chose, I first referenced each organization's website. If the organization was a nonprofit, I looked at their financial statements and/or 990s forms to better understand their financial structure. With for-profit organizations, financial statements are not published publicly so I conducted research on these organizations using other sources such as published impact reports and other news articles I could obtain. From this initial analysis, I divided the impact investing organizations into six different categories based on how oriented they were to either maximizing financial or social returns. These six categories are: 1) traditional venture capital, 2) impact private equity, 3) impact venture capital, 4) impact debt, 5) venture philanthropy, and 6) traditional nonprofit. These six categories show a spectrum of emphasis on financial return and social impact. Traditional venture capital is focused on maximizing financial returns, while on the other side of the spectrum traditional nonprofits are focused on maximizing the social impact of their organizations.

Expert Interviews

I interviewed a total of ten experts. Eight of them represented the eight organizations included in my research. Combined, they have more than 20 years of experience in the field of traditional investment and impact investment. The ten experts are headquartered in locations throughout the United States, Britain, and South Korea, and their organizations cover a wide array of impact themes including education, healthcare, energy, climate and environment, and many others. Each interview was conducted either via Zoom, email, or in person. The interviews lasted between 30 minutes and six hours, with a total interview time of 14 hours.

For two of the experts, I called upon personal contacts at the University of San Francisco to serve as interviewees, Professors David Greco and Nicholas Almeida. Additionally, Dr. Marco Tavanti introduced me to Timothy Freundlich so that I could conduct an email interview with him. The last seven professionals were all contacted through their organization's email or through their personal social media such as LinkedIn and/or Facebook.

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Section 1: Introduction

Impact investment has been an emerging topic for the last few decades in the for-profit and nonprofit sectors. The size of the entire market is growing year over year, and impact investment has begun earnestly in many countries that, to date, have not been mainstream players. According to the Global Impact Investing Network (GIIN) 2020 Annual Impact Investor Survey, the impact investment market is approaching $715 billion in size.

This report begins by asking whether All Stars Helping Kids, a nonprofit organization based in Santa Clara, can develop an impact investing fund to create more social and financial impact through its grants-receiving nonprofit portfolio companies. In light of this question, this research paper attempts to show the various ways in which nonprofit organizations, such as All Stars Helping Kids, can build an impact investing organization or an impact fund.

While individual investors, family offices, and nonprofit organizations are increasingly interested in impact investing, information about building impact investing organizations or impact funds is not readily accessible. Despite having sufficient resources, many players in the nonprofit sector, regardless of their interests in impact investing, have difficulty accessing important information which explains the different types of impact funds or organizations to collaborate with when impact investing. Therefore, this research project is designed to address this problem by providing crucial information about economic models that should be considered before impact investing, both for individuals and organizations in the industry.

In Section 2, this paper will primarily define various terms, including the different asset classes that are most commonly used in impact investing. Further, we will give a general idea of how an impact fund's economic model is structured.

Based on interviews and surveys of various organizations, Section 3 of this report will address different perspectives on investment in the for-profit and nonprofit sectors. After that, we will cover some factors that must be considered when creating a sustainable economic model for an impact investing organization. Those factors include the purpose of investment, economic model, financial returns, legal entities, asset classes, investment strategy, risk management, and employee compensation.

Finally, this report will provide four key recommendations to implement when building a sustainable economic model for impact investing organizations.

Section 2: Literature Review

2.1 Impact Investing Definition and Background

The definition of impact investing has developed over time. A broad but commonly used definition of impact investing is defined by the Global Impact Investing Network (GIIN) as "investment made into companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return." Impact investing can be performed by various players, including individual investors, nonprofit foundations, and financial institutions.

The concept of impact investing dates back to the 19th century (Rodin 2014). When religious institutions attempted to avoid investing in "sin" stocks, such as those in the tobacco or alcohol industries, they started to screen the sin stocks, which led to the development of socially responsible investments (SRIs) in the 1970s. SRIs are a pioneering concept in investing that consider social and environmental returns along with financial returns. They often use publicly traded stocks as an asset class to make investments. SRIs served as a bridge between traditional investing and impact investing. The term "impact investing" was first coined at a conference convened by the Rockefeller Foundation in 2007 (Rodin 2014 p.31). Since then, the impact investing market has grown rapidly. According to the GIIN, the impact investing market has grown from $25.4 billion in 2013 to $715 billion in 2020 (GIIN 2020).

2.2 Impact Investing Across Asset Classes

When investors consider how to allocate their capital, they first consider which asset classes will be most relevant to their investment. An asset class is "a grouping of investments that exhibit similar characteristics and are subject to the same laws and regulations" (Investopedia 2020). In the traditional financial marketplace, equities (stocks), fixed income (bonds), and cash are considered the three main asset classes. Investors can buy a publicly traded stock, a bond to generate financial return, or they can make a cash deposit in a bank to generate interest while preserving their principal. Today, in addition to the three main asset classes, commodities (real assets) are considered to be a fourth asset class. In impact investing, asset classes are similar to those in traditional financial marketplaces but add some other financial instruments, such as grant support, private equity, loans, and guarantees. Asset classes in impact investing are distinguished by their financial return orientation. For example, as shown in Figure 1, asset classes such as private equity, public equity, fixed income, cash, and guarantees are used by investors to achieve market-rate returns. On the other side of the spectrum, asset classes such as grants, loans, and equity are used by investors to achieve below market-rate investments.

Figure 1: Impact Investing Asset Classes by Global Impact Investing Network (GIIN 2020)

According to the GIIN 2020 Annual Impact Investor Survey, 294 impact investors, who collectively manage $221 billion, responded that 21% of their assets are under management using private debt as their primary asset class, while 19% use public equity and 17% use private equity. However, "private equity is the most common asset class, with 70% of impact investors having at least some allocation, while 59% of respondents are active in private debt" (GIIN 2020 pp. 51). In this report, we will delve further into the two most used asset classes: private equity and private debt.

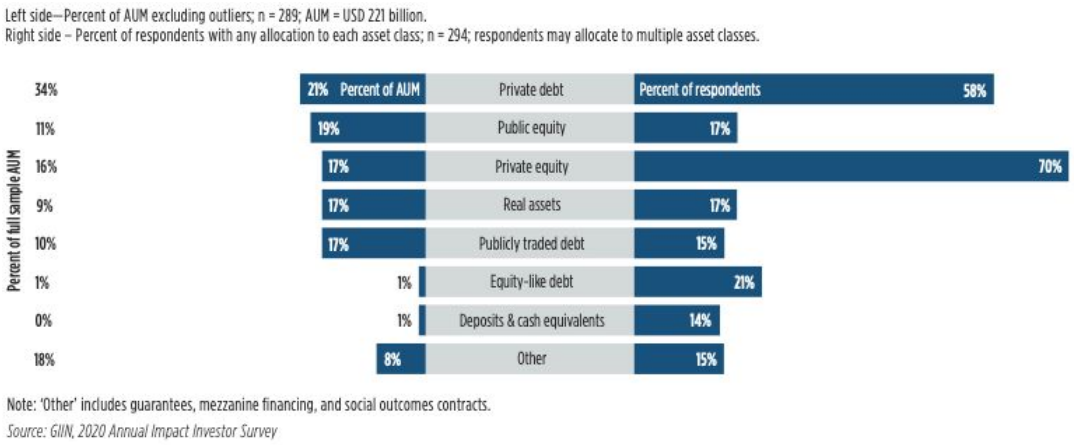

Figure 2. Impact Investing Asset Classes used situation (GIIN 2020)

a. Private Equity as an Asset Class

Private equity, more commonly referred to as "equity," is the most common investment instrument used by impact investors. When investors invest in a company, they are buying a portion of equity of that company. As the company is not publicly traded, the fund owns a portion of a company's equity privately. Then, once the investee company attains a certain level of maturity, the fund can decide to sell the portion they bought previously to the market and generate profits.

Impact funds are a tool for private equity investors. An investment fund can be defined as a "consolidated pool of capital from numerous individuals or financial institutions, collectively invested in a portfolio of investments" (GIIN 2020). Impact investors are raising funds to invest capital to impact enterprises which have social and/or environmental missions. Mainstream investors, such as institutional investors, banks, and governments often find that impact companies require too small a sum of money to invest via private equity investment funds, so they opt instead to invest through investment funds.

The concept of private equity impact investing funds originated from traditional venture capital and private equity. In traditional marketplaces, venture capital funds invest in enterprises at various stages, including seed-stage, mid-stage, and late-stage. Normally, seed-stage funds provide the first investment to the impact companies in the investment rounds up to Series A. The size of seed-stage funds generally range up to $150 million per fund. Mid-stage funds are those that typically invest in Series B and later rounds. The size of mid-stage funds generally ranges from $200 million to $1 billion in size. Lastly, the late-stage funds are generally doing the last financing before the company goes to initial public offering (IPO) (Feld and Mendelson 2016). The private equity funds are different from venture capital in terms of the size, as well as the stage in which they invest in companies. Private equity funds invest in mostly matured companies, usually with investments of more

than $100 million in a single company. The investment process used by private equity funds is often called “buy-out.”

b. Overview of a Typical Structure of Private Equity Impact Investment Fund

Similar to an equity fund, such as a venture capital fund or private equity fund, there are three main components that structure a private equity impact investment fund, as shown in Figure 3: the Limited Partnership, General Partnership, and Portfolio Company.

First, the Limited Partnership (LP), also called as limited partners (LPs), provides the main investment source for the fund. When a fund manager mentions the “fund,” or that their firm raised a fund of $X, the fund manager is actually talking about a limited partnership vehicle that contains the investors in the fund. Financial institutions, banks, development finance institutions, pension funds, insurance companies, family offices, individual investors, private foundations, and nonprofit organizations can all be limited partners for an impact investing fund.

Second, the General Partnership (GP), or the general partners (GPs), are the main investment professionals who are actively engaging in the main investment activities from fundraising to deal sourcing. An investment fund is generally managed by GPs.

Finally, the Portfolio Companies are impact oriented enterprises which receive investment from GPs. In impact investing, portfolio companies can be for-profit and nonprofit entities.

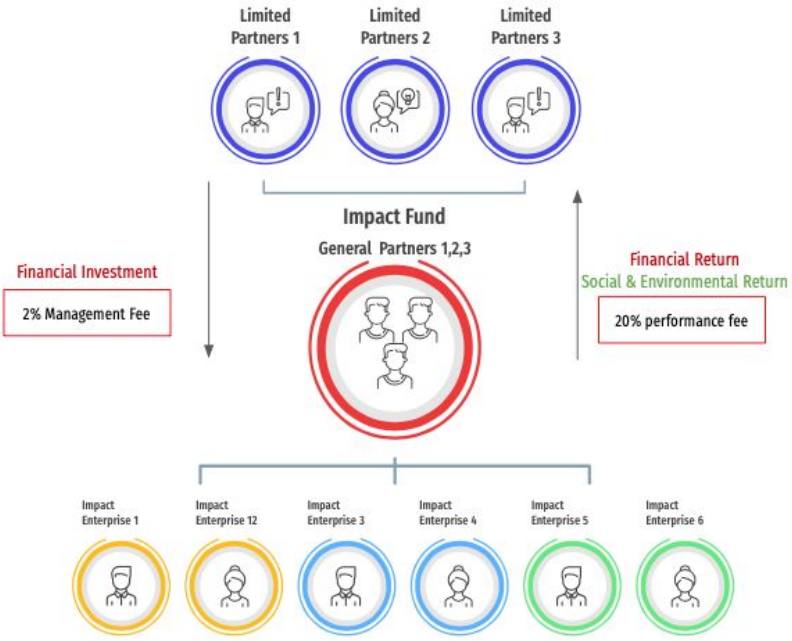

Figure 3: Impact Fund Economic Model Structure

c. *Management Fee and Performance Fee Structure*

Once a private equity impact fund successfully raises capital, the management fee is arranged. The intention of a fund management fee is to finance the operational costs of the fund, and to compensate the managers, including investing partners and other staff, for their time and expertise for managing portfolios.

Management fees can range from as low as 0.5% to more than 2.5% of committed capital. The fee is paid during and after the commitment period, which is the period of time when the fund can make new investments. Fund managers receive an upfront fee of 1% from LPs to fund launch costs and then receive the remainder of management fees later (GIIN). The investment period varies from 5 years to 10 years, depending on the portfolio strategy, and these fees are collected annually (Feld & Mendelson 2016). For example, if a fund raised $100 million and was committed to have a 2% management fee for 10 years by the LPs, the fund will receive a total of approximately $20 million as the management fee and $80 million as the investment capital. Most of the time, the fund will receive management fees annually after investments are made into the portfolio companies.

The management fees are used to cover the fund's expenses and payroll for managers and staff. The fund's expenses include legal expenses, audits, administration, and communications. These expenses “should account for less than 0.5% of the fund” (GIIN 2020). Payroll often accounts for the largest percentage of fund operating costs. Payroll is an important factor in the operating budget, and it is calculated by the day-to-day level of time spent by managers performing due diligence, screening, and other administrative tasks.

While the management fee is paid to meet the fund’s operation needs, the performance fee is dedicated to compensate fund managers for their investment performance as an incentive. A performance fee, also called Carry, is a payment made to the fund managers for the profits that the fund generates through equity investment in a company. The profit is usually generated by exit, such as selling the company to a corporation, or going to an IPO.

The private equity impact funds follow the typical 2-20 management and performance fee structure present in traditional venture capital. This means that the fund will get around 2% of the total committed investment capital as a management fee per year and 20% of the profit generated after finishing investment as a performance fee. For example, if a fund invested $100 million in a company and successfully returned $300 million, then they have $200 million in profit. In this case, the principal $100 million goes back to the LPs, and the remaining profit of $200 million, 80% will go to the LPs and 20% will go to the GPs. Finally, the private equity impact fund will get $40 million as performance fee and the LPs get the remaining $160 million (Feld & Mendelson 2016 p.134).

d. *Raising Multiple Funds*

Raising multiple funds can be a strategy to collect new management fees. Most venture capital firms raise new funds every three to four years, with some venture capital firms raising funds even more frequently (Feld & Mendelson 2016). While traditional venture capital firms can raise funds such as an early-stage fund, a growth stage fund, or a China fund, impact investing firms can create multiple funds which can be education funds, climate change funds, or regenerative economy funds.

By raising multiple funds, impact venture firms can stack up the fees across the funds. If an impact investing fund raises a fund every five years, it has a new management fee that adds to its old management fees. Feld and Mendelson comment that "although venture capital firms tend to grow head count (Partners and staff) as they raise new funds, [...] the head count rarely grows in direct proportion to the increased management fees" (Feld & Mendelson 2016). As a result, "the senior partners of the venture capital firm see their base compensation rise with each additional fund" (Feld & Mendelson 2016 p.133).

2.3 Impact First and Financial First Investors

Impact venture capital, venture philanthropies, and other types of impact investing organizations exist by pooling capital from numerous investors. Those investors are often "financial institutions, corporate pension funds, large corporations, banks, educational endowments, high-net-worth individuals, fund of funds, charitable organizations, family offices, and insurance companies" (Feld & Mendelson 2016 p.131). Despite investing financial capital in impact investing organizations, not every funding source has the same purpose and return policy for the investment. For example, some impact investors, such as foundations using program-related investment money to invest, and wealthy individuals who are interested in venture philanthropy, can prioritize social or environmental returns on their investments over financial returns, while institutional investors seek to optimize financial returns because of the fiduciary duty.

This financial and impact spectrum led to a distinction between "finance-first" and "impact-first" investors. Institutional investors, such as pension funds, insurance companies, and investment banks are typical "finance-first" investors. In contrast, charitable organizations, such as foundations, are "impact-first" investors. Impact venture capital funds are more accessible since capital is pooled from institutional investors, and venture philanthropy funds often raise money from foundations, high-net-worth individuals (HNWIs), or family offices. Bridges Fund Management, an impact private equity firm focused on investing in tech-oriented startups, is an example of a firm raising impact private equity funds which raise money from institutional investors. On the other hand, the Acumen Fund, a venture philanthropy fund focusing on companies in developing countries to tackle poverty, is raising money from foundations and HNWIs.

2.4 The Characteristics of Various Funding Sources

The advantage of raising money from institutional investors is being able to access larger deal sizes. The fund can raise a large amount of capital, compared to doing so with individuals or philanthropic organizations (WEF2012 p.31). However, the fiduciary duty that comes with having access to a larger amount of capital can negatively impact general partners in impact venture capital funds by creating pressure to generate above market-rate financial profits, and GPs may also not attempt to invest in high risk opportunities even though they have the potential to have a large impact in society.

In contrast, the advantage of raising money from donation-based charitable investors is that funds have "the flexibility to pursue risky investments that demonstrate the potential for social impact and financial sustainability without the pressure of attaining traditional venture capital returns" (Batavia, Chakma, Masum, and Singer 2011 p.67). Also, it gives the fund "more space for innovative approaches, trial and error, sector development

activities, pre-seed deals, highly contextualized impact analyses and investments in regions where purely commercial funds would not be able to get involved" (WEF 2013 (b) p.31).

2.5 Program-Related Investment

Program-related investments (PRIs) are below market-rate investments made by foundations to support nonprofit and/or for-profit organizations that involve charitable activities aligned with the foundation's mission. A PRI can be defined as "a loan, equity investment, or guarantee, made by a foundation in pursuit of its charitable mission rather than to generate income" (Brest 2016 p. 19). A PRI is regulated by the US Internal Revenue Code, similarly to grants. In other words, foundations do not expect to generate market-rate returns when making PRI, and sometimes they generate returns below the level of the principal they invested (Brest 2016). PRIs take many forms, including loans of guarantee, grants, or equity investments.

The Internal Revenue Service has defined criteria that regulate the use of PRIs (IRS 2020):

1. The primary purpose is to accomplish one or more of the foundation's exempt purposes,
2. Production of income or appreciation of property is not a significant purpose, and
3. Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose.

The Rockefeller Foundation pioneered the use of PRIs in the early 1990s. It supported the field of impact investing by founding GIIN, as well as serving as the anchor investor for philanthropic impact investing funds such as Kiva, Acumen Fund, and Root Capital (The Rockefeller Foundation 2013). Acumen Fund is also considered a pioneer among venture philanthropists. In 2001, Acumen raised its first investment capital by targeting foundations and philanthropists as primary limited partners (WEF (b) 2012 p.31). Other examples of PRIs are low-interest or interest-free loans to low-income communities, high-risk investments in affordable housing projects, and low-interest loans to small and medium sized businesses owned by economically disadvantaged people (IRS 2020).

Section 3: Data Analysis

3.1 Venture Philanthropy

Venture philanthropy usually refers to a nonprofit organization raising philanthropy capital to invest in impact enterprises. The philanthropic capital can be grants, contributions, program-related investments, or other charitable assets. It is the most common vehicle for nonprofit organizations to do impact investing. Venture philanthropies mainly consist of three parts, as shown in Figure 4: philanthropic investors, venture philanthropy, and social companies. When philanthropic investors make donations or program related investments to venture philanthropy, they are making grants to their portfolio companies. It is very similar to that of a venture capital fund, in that they can take equity from the investee company but the final returns have to go back to charitable organizations and cannot be dispersed privately. Since the assets used by venture

philanthropy organizations are charitable assets with restrictions, it is imperative that all financial returns stay in the organizations.

Conversely, if an organization did not take any equity position but did grant making, the investee company is not required to pay back any financial return, though they are duty bound to create committed social and environmental outcomes. In venture philanthropy, if grant making is used as the main form of investment, then there is no management and performance fee structure in place. Instead, their economic model functions very similarly to general nonprofit organizations.

Venture philanthropy can make investments in both nonprofit and for-profit companies. However, because the assets used by venture philanthropies are the charitable assets with restrictions, the returns must stay within the organizations. In the US, most venture philanthropies use charitable assets and perform under the 501(c)(3) tax-exempt status.

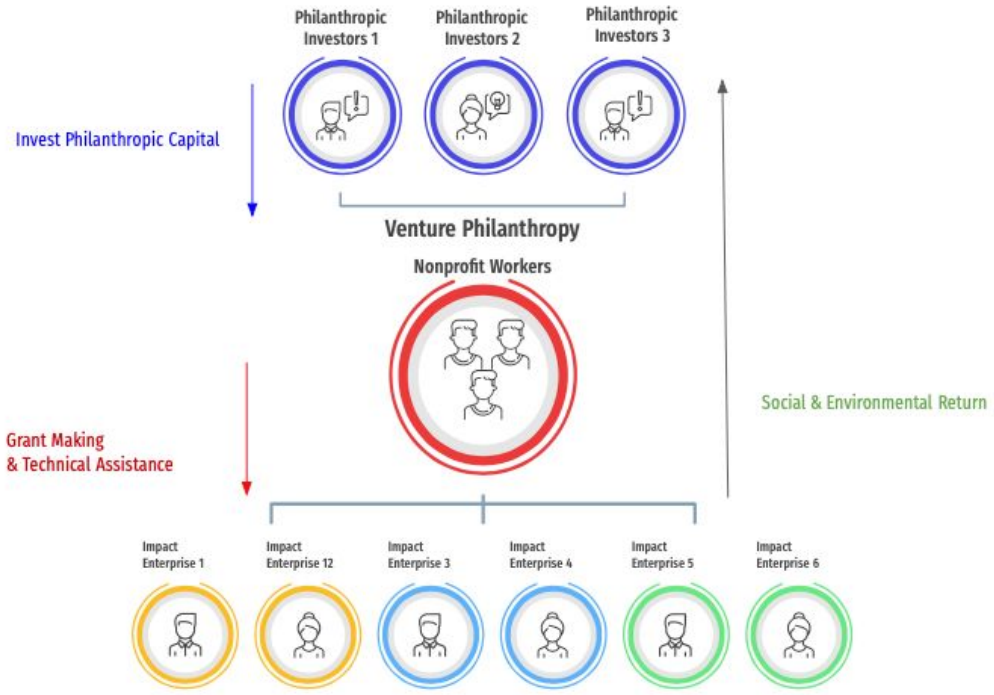

Figure 4: Venture Philanthropy Economic Model

3.2 Different Perspectives on 'Investment'

There are many arguments about whether venture philanthropy is actually impact investing because the term 'investment' can take on many definitions. GIIN defines impact investing as an "investment made into companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return." Here, the definition of investment assumes a situation in which there is a financial return. One expert in the for-profit sector explains that "[i]n venture philanthropy, you are not investing money in companies but giving away the money." According to his explanation, when referring to an activity described as 'investment,' we should generate a

financial return. Another expert in the same sector also notes that "many of the venture philanthropy firms are saying that they are doing impact investing, but what actually they are doing is just grant making. Making grants is not an investment; an investment is needed to get value back." Both experts assert that when the word 'investment' is used, it necessitates that value is created in the form of financial return, and this aligns with the GIIN definition of impact investing, which requires a financial return.

Unlike the investments mentioned by the two experts above, the investments made by venture philanthropies often do not make any financial returns. Using the term 'impact investing', REDF is making grants to its portfolio companies. They proceed with 'investment' as a form of donation. In the definition of investment which asserts that financial return is a necessary component of investing, grant-making cannot be considered a form of investment. This is because the principal invested by the REDF is not only left unrecovered, but also does not generate any financial return for the organization.

So, can the term investment only be used when a financial return is produced? The Cambridge English Dictionary defines investment as "the act of putting money, effort, time, etc. into something to make a profit or get an advantage, or the money, effort, time, etc. used to do this." Under this definition, investment is not necessarily limited to the act of creating financial value, but value can be created in other ways as well.

If we go back to the case of REDF, David Samuel, CFO at REDF, explains "[w]e are giving them money and giving them advice on how they can actually use that money and grow their businesses effectively. The grants we make are not recovery grants. Most of the recipients are nonprofits that have no equity structure to give us. We are not taking a piece of equity. What we are asking for in return is social impact so we are truly social impact investors." REDF aims to create pure social impact through grant making and impact investment.

Let us take a closer look at the social impact that REDF aims to create. REDF invests $100,000 or $200,000 a year in each social enterprise in its portfolio with business consulting that helps grow the social impact of that social enterprise significantly. As a result, REDF's social enterprises are showing a compounded annual growth on average of 15% a year, and they successfully employed more than 10,000 people last year. Samuel also notes that "those 10,000 people are not going to the emergency room, not going to the provisional officer, not being incarcerated. What the $100,000 or $200,000 and only 8 hours of consulting week will get the social companies in terms of social return in impact is outstanding compared to many other governmental social investments" as it relates to helping underserved groups of people Through investment, REDF is attempting to create jobs so that people can improve their standing in life. They are trying to use the charitable money to help grow sustainable social businesses, thereby fostering quality social jobs in their portfolio companies and improving their ability to pay their employees living wages. Jed Emerson, the founder of REDF, explained during his interview that "[t]he investment we made is to build a field of practice and a knowledge [base] and really [show] people that you can do this and [think about it] differently. I would argue that the value that fund created in that ten year period in terms of catalyzing millions of dollars [...] and that's a very significant return. We contributed to the growth of the field in that way."

Both impact funds and venture philanthropy can be seen as making impact investing, but when we take a look inside, we can easily find that their perspectives on 'investment' are largely different from one to the other. In the perspective of what for-profit sector experts think about investment, REDF is not making an investment, but given that their invested companies are actually generating profits they wouldn't have made if they hadn't

invested by REDF, and solving social problems through creating jobs, REDF also can be considered as doing investments with social return with indirect financial returns.

Individuals, institutions, banks, etc. in groups we usually call LPs or philanthropists all acquire or produce capital from society. Such money is paid to impact investors in the form of "investment" or "donation." At this time, the role of Impact Fund is to make financial returns that are more than principal to limited partners by investing in portfolio companies. Here, the role of capital here is to generate surplus income for limited partners, in addition to creating positive social and environmental outcomes.

On the contrary, the role of venture philanthropies, which received "charitable money" that is aimed at "creating social and environmental impact" from investors or philanthropists, is to allocate that money to portfolio companies. In other words, their role is to be the intermediary which directs capital to create social outcomes. At this time, the direction of capital and social impact is entirely going back to society and the environment, not toward investors or philanthropists.

In other words, the direction of capital or social impact is determined by what purpose the group that had capital of money first performed the act of investment. If the goal of investment was to generate financial benefit, then the surplus capital would return to the group that had capital; however, if the main goal is social and environmental impact, then capital would return to society. Therefore, investment needs to be explained in relation to the purpose of capital.

3.3 The Purpose of Impact Investment

In impact investing, the purpose of investment is not simply to generate more money for investors, but to create diverse social returns alongside financial returns. The act of making an investment is the act of producing a certain value in society using the capital. Therefore, it is important to fully grasp the purpose of capital before discussing the purpose of investment.

Jed Emerson, who came up with the concept of 'blended value' and authored *The Purpose of Capital,* mentioned in our interview that he "think[s] the purpose of capital is not simply to make more capital. In business school, the purpose of capital is to generate its best risk in return and optimize the financial return. But [he does not] think this is true. [He thinks] people want to have money for different reasons. They want to have money so that they can have freedom. They have money so they can have choices. They want to have money so that they can do some other things for people. Why not start there and think about all of those things then structure your capital so that you are able to do what you want to do first instead of after" (Emerson. Personal communication. 2020).

As Emerson mentions in the interview, the purpose of capital may include generating more freedom, choice, and power. In impact investing, investors are attempting to create broad social value through capital investment. Impact investors are motivated by values such as building a more just and equitable society, helping people live with dignity, restoring nature, and reversing anthropogenic climate change. By analyzing various data collected through research, when hone in on several motives and goals that drive impact investing.

As shown in Figure 5, there are four different purposes of impact investment that are analyzed by research.

Figure5: the purpose of impact investment

a. Seeding

The purpose of seeding capital is to provide essential support to social companies that have not yet achieved business sustainability, especially in the early stages. All Stars Helping Kids, a nonprofit organization based in Santa Clara, California, makes seed stage investments and provides accelerating programs to educational and healthcare organizations that help underserved teenagers successfully complete K-12 education and obtain better access to healthcare in Silicon Valley. Their goal is to support these seed stage organizations to achieve business sustainability. All Stars Helping Kids believes that if their investee companies can establish a strong business model and operate sustainably, then they can actually make a sustainable social and humanitarian impact for teenagers. These educated young teenagers can ultimately disrupt the cycle of poverty in the Bay Area. These educational organizations do not return the surplus capital generated in the course of business back to All Stars Helping Kids or take personal surplus, but reinvest that capital to grow the size of the organization and further their mission.

b. Scaling

Nancy Roob, currently the CEO of Blue Meridian Partners and president of Edna McConnell Clark Foundation, explained in a TED lecture that "ast year in the U.S., individuals and foundations contributed $400 billion to charity but most of it went in small bites to startups and individuals programs. The average foundation grant size was $35,000. If we are to be brutally honest with ourselves we have to ask, is this piecemeal approach our best bet for solving social problems? Today money trickles to what works. If we're serious about solving social problems, we have to make it flow. Successful business investors already work this way. So, when a Kleiner Perkins or another VC meets a visionary like Larry Page or Sergei Brin, they invest holistically, not piecemeal to help that innovator bring his or her vision and company to life" (Roob. TED Lecture. 2017). She identified successful strategies for addressing social problems, confronting young people and families in poverty, and helping scale business focused on social impact. From 2016, Blue Meridian Partners has

pooled almost $2 billion in philanthropic capital from various investors and started making large, longterm, and unrestricted investments tied to performance. Blue Meridian Partners invests $100 million or more in each strategy. Their capital is helping impact enterprises realize economies of scale and reach various geographies and large populations.

c. Filling Gap

Mission Driven Finance provides lending capital to support San Diego's local small impact enterprises and provides access financial capital. David Lynn, the founder and CEO of Mission Driven Finance, explained in his interview that "our goal is to bring debt to fill the gap; those small businesses, [...] will not provide those upside return for impact venture capital, so there is no venture play. That's why we are filling that gap and as we are going up, we've been seeing more companies where debt is quite the right solution" (Lynn. Personal Communication 2020). The capital provided organizations like Mission Driven Finance can support small businesses which are systemically vulnerable to failure in traditional banking systems. This type of capital will ultimately help social companies sustain their businesses, many of which could not otherwise operate with commercial viability. Private debt and long term guarantees are often the instruments used to fill this role.

d. Catalyzing

Catalyzing capital can be used to stimulate the mainstream investors participating in impact investing. By doing this, they ultimately hope that the overall size of impact capital that flows into the impact investing market significantly increases over time.

Doug DuckJun Lee, CEO of D3 Jubilee, said "[c]reating financial value is not solely for creating a virtuous cycle of investors' net profits just as we did traditionally, but for responding to social needs and creating the value needed for them [...]. One of our purposes to operate investment activity is to help individuals, families, and mainstream investors to participate more in impact investing" (Lee, Personal Communication, 2020). He said one of the impact measurement indicators of D3 Jubilee's impact creation is how many mainstream investors change their minds and turn their wealth and spare money into impact investments.

3.4 Legal Entity: Nonprofit vs For-profit

After considering the purpose of investment, investors must next consider what legal entity should be chosen. When creating an impact investment organization in the United States, we can broadly classify the legal entities as nonprofit organizations or for-profit organizations. If we are considering making investments which maximize the social and environmental outcomes over financial profits for the investors, then non-profit organizations best align with those goals. In contrast, if we seek funding from investors to generate financial returns for investors, we can prioritize for-profit entities. Selecting a legal entity is greatly influenced by the types of capital used and how the organization operates and grows.

In the for-profit sector, there are many legal entities to choose from, such as a sole proprietorship, partnership, corporation, limited liability company (LLC), and S corporation. If the main purpose of investment is maximizing social and environmental return without considering the charity function,, we can think of legal entities such as low-profit limited

liability companies (L3C), benefit corporations, social purpose corporations, and Delaware public benefit corporations. Lastly, if funding will be obtained primarily from contributions and grants, nonprofit organizations might be the most appropriate legal entity.

The advantages and disadvantages of each sector and each legal entity are clear. We will now further explore the nonprofit and for-profit sectors as a whole. First, we will explore the advantages and disadvantages present in the nonprofit sector:

Advantages

1. Less pressure: there is no responsibility or obligation to generate financial returns to the investors or philanthropist who made the initial capital contribution, provided that funding was in the form of contributions or grants. In this case, the nonprofit organization can fully concentrate on the committed social and environmental outcomes. Those who work in the nonprofit sector are under relatively less pressure than those who are working in the for-profit sector and must work to generate market-rate financial returns.
2. Opportunity to take high-risks: No matter how much social and environmental benefits are maximized, for-profit impact investors cannot make investment decisions if the investment cannot generate enough of a financial return. However, moving to the nonprofit sector, this investment opportunity could be a good investment option. Taking relatively higher risk can be acceptable in the nonprofit sector if they are making investments using grants or donations as the source capital.

Disadvantages

1. Heavily regulated: Nonprofit organizations receiving tax benefits are more regulated than for-profit organizations. In particular, when receiving a program related investment capital, nonprofit organizations are required to comply with the provisions of the IRS, as well as abide by numerous regulations to maintain their non-profit tax exempt status.
2. Less competitive compensation: It is commonly understood that employees in the nonprofit sector are paid less relative to those in the for-profit sector. Even in the impact investing domain, the compensation for high-level employees in the nonprofit sector can be less than those in the for-profit sector.
3. Less sizable funding opportunity: The amount of funding available in the nonprofit sector may be more limited than in the for-profit sector because investors who make large size investments, such as institutions and banks, cannot invest in small sized investment opportunities or investments which have no obligation of fiduciary duty.

The advantages and disadvantages of impact investing in the for-profit sector are outlined below:

Advantages

1. Regulatory flexibility: For-profit entities are less regulated than nonprofits in terms of funding and finances..
2. Competitive compensation: The employees working in the for-profit impact investing sector tend to have relatively competitive compensation compared to employees in

the nonprofit sector. This not only applies for low-level employees, but also high-level employees.

3. Strong earned revenue: For-profit entities can build a stronger business model through return on investment, which allows them to not rely on charitable assets. This leads to a self-sustainable model.
4. Sizable funding opportunities: For-profit impact investing organizations have more opportunity to receive relatively large funding from different types of investors, including institutions, government, and others.

Disadvantages

1. High fiduciary duty: Contrary to the employees in the nonprofit sector, employees in the for-profit sector might have more pressure to generate a financial return.
2. Compromised social impact: Despite expecting to have higher social returns, for-profit investors cannot invest in organizations deemed unable to generate sufficient financial returns.

3.5 Asset Classes: Grant, Debt, Equity

There are various asset classes available for impact investing, including: private equity, public equity, fixed income, cash, guarantees, loans, equity, and grant support. Among them, private equity, public equity, and fixed income are more targeted at generating above market-rate returns. In contrast, grants, equities, and debts are more aimed at generating below-market rate returns, or maintaining principal. Interviews conducted for this research mainly focused on three asset classes: grants, debts, and private equity.

a. Grants

It is debated whether grants should be considered an asset class. However, when viewed in the context of investments in the nonprofit sector as a whole, grants are clearly used as an asset class. Grants refers to the cash or cash equivalent assets offered to social companies in order to achieve committed social and or environmental returns. If a nonprofit organization gives a grant to a nonprofit or for-profit company which has a social purpose, then the organizations will not expect financial return, but rather expect measurable social, humanitarian, and/or environmental returns. The nonprofit organization that offered the grant will not actually receive any direct financial returns from their portfolio companies, but they might expect indirect financial returns from their portfolio companies. In this case, indirect financial returns may refer to financial income that portfolio companies generate through their investments with the grant money that they receive, and this added revenue would not have occurred without the grant from the organization. If the portfolio companies can generate enough financial revenues, they can hire more employees so that ultimately the financial gains can trickle down to society.

If grants are viewed as an asset class, they can be seen as a bridge between the primary investors and beneficiaries. There are many nonprofit organizations using grants as an asset class to make impact investing. Among them are All Stars Helping Kids, REDF, Blue Meridian Partners, Omidyar Network, and others.

b. Debt

Debt is the most commonly used asset class in the nonprofit and for-profit sectors. Debt is an asset class in which investors lend a certain amount of cash to investees, with the ultimate goal of generating financial gains through collecting interest. In impact investing, for-profit organizations and nonprofit organizations often lend to social companies with interest rates between 0% and 9%, depending on the initial investment interest they have. The nature of the initial investment usually determines how much profit an organization can make from the deal. For example, if the LPs want to lend money without adding any interest to the organizations, the organizations will lend out that capital to the social companies without taking any interest on it. At this time, the organizations may take management fees to finance the operational costs and to compensate the employees for their time and expertise for managing portfolios. The amount of interest and management fee can be set among the investors and organizations.

The most important feature of debt as an asset class is that the risk of losing principal is relatively low. However, because the risk is low, the financial returns will also be relatively low. An advantage when using debt as an asset class is that organizations may initiate impact investing by lending out money without building an extensive track record. In the case of organizations using private equity as an asset class doing impact investing, they might face more difficulties when attempting to obtain funding from investors without building reliable track records. Oftentimes, building investment track records with debt is less time consuming than with private equity.

In impact investing, debt funding is often used to support small businesses or nonprofit organizations which might have difficulties getting funding from the mainstream financial market. In many cases, they are unable to demonstrate the necessary creditworthiness or or obtain sufficient collateral that is required by traditional banks. In other cases, the side of their business is limited to a point where it impacts scalability which makes them less attractive to traditional venture capital.

The organizations which use debt as an asset class can be nonprofit organizations like REDF, but also be for-profit entities like Mission Driven Finance, or hybrid entities like Community Development Financial Institutions (CDFIs) such as Accion.

c. Private Equity

Private equity is the most commonly used asset class in impact investing. According to the GIIN 2020 survey report, among 289 impact investing institutions, more than 70% of the investors are using private equity as their main asset class. Organizations that raise funds and use private equity as their main asset class can be called Impact funds, impact venture capital, or impact private equity. Both impact venture capital and impact private equity own an equal percentage of equity in their portfolio companies and sell those positions to make profit. The main difference between the two is the stage at which they make their investment. When it comes to impact venture capital, they are investing in relatively early stage companies. Early stage may include the time from the pre-seed stage to Series A or B. With impact private equity, they tend to buy more mature companies and sell them to make profits.

When making investment in early stage companies, impact investors can participate in their governance and management such that they can influence the company's overall growth and reduce risk. Also, impact venture capital can expect a relatively high return on

their investment with a small amount of investment capital committed. According to the interviewees who are using private equity as their asset class, they expect an internal rate of return between 7% and 15%. Considering the social and environmental outcomes they can generate, the private equity asset class is attractive for those who want to make higher financial returns.

However, the risk that those investors need to take is also high. In contrast to debt, which can ensure the principal is preserved, private equity cannot guarantee any principal. Private equity investors have a high rate of failure on their investment. To make high profit, investors must necessarily take on more risk.

3.6 Investment Strategy

Every impact investor has their own investment strategy. Among them, there are some common investment strategies that emerged after each interview.

a. Themes:

Through impact investing, investors can make investments which primarily go towards social companies that aim to solve pertinent social or environmental problems. Organizations often employ one of several strategies depending on their unique goals. For example, the United Nations Sustainable Development Goals (UN SDGs) are often used as a reference point to guide the agendas of many impact organizations. There are a total of 17 goals that the United Nations outlined. Among them, they aim to eradicate poverty and hunger, promote good health, well-being, quality education, gender equality, clean water and sanitation, affordable and clean energy, decent work and economic growth, and others. In general, organizations employ one of several themes depending on their strategies. Through our research, we uncovered some common themes that experts believe can generate relatively high returns compared to other focus areas. These are healthcare, energy, tech, and fintech.

b. Market Size

An important criterion that determines the success of an investment is how much social impact and financial return can be created by a portfolio company. In order to achieve a larger impact, companies must be able to capture a sufficient share of the market. Therefore, it is necessary to size the market in the industry that companies are trying to enter and also assess the scope of the services they plan to provide. In addition, companies must consider whether they have growth potential in both local and global markets. Lastly, the market trend is also an important factor to consider because a company's service or product may seem interesting for the short term, but its market share can significantly contract in the long run based on trends.

c. ***Product***

The products or services that a portfolio company offers are also important factors to consider when determining whether to invest. It is important to consider how innovative their products and services are and how much market power it had in the past if a similar

model existed. Investors should also look at whether the business model itself can sustainably make a profit. Finally, it is important to consider the quality of customer relationships that the portfolio company has built.

3.7 Risk management

a. Due diligence

There are different ways to manage risk. Among them, one common option, and the one REDF takes, is to conduct a severe due diligence. David Samuels, CFO at REDF, explains, "[w]e manage risks by due diligence, very thoughtful risk assessment before we provide the loan" (Samuels. Personal Communication. 2020). REDF raised an impact fund which lends money to social companies which create quality job employment opportunities. To get their funding, a company must fulfill four different criteria. First of all, they need to have at least three years of operation. Second, they need to demonstrate profitability with growing profit margins. Third, they should have positive sales growth. , they need to show a strong management track record. Through due diligence, REDF can ascertain whether a company fulfills their criteria and manage risk in that way.

b. Technical assistance

Technical assistance is a common way of managing risks by impact investors. Impact investors directly participate in governance by participating as board members, and directly or indirectly engage in various aspects of the management of portfolio companies. An accelerating program is one example of technical assistance that an impact investing organization can provide. Samuels mentions that "[o]ur standpoint on technical assistance is we are helping businesses working through their business model or their impact framework that we can underwrite them, and we underwrite it and work through their business model. By doing the technical assistance, we figure out how we are going to invest in them."

Section 4: Recommendations

4.1 Building a sustainable economic model for venture philanthropy

The economic model of a venture philanthropy functions similarly to that of nonprofit organizations. Most of the time, their revenue sources consist of two parts: charitable contributions, including donations and grants, and earned income. To operate sustainably, a venture philanthropy should create a reliable revenue stream that covers the total cost of doing business. Oftentimes, nonprofit organizations suffer financially due to insufficient funds. In fact, if we look deeper into the financial situation of nonprofit organizations, insufficient funds usually occur because these organizations were not able to set aside enough funding in the first place. The fully loaded cost of doing business does not only include the program and operating expenses. It includes all the growth funds that a nonprofit organization can grow steadily from a long-term perspective, and those growth funds can include contingency expenses that will cope with unexpected situations, research and development expenses that ultimately help organizations functions more efficiently and effectively, employee fringe benefits that can benefit employees for their time and expertise, and liquidity organizations use to pay their daily operating costs. David Greco, President of Social Sector Partners, where he works to transform social sector organizations to achieve more financially sustainable social impact, explained the structural deficit in nonprofit organizations:

> "I think what most people end up doing is they focus too much on programmatic cost. They have the revenue stream that generates enough money to cover the cost of the programs but does not cover the fully loaded cost of doing business. This is a structural deficit, which means you are not generating enough reliable revenue and year after year they are supposed to cover the full cost of doing business. Most nonprofits can generate pretty much revenue which can cover the cost but everything else is not enough. Every year they scramble the money to make ends meet but it is not sustainable. So a lot of nonprofits are doing with Sweat equity. We overwork our people and we underpay them. Particularly when you are underpaying staff, the organization can not be seen as sustainable. We need to think about the operating needs are artificially low so we are relying on the time that people are donating."
>
> (Greco. Personnel Communication. 2020)

Venture philanthropies that operate with economic models similar to that of a nonprofit organization should be considered in the same context. They must generate sufficient revenue to cover the fully loaded cost of doing business. An organization's sustainability is not solely determined by their funding sources. Whether it is government grants, major gifts, individual donations, or earned income from the organization's investment activity, the important thing is that an organization should have a revenue engine that generates the necessary amount of reliable revenue every year so that it can cover the total costs.

4.2 Building sustainable economic model for impact funds

The economic model of impact funds in the for-profit sector functions differently from that of venture philanthropy. Impact funds operate with investment from limited partners (LPs), and a management fee is the source of income for impact funds; after investment, they can also earn performance fees. In order to have a sustainable economic model, impact investors need to consider the size of the fund that they wish to have and make an effort to raise the minimum amount of funds accordingly. Experts in the field of debt funds and private equity funds suggest that an investment of $50 million is needed to run a lease-sized impact fund. When calculating the basic math, given that the management fee rate is 2% for a 10 year time period, the organization will receive around $1 million each year as a management fee. Therefore, the impact fund will receive $10 million in management fees over 10 years. However, receiving a large management fee is not always good because then the funds have less money available to invest. With the above calculation, the fund will have $40 million to invest after management fees are deducted. They might use that $40 million to make profitable investments and generate sufficient financial gain, but they can also fall into a situation whereby they are unable to make appropriate investments due to insufficient funds.

In addition to raising the necessary money for the fund, building a sustainable economic model requires generating substantial profits at the end of an investment cycle. If profits are not generated, it signals poor financial performance, regardless of the social or environmental impact generated. Thus, the impact funds might face difficulties in subsequent attempts to raise capital. When an impact fund can generate profits that are in line with its initially projected returns, it can use that capital to create a new investment cycle. In the long term, a sustainable economic model for an impact fund is one that continually raises investment funds by using the profit collected from prior investment cycles. .

In conclusion, we recommend that if impact investors aim to build a sustainable economic model, impact investors should 1) consider the size of the investment, 2) raise an appropriately sized fund, 3) build a portfolio through good investment, 4) measure social and/or environmental impact, 5) achieve the targeted financial return, and 6) use a certain amount of the profits to reinvest in subsequent investment cycles. By completing this cycle, an impact fund can create a sustainable economic model.

4.3 Building track records

Impact investing organizations, whether they are nonprofit or for-profit, should thoroughly manage their track records. These track records are measured by evaluating the financial returns organizations have generated, along with assessing their social, humanitarian, and environmental impact. When asked about the most difficult aspect of investing, David Lynn, CEO of Mission Driven Finance, answered that, “[j]ust like any other new fund manager getting the size and track records, institutional capital wants to see ten year track records and if you already have a hundred million or five hundred million on your balance sheet, in that stand point where we see that we need to get the size and sustainability and track record. When investors invest their money, 100% they think the track record and size are the most important factors to consider” (Lynn. Personal Communication 2020). As we can see from his experience, for an impact investing organization, ensuring reliable funding is the key to building an economic model for a fund. To get appropriate funding, it is important to build and manage reliable track records.

Section 5: Conclusion

The purpose of this Capstone project was to give a guide to the economic model that a non-profit organization must create to start an impact investing. By conducting this research, I tried to refer to as diverse opinions as possible by interviewing experts from nonprofit and for-profit organizations that are active in the field of impact investing.

Through research, I realized that the fields referred to by impact investment terms are very broad, and the perspectives toward impact investing are very different from the nonprofit to for-profit sectors. The starting point of creating an impact investing organization should be started by considering what is the purpose of the capital they are trying to use. The nature of capital determines the purpose of the investment, and then the purpose of the investment determines the asset class that investors are going to use. For example, if an organization wants to use monetary capital to generate above market rate returns, alongwith social outcomes, the organization needs to choose an entity in the for-profit sector rather than in the nonprofit sector, and with the purpose of generating higher profits, the organization might need to choose private equity as its asset class.

In light of these reflections, as shown in the figure 6, we can conclude that there are five steps to build a sustainable economic model for an impact investing organization.

First of all, we need to understand the purpose of doing impact investing by understanding the purpose of impact capital an organization wants to use. Then, the organization needs to build a system or structure that allows that capital to flow in the direction where it meets the organization's purpose of doing investment. This process may include choosing the right sectors, nonprofit or for-profit, appropriate legal entities, and adequate asset class. Alongside the structure, the organization needs to consider what investment strategy applies for doing investment. Once the organization builds the system and structure, it can start to make investment by using the system, and attempt to build a good track record. For a certain period of time of doing investment, the organization may generate expected financial returns and/or social returns. In impact investing, the measurement of social impact should be considered in this part, and this will be included in the organization's track records. Once the organization generates enough financial returns and/or social returns, it can be able to recreate the same investment process repeatedly. When the organization could successfully generate enough financial returns from the investment and reached social outcomes that it expected, it can start the investment process again from step three.

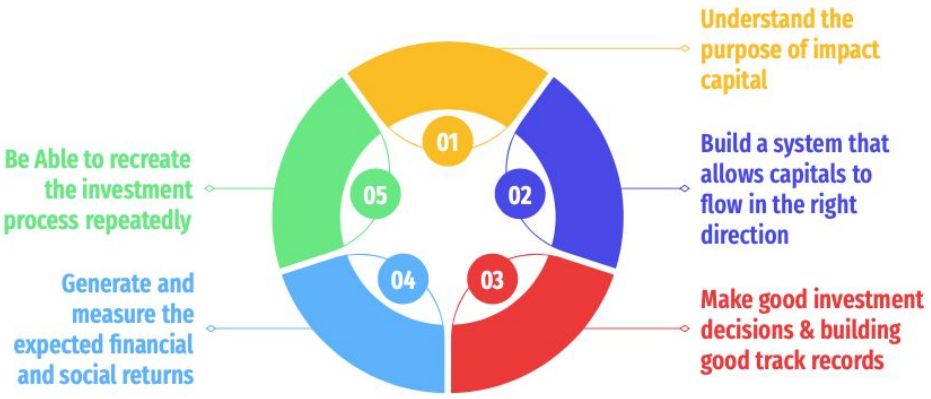

Figure 6: Build a Sustainable Impact Investing Process

Despite it covers the overall process of doing impact investing, this process may clearly require deeper research and reflection. Additional research efforts can be in each sector, legal entities, and asset classes.

More and more organizations and individuals are developing their interests in impact investing. If we understand how the investment process functions, I believe that everyone who highly wants to make investments in companies with a social and environmental mission, can participate in the process of impact investing.

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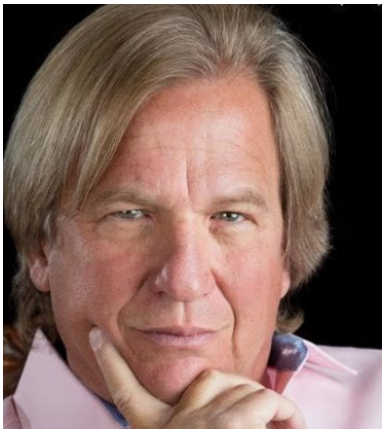
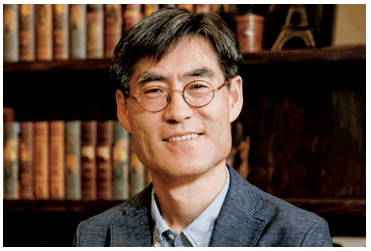
Appendix A: Interview participants

Name of Interviewee	Interview Schedule	Introduction
Nicholas Almeida 	Date:2020/7/16 Time: 14:00-16:00 KST Duration: 2h Interview Conducted via Zoom	Title: Budget Director and Chief Service Officer at San Jose Mayor's Office of Strategic initiatives Nicholas Almeida has over 15 years of multi sector experience across the public, nonprofit, and business sectors. His experience includes working with social entrepreneurs and impact investors to push for social innovations. He is also the co-founder of the impact investing firm Sidecar Social Finance, and served as a senior leader at Tides Foundation where he led impact investing projects. He teaches social entrepreneurship as an adjunct professor at University of San Francisco. He graduated from Stanford University with a Bachelor's degree in Public Policy and a Master's degree in Sociology.
David Lynn 	Date: 2020/7/18 Time: 6:00-6:30 KST Duration: 30 minutes Interview Conducted via Zoom	Title: CEO at Mission Driven Finance David Lynn has over 20 years of experience in the financial and philanthropic sectors. He is the founder of Mission Driven Finance, an impact investing firm and certified B Corporation dedicated to building a financial system that allows businesses to access affordable financial capital. He has experience in multiple leadership roles in both for-profit startup and philanthropic organizations.
Jed Emerson 	Date: 2020/7/21 Time: 7:00-7:30 KST Duration: 30 minutes Interview Conducted via Zoom	Title: Independent Strategic Advisor Jed Emerson is an internationally recognized leader within the impact investing field. He has led, co-founded and served on the board of directors of various impact funds, social enterprises, and family office investment committees, including Impact Assets, RS Group Asia, Center for Social Investing University of Heidelberg, REDF, and many others. He is originator of the concept of Blended Value, and author of *The Purpose of Capital*, and co-author of *impact investing: Transforming How We Make Money While Making a Difference*, the first book on impact investing, and the *Impact Investor: Lessons in Leadership and Strategy for Collaborative Capitalism*.

David Greco 	Date: 2020/7/22 Time: 7:00-8:00 KST Duration: 1 hour Interview Conducted via Zoom	Title: CEO of All Stars Helping Kids, and President & CEO of Social Sector Partners David Greco is a nationally recognized speaker, author and consultant on creating a more financially sustainable and effective social sector. As a CEO of All Stars Helping Kids, David works to disrupt the cycle of poverty by funding startup nonprofits in the Bay Area. He has over 25 years of experience in driving growth of organizations, launching new revenue generating operations in the nonprofit sector. He is President and CEO of Social Sector Partners where he works to transform social sectors organizations achieving more financially sustainable social impact. He served as Vice President at nonprofit finance fund, an impact investing firm providing loans and financial services to nonprofits.
Phil K. Yoon 	Date: 2020/7/27 Time: 9:00-10:00 KST Duration: 1 hour Interview Conducted via Zoom	Title: Founder and General Partner of Big Basin Capital Phil K. Yoon is the founder and general partner of Big Basin Capital. Since founding Big Basin, he has raised two seed-stage funds and invested in more than 20 startups in Korea and the US in various sectors. Prior to Big Basin, he was the Investment Director at Walden International, a global VC headquartered in Silicon Valley, where he honed his skills in cross-border investments. He holds a B.S in Electrical Engineering from Seoul National University, and an M.S. in Electrical & Computer Engineering from Carnegie Mellon University, and received an M.B.A. from Wharton School of University of Pennsylvania.
David Samuels 	Date: 2020/07/25 Time: 6:00-6:45 Duration: 45 minutes Interview Completed via Zoom	Title: Chief Financial and Administrative Officer at REDF David Samuels is CFO at REDF, where he leads finance, information technology, human resources, and legal compliance. He has over 25 years of experience in various industries and geographies, including CFAO of Bio-Rad Laboratories French subsidiary in Paris, Director of Finance at eBay in San Jose, CFO at Backroads in Berkeley, and CFO-COO at Rubicon Programs, Inc. He has decades of experience in the Social Enterprise sector. He has an undergraduate background in the Sciences, and several years of field research with the University of California and the Israeli Institute of Agricultural research.

Timothy Freundlich 	Date: 2020/7/23 Time: / Duration: Written Interview Interview Completed via Email	Title: Founder and Executive Director at Impact Assets Timothy Freundlich is a long-time innovator in new financial instruments in the social enterprise sector, which he now applies as the head of impact Assets, the $1 billion boutique donor advised fund and investment note offerer for impact investments. While previously at Calvert Foundation for 12 years, he conceived of and launched the donor advised fund. He was also instrumental in building the $250M Community Investment Note with more than $1billion invested into 300-plus nonprofits and for profits globally. Tim holds an MBA from the University of San Francisco, and BA from Wesleyan University.
Doug Duckjun Lee 	Date: 2020/7/28 Time:16:30-18:30 KST Duration: 6h Interview Conducted in Person	Title: CEO and General Partner at D3 Jubilee Doug Duckjun Lee is an impact venture investor and advisor at D3 Jubilee, an impact venture firm that supports social enterprises to build capacity, based in Silicon Valley and Seoul. He is a financial expert with 30 years of experience in asset management, portfolio management, and M&A. He is the former CFO of G-Market which was acquired by Ebay. Doug holds B.A. from Seoul National University and M.A. from the London School of Economics & Political Science.
Brian Trelstad 	Date: 2020/7/28 Time: 6:30- 7:00 KST Duration: 30 minutes Interview Conducted via Zoom	Title: Partner at Bridges Venture Fund, and Professor at Harvard Business School Brian Trelstad is a Partner at Bridges in the U.S. Sustainable Growth Fund, and director of the Bridges Impact Foundation in the U.S. He has nearly 20 years of impact investing experience, having written the business plan for Acumen in 2000 and served as the Chief Investment Officer until 2012, where he oversaw $55M of investments into companies that were delivering health, water, energy, and agriculture services to economic base of the pyramid in South Asia and Sub-Saharan Africa.

Hyunjoo Je 	Date: 2020/7/30 Time: 4:30- 6:00 KST Duration: 1h 30 Interview Completed In Person	Title: CEO & Representative Director of Yellowdog Hyunjoo Je is CEO and managing partner of Yellowdog, a leading impact venture capital in Korea. Established in 2016, Yellowdog has invested approximately $50 million in 25 companies in Korea, Vietnam and US, and is currently managing over $100 million assets. Yellowdog invests in startups from Seed stage to Series B, funding innovative companies in four key impact domains: (1) climate and environmental solutions, (2) wellness and healthcare, (3) education, and (4) workstyle solutions. Yellowdog also considers gender lens investing principles important across all the funds. Prior to Yellowdog, Hyunjoo worked at Carlyle Asia Buyout Fund, Credit Suisse and McKinsey & Company.

Appendix B: Interview Questions

Part 1 with Nicholas Almeida

1. What are the differences between various names for impact investing?
2. Can you briefly explain the economic model for various impact investing firms?
3. How does a for-profit oriented impact investing fund also rely on charitable money?
4. Is there any other way that they can have an extra income?
5. If I were a social enterprise and wanted to be funded by investors, would I have more funding opportunities in traditional venture capital or impact investing?
6. Please explain the impact-oriented incentives to employees at impact investing funds.
7. What is your recommendation for an organization which wants to create an impact fund?

Part 2 with David Lynn

1. Why have you chosen a for-profit entity instead of a nonprofit entity?
2. How did Mission Driven Fund design a sustainable business model?
3. How many funds does MDF operate? And how much Asset Under Management by MDF?
4. How do partnerships with other nonprofit organizations function?
5. Are interest rates the same for everyone?
6. What kinds of investors (limited partners) are you working with?
7. How are management fees structured?
8. Is your model sustainable? Do you meet the operation needs?
9. On average, how much gap return do you get from the investors?
10. Do you have any plan to build a private equity investment, in the future?
11. Why did you choose debt as an asset class to start Mission Driven Finance?
12. Do you think this is the main reason why other impact funds are using debt as a main asset class to build their business models?
13. How does Mission Driven Finance fund technical assistance costs?
14. What difficulties are you facing when you are dealing with your economic model?
15. if somebody has no such track records and size, how do they approach those investments?
16. What is your recommendation to those who start their new impact fund?
17. Do you have any other income stream?
18. Can impact firms raise various funds to increase their management fees?
19. How many employees do you have? And are they lower paid compared to the sector?
20. Why do you choose impact investing?

Part 3 with Jed Emerson

1. How do you build a sustainable economic model?
2. What is the purpose of capital?
3. How do you define sustainability for venture philanthropy organizations?
4. What is your investment strategy?

Part 4 with David Samuel

1. What economic/business model does REDF have?
2. Tell me about REDF's economic model.
3. How much money or interest did REDF get through these lending activities?
4. Why did REDF set up a debt fund?
5. How are you going to use the money that is being returned from the portfolio companies?
6. Who are those funders/investors ?
7. How do you manage your money after lending out?

Part 5 with Timothy Freundlich

1. How does an organization's economic model function?
2. How are fund management fees, performance fees, grants, technical assistance be structured?
3. What are other income streams that a fund receives?
4. Do your revenues cover costs?
5. How does the performance fee function?
6. Do you think the Carry structure works in the impact investing field? If yes/if not, why?

Part 6 with David Greco

1. What is your definition of a sustainable economic model for nonprofit organizations?
2. Does funding matter when classifying organizations as sustainable?
3. Do you think the traditional venture capital model works for impact investing firms?

Part 7 Brian Trelstad

1. Why does Bridge Fund management use the form of Fund as a tool to do an investment?
2. How much total capital does Bridge Fund manage?
3. Why did Bridges choose the for-profit entity instead of the nonprofit entity?
4. What are the main differences between the financial structure of Acumen and Bridge?
5. Are Bridge's assets 100% under for-profit assets?
6. How can you define a sustainable economic model for an impact fund?
7. If the money is backed by philanthropy money do you think it is still seen as a sustainable business model?
8. Does your organization use the 2/20 model just as venture capital?
9. What makes the management fee little higher than the general vc fund?
10. Do you think you can generate enough return from the companies that you are investing in? Just like a venture capital firm?
11. Why then does Bridge choose private equity instead of venture capital ?
12. Do you think the themes that Bridge uses for investment such as healthcare, education, and energy are the themes where you can have more financial return than the others?

Part 8 Doug Duckjun Lee

1. Please introduce D3 Jubilee.
2. What economic model do you have?
3. What is your estimated financial return?
4. What is a sustainable economic model for you?
5. Compared to the traditional VC, how is the cost structure?
6. What is the compensation level of your organization's employees compared to the impact investing sector in general?
7. How do you persuade mainstream investors to participate in the impact investing sector?

Part 9 Hyunjoo Je

1. How does the economic model of Yellowdog function?
2. Are you investing to maximize financial return?
3. If the social impact is likely to be very high, but it is unlikely to have financial returns, what would your organization choose?
4. What if the return on investment seems to be low and it does not go well?
5. You talked about market returns. How do you define market returns?
6. Do your employees get competitive compensation?
7. What kinds of efforts do you make to save money?
8. Do you receive any charitable money?
9. You've been investing for about 3 years now, and it hasn't been a cycle yet, how long are you planning to work on it?
10. Are there many possibilities for Exits or IPOs?
11. Why did you choose private equity as the asset class?
12. Are you thinking of using another asset class later?
13. Do you think an impact investment itself can be an asset class?
14. What kind of themes do you think expect higher returns?
15. What stage are you investing in? Is there any special reason for you to do that?
16. Are you willing to invest actively in other countries besides Korea, Silicon Valley, and Vietnam?
17. How do you source deals?
18. What advice can you give to the newcomers in the impact investing field?
19. What kind of people are impact investors supposed to hire?

Part 10 Phil K. Yoon

1. Please explain the economic model of your venture capital firm.
2. Do you have any other revenue model besides basic management fee and carries?
3. Do you have an Anchor investment?
4. How does managing multiple funds help you generate revenue? Do you recruit new employees every time you start a new fund?
5. Is there a reason why you chose equity investment instead of asset groups such as debt and real estate?
6. What are the criteria for financial return and how do you define market returns?

7. What do you think is a sustainable economic model?
8. What do you think about the usual 2/20 approach?
9. What stage-oriented investment do you make when investing in portfolio companies and why?
10. How do you manage risk for portfolio companies?
11. Do you have an accelerator program or a similar technical assistance program? If so, is the cost included in the management fee?
12. What is the ultimate financial investment goal for portfolio companies?
13. What are the big costs of fund management?
14. Is there any social or environmental impact that Big Basin Capital is pursuing?
15. When was your most rewarding moment when you ran the VC company?
16. Do you have any particular difficulties in managing investment funds?

Author's Bio

Jieun Lee is an award-winning journalist, social entrepreneur, and impact investing professional.

Through her experience in various sectors, she realized that the creation of more hybrid nonprofits and social enterprises could eventually solve social and environmental problems and generate socio-economic capital. Therefore, she is expanding her experience in the impact investing field to fuel growth social companies and nonprofits. She is currently designing an impact investing fund with a nonprofit organization called All Stars Helping Kids in Santa Clara.

After graduating from the University of Strasbourg in France, she traveled over 30 countries in the world to meet various social entrepreneurs and nonprofit activists to share their stories with Korean and French National TV stations, including KBS, YTN, KTV, and Le Voyage. Focused on sustainability, agriculture, social and environmental problems, and their solutions, she led all aspects of documentary projection, interviewed over 800 people, and produced 60+ documentary films. She received the Best Journalist Award from the Korean Government Ministry of Culture for generating positive news and improving the overall news quality through solutions journalism.

With her passion for social enterprise, she raised $100,000 and started an organic wine company to promote local organic wine businesses in southeastern French regions and support local winemakers using an environmentally-friendly agriculture method. She introduced French Organic Wine to the Chinese market, and developed Go-to-market strategies and cultivated wholesale and channel business.

As a nonprofit activist, she actively volunteered for five years in a French nonprofit organization, Regard'Ailluers. Among her works, she developed partnerships with a local NGO in Nepal to raise funds for building a dormitory for Tibetan refugee camp. She also participated in marketing through content creation for revitalizing communities suffering from desertification in the Sahara desert.

She lived in eight different cities in the world, including Seoul, Shenzhen, Shanghai, Beijing, Paris, Strasbourg, Colmar, and San Francisco, and can speak five languages, Korean, Mandarin, French, English, and Japanese.