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How market mechanisms from the private sector could energize the nonprofit world

by Robert S. Kaplan and Allen S. Grossman

The Emerging Capital Market For Nonprofits

Fifty years ago, Microsoft, Wal-Mart, Intel, Apple, Cisco, Oracle, and Google didn't even exist. Today each one has a market value exceeding $100 billion. Meanwhile, many companies that were business giants in 1960—including Bethlehem Steel, U.S. Steel, CBS, RCA, GTE, ITT, and LTV—have disappeared, shrunk, or merged into other companies. These dramatic shifts in fortune are vivid examples of the cycle of creative destruction famously described by the economist Joseph Schumpeter.

Few new nonprofit ventures, in contrast, ever reach national scale (Habitat for Humanity and Teach for America are among the exceptions), and the largest nonprofits rarely fall out of the top rankings or disappear. Apparently, Schumpeter's cycle doesn't operate in the social sector.

That few innovative nonprofits grow to a significant size is, at first, surprising, since each year people make massive new investments in this sector. In both 2007 and 2008, donations to nonprofits in the United States exceeded $300 billion—more than 2% of GDP. But small local organizations dominate the sector. More than 700,000 nonprofits operated in the United States in 2009. Ninety percent of them had annual budgets of less than $500,000, and 99%

ILLUSTRATION: ALISON SEIFFER

spent less than $10 million on their constituents. The average grant size for large foundations was only $50,000.

While small may be beautiful, size matters when it comes to having a substantive impact on society's pervasive and complex problems. By leveraging economies of scale and management talent, large nonprofits can deliver improved services at lower cost. They can offer their staff better compensation and career opportunities. They have greater capacity to conduct experiments, assess innovations, and share best practices across multiple locations. In an effective system, innovative nonprofits with the best management and social change agendas would grow in scale and scope while less effective and efficient ones would diminish and eventually disappear.

Why, then, do the dynamics in the for-profit and nonprofit sectors differ? Why do effective business start-ups grow into large, successful corporations while their nonprofit counterparts struggle to achieve national scale? We believe that a lack of development in the mechanisms and institutions that channel information and money between donors and nonprofits is to blame.

The good news, though, is that a new generation of charitable foundations and intermediaries is changing the game by measuring the social impact of donations and offering ways to funnel dollars to the most-effective nonprofits. In the following pages, we sketch out how the nascent capital marketplace for nonprofits is developing. To set the context, let's look first at the current deficits in the sector's infrastructure.

A Tale of Two Markets

In the private sector, capital markets connect investors who have money with entrepreneurs who have ideas but little money. The flow of funds is rarely direct, however. A set of institutions has evolved over hundreds of years to facilitate the exchange of information and capital between investors and businesses.

Consider the role of financial reports. Companies use these statements, which are independently audited by accounting firms, to communicate their performance to current and potential investors. Information intermediaries, such as financial analysts and business publications, then help investors interpret the reports.

Lacking the time and the expertise to intelligently process all the available information, many investors rely on financial intermediaries to invest their funds in successful or promising enterprises. The financial intermediaries conduct or purchase research, thereby reducing much of the information-processing costs that would have been incurred by individual investors.

Financial intermediaries come in various types. Mutual funds raise large sums—often in small amounts—from many investors, pool the money, and invest in a diversified portfolio of companies. Venture capital and private equity firms raise large sums from a few high-net-worth individuals, foundations, and endowments; perform a great deal of private, rigorous research; and invest heavily in a limited number of companies that they consider undervalued or capable of substantial and profitable growth. All the information and financial intermediaries facilitate efficient—and usually effective—allocations of capital from investors to companies.

The mechanisms for directing funds to nonprofits are much less developed. Like their private sector counterparts, nonprofits produce audited annual statements about their financial condition that show whether funds received and earned exceed funds disbursed during the reporting period. But a nonprofit's financial report reveals virtually nothing about its effectiveness or efficiency in creating social value. The report supplies no information about the social outcomes the organization has achieved, the costs it incurred to produce them, or the links between those outcomes and management's decisions and strategy.

What's more, donors and foundations can't get reliable, consistent data to compare the performance of nonprofits. Few public databases offer information on outcomes, and what data can be found aren't comparable across organizations. The media don't do much independent analysis on the most and least

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Idea in Brief

Over the past 50 years, many businesses have reached national scale, but few nonprofits have grown to a large size. This disparity is caused by a lack of development in the mechanisms and institutions that channel information and money between donors and nonprofits.

Signs of change are appearing, however. New intermediaries are demanding clear performance metrics and accountability from nonprofits.

Some intermediaries now play a role analogous to that of mutual funds. They solicit money from individuals and foundations, conduct due diligence to find the nonprofits that will use donations most effectively, and monitor postgrant performance.

A few intermediaries are more like venture capital funds. They have extremely rigorous selection processes and partner with fund recipients to formulate and execute a strategy for delivering social impact, using tools such as the balanced scorecard.

These approaches will help capital and talent flow toward the most-effective nonprofits, enabling the best to grow in scale and impact.

successful nonprofits. And even specialized clusters within the sector, such as public education, youth services, and adult training, lack standard processes for reporting and auditing their performance. As a result, it's difficult to control for variations in the populations served by different organizations and to understand whether a nonprofit has actually had a significant social impact.

In the absence of useful public data, the sector's few analysts focus on the nonprofits' financial reports, which as we've said don't contain information about the social benefits produced. One financial ratio widely used by nonprofit analysts—administrative expenses divided by funds raised or disbursed—is even misleading. Some organizations may disburse a great deal of money with a small central staff but accomplish little. Others may have higher administrative expenses but attract outstanding staff, have a great model for achieving change, and actually deliver high-impact social services to their constituents. The traditional financial expense ratio makes the first group appear better managed than the second.

The institutions that channel capital to nonprofits do little to make up for the lack of information. Many community philanthropies and foundations operate like mutual funds, raising money from thousands of contributors and allocating it to numerous local agencies. But unlike mutual funds, these charities have traditionally done little research on the performance of the organizations that receive their money and have rarely committed to multiyear support. Indeed, the incoming CEO of one large charitable organization, which had distributed tens of billions to health and human services nonprofits, was recently unable to name a single improvement that he could link to his organization's efforts.

This is also typical of the 75,000 charitable foundations in the United States, which have total assets of more than $550 billion and make annual distributions of more than $45 billion. In principle they could be powerful and influential intermediaries. But while they strive to invest in good causes and new ideas, they rarely hold their grantees or themselves accountable for improving social outcomes. This is especially unfortunate since the U.S. government massively subsidizes charitable foundations by allowing donors to deduct contributions from taxable income and exempting the foundations from taxes. U.S. citizens provide these subsidies without any accountability from the foundations regarding their social returns.

The lack of good information and the more general lack of accountability create several problems. For a start, high-performing nonprofits continually have to scramble to fund their growth and development. Surveys of nonprofit executives indicate that they spend more than half their time raising money. The ongoing pressure for funds often makes them vulnerable to their large donors' special preferences and demands, distracting them from their core mission and potentially compromising future performance. Effective nonprofits struggle to serve more constituents while ineffective and inefficient ones swallow up dollars that could be better spent elsewhere.

As long as this state of affairs continues, American society as a whole will earn a low rate of return on its hidden tax subsidies and on the more than $300 billion in annual investment in the sector. Fortunately, a few signs of change are emerging.

A Movement for Accountability

A new generation of charitable foundations, backed by successful entrepreneurs such as Bill Gates and Michael Dell, are importing practices from the private sector and using them to evaluate the returns on their investments. The Bill & Melinda Gates Foun-

dation, for instance, dedicates an entire department to assessing the performance of its grants. The new foundations want their grantees to be held responsible for delivering results and to use governance structures that will monitor and guide the journey to successful outcomes. Their goal is, essentially, to find and fund the Microsofts and Dells of the nonprofit sector.

Some older foundations are part of this movement, too. In 1999, more than 30 years after its creation, the Edna McConnell Clark Foundation (EMCF) began to focus its grants on increasing the capacity of a select group of organizations that proved they could deliver measurable improvements in the lives of low-income youths. A former CEO of EMCF explained the shift this way in the foundation's annual report: "In previous years, we invested more in the development of new ideas than in their production, scale, and sustainability. Our goal [now] is not only to help create better services and systems, but to bring their benefits to more people."

Three years ago, EMCF formed the Growth Capital Aggregation Pilot (GCAP), a $120 million pool comprising funds from other foundations (including the Gates Foundation). The GCAP focused specifically on making long-term investments in high-performing enterprises. It conducted extensive due diligence to select three organizations—Nurse-Family Partnership, Youth Villages, and Citizen Schools—that had a record of success, an explicit model for accomplishing social change, and excellent current and potential capabilities. To reduce the administrative burden on grantees, the coinvestors have aligned their reporting and oversight requirements with EMCF's. EMCF made a five-year funding commitment to the three GCAP grantees (in stark contrast to the one-year, program-specific grants made by other foundations) and provides them with additional support in areas such as talent development and evaluation.

The foundation, which now has about $800 million in assets and annual grants of about $35 million, is prepared to fund organizations at three stages of development. The most mature, *sustainable growth programs,* have been scientifically proven to work through experimental research, including randomized controlled trials. *Growth-ready programs* have been analyzed by independent third parties, which collect data on them and compare their participants with youths not receiving the programs' services. *Early stage programs* have, at a minimum, systematically gathered data showing that young people are benefiting from them as intended. Each type of program must hit specific performance milestones related to service accomplishments, growth, and expansion to new locations. In an annual review EMCF

New Web Ventures Bridge the Information Gap

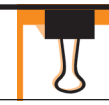
The Robin Hood Foundation and New Profit serve as both information and financial intermediaries between donors and nonprofits, a classic combined model that's prevalent in the for-profit sector. But in both sectors, the internet has made it increasingly feasible to separate these roles. In the nonprofit world, information intermediaries have moved onto the web first.

In 2001 a group of former investment bankers responded to the dearth of guidance for identifying effective nonprofits by establishing New Philanthropy Capital, an information provider for donors in the United Kingdom. NPC wants to build a philanthropic marketplace that puts "effectiveness at the heart of how funders give" and to promote a conversation about how to measure impact.

To date, NPC has written more than 50 reports on various charitable sectors, including education, the environment, and child services. The reports discuss the challenges in each field and the nonprofit organizations most effective at addressing them. All the reports are available free of charge on the web.

For donors, NPC also produces customized reports that evaluate the current and potential effectiveness of specific nonprofit organizations. These analyses are based on its charity analysis framework, which looks at organizations along six dimensions—activities, results, leadership, people and resources, finances, and ambition. The framework also helps any interested donor evaluate a nonprofit on his own by answering a series of illuminating questions in each dimension. NPC will soon begin to expand its services into Germany, India, and the United States.

Two information intermediaries, South African Social Investment Exchange and GlobalGiving, provide independent research and evaluate and monitor projects listed on their websites. By the end of 2010, another web-based organization, Charity Navigator, will be disseminating performance metrics for U.S.-based nonprofit organizations.



FOR FURTHER READING
For more information on nonprofit innovators, read the Harvard Business School cases on the Edna McConnell Clark Foundation, the Robin Hood Foundation, New Profit, Year Up, and United Way.

monitors the progress that each organization makes toward its targets before setting milestones for the next year.

Of course, most foundations and, certainly, individual donors don't have the resources needed to conduct due diligence, establish specific performance criteria for funding, and monitor postgrant performance. To fill this gap, the nonprofit sector needs new intermediaries to perform functions equivalent to those of a mutual fund, venture capital firm, or investment adviser.

A Social Mutual Fund

The Robin Hood Foundation finds, funds, and partners with more than 240 organizations in New York that attack poverty on a variety of fronts—including health care, job training, education, and access to private and government benefits. The foundation holds every one of them accountable for delivering results.

Each funded organization must measure the outcomes that it achieves, such as the number of four-year-olds capable of starting kindergarten, the number of high school graduates, the number of unemployed trained and hired, or the number of meals served. Robin Hood, in an innovative twist, then translates the reported outcomes from diverse programs into two standard metrics: the increase in the discounted present value of a program participant's lifetime income stream, and quality-adjusted life years—a measure of improvement to the participant's living standards. These common metrics enable the foundation to calculate a benefit-cost ratio for every enterprise and compare hundreds of dissimilar programs.

Using the information collected through this model, Robin Hood solicits funds from individuals and foundations, which it allocates to the most effective poverty-fighting nonprofits in the city. Donors rely on Robin Hood's due diligence, research, monitoring, and reporting processes to help them direct money where it will have the biggest impact.

Although extensive research goes into Robin Hood's translation of results into lifetime income value and quality-adjusted life years, the foundation's approach is not exact science, and many assumptions must be made—and perhaps validated and refined in future years—to do the benefit-cost calculation. But Robin Hood understands that it must not let "the best be the enemy of the good." It acknowledges, "We do not use metrics as the sole basis of grant decisions; we rely heavily on the detailed expertise of our program officers and a wealth of qualitative data." It also relies on a knowledgeable board that reviews every grant recommended by the staff.

A Social Venture Capital Fund

Founded in 1998, New Profit raises large sums of money from a few wealthy individuals and family foundations, which it directs to innovative nonprofits that it believes have the most potential to generate a lasting impact for low-income Americans. New Profit operates much like a sophisticated venture capital firm, performing detailed, rigorous analysis on potential fund recipients and actively managing its investments to increase their social impact.

Like a venture capital firm, New Profit performs rigorous analysis on potential fund recipients and actively manages its investments.

Elizabeth Riker, a New Profit partner, describes the approach this way: "We offer multiyear funding and highly engaged strategic advice, with follow-on funding tied to each organization's achieving specific performance goals derived from its model for social change."

An intensive selection process. New Profit screens candidates for funding in a six-month, three-stage process. Once its extensive formal referral network recommends an organization for consideration, New Profit staff members determine whether the organization is addressing a large, urgent problem that affects social mobility in the U.S., whether its program model can be scaled up to serve significantly more beneficiaries in a cost-effective way, and whether it has demonstrated that it can deliver positive results. Typically, this initial screening narrows a pool of 100 nonprofits down to 10 or 12.

The second stage further examines each remaining organization's ability to create social change and its capacity for growth. New Profit's staff determine whether the leadership team, employees, and board are aligned around the organization's mission, strategy, program model, desire for national scale, and needs for long-term sustainability. The organiza-

Translating Social Objectives into Action

New Profit uses the tools of the balanced scorecard system to manage and track the performance of the organizations it funds. Here is the strategy map it created with Achievement First.

Mission To deliver on the promise of equal educational opportunity for all of America's children

SOCIAL CHANGE

AND DRIVES

Direct impact

Create high-performing charter schools that close the achievement gap and enable students to graduate from college and be successful in a competitive world

METRICS
- AF STUDENT ACHIEVEMENT VERSUS STATE NON-LOW-INCOME AND STATE TOP-DISTRICT STUDENT ACHIEVEMENT
- HIGH SCHOOL GRADUATION RATE; COLLEGE ACCEPTANCE, MATRICULATION, AND GRADUATION RATES
- OVERALL SCHOOL QUALITY—AF SCHOOL REPORT CARD

Systemic impact

Create a proof point of the ability to close the achievement gap at scale (size of a medium-sized public district) using tools and systems that are replicable and shareable

METRICS
- SCALE (NUMBER OF STUDENTS, NUMBER OF ACADEMIES)
- PARTNERSHIPS

OUR CONSTITUENTS

WHICH CREATES VALUE FOR

INTERNAL

Students/parents

Achieve academic excellence and strength of character necessary for success in college

METRICS
- STUDENT APPLICATIONS
- PARENT FEEDBACK

Staff

Be the top choice for high-caliber talent to engage in thought-leading work

METRICS
- NUMBER OF QUALITY APPLICANTS/POSITIONS

EXTERNAL

Philanthropists

Provide maximum impact of funders' dollars and time

METRICS
- SIGNIFICANT DONORS RENEWING

Boards

Create ally and advocate in accomplishing mission

METRICS
- BOARD ENGAGEMENT AND SATISFACTION

State and local policy makers

Secure equitable public resources and support

METRICS
- PER PUPIL FUNDING RATES
- FACILITIES SUPPORT
- CHARTER RENEWAL TERMS

NETWORK PARTNERSHIP

THAT SUPPORT

School/network partnership

Build strong partnerships with clearly defined responsibilities, support, and communication

METRICS
- NETWORK-SUPPORT-TEAM AND SCHOOL-LEADERSHIP EFFECTIVENESS

CORE OPERATIONS ONGOING

ENHANCES

Student recruitment

Recruit and serve target population of students

METRICS
- COMPOSITION OF STUDENT ENROLLMENT
- PERSISTENCE AND MATRICULATION RATE

Talent development

Develop outstanding teachers, principals, and network-support staff

METRICS
- EMPLOYEE PERFORMANCE
- EMPLOYEE ENGAGEMENT AND SATISFACTION

Finance

Ensure strong financial processes to operate at scale within target public funding

METRICS
- NETWORK SELF-SUFFICIENCY
- CLEAN AUDITS
- STRONG BUDGET PERFORMANCE

ORGANIZATIONAL STRENGTH AND STABILITY

Organizational stability

Build next-generation management team, organizational structure, and processes

METRICS
- NUMBER OF OPEN POSITIONS
- FORWARD-LOOKING, BOARD-APPROVED ORGANIZATIONAL CHARTS
- SUCCESSION PLAN

Facility stability

Secure appropriate facilities at affordable cost

METRICS
- PERCENTAGE OF SCHOOLS WITH SECURE, AFFORDABLE, TIMELY FACILITIES

tion must have a track record of growth and sound financial management. This stage consumes about 20 hours of staff time per organization and includes at least one on-site visit. Out of every 10 to 12 organizations reviewed, New Profit promotes up to four to a final due diligence stage.

At this stage, New Profit invests about 100 hours in analyzing each nonprofit's mission, financial model, impact, and growth strategy. It also assesses the strength of the leadership team and its willingness to partner with New Profit to enhance its capabilities. New Profit staff members conduct program evaluations and site visits, review board materials, and meet with the organization's board, management team, and clients. New Profit may also seek external assessments from sector thought leaders, other funders, and peer organizations.

When New Profit decides to fund a nonprofit, it formulates a comprehensive investment hypothesis highlighting the organization's key opportunities and risks, which it shares with the organization. New Profit and the nonprofit jointly develop a 12-month action plan. All of that thinking forms the basis for the term sheet and partnership agreement, in which New Profit makes a four-to-six-year commitment to provide funding and strategic support.

A model for monitoring and reporting performance. New Profit helps the nonprofits in its portfolio develop frameworks to measure both impact and organizational performance. Riker notes that New Profit uses two metrics for all the organizations—growth in lives touched and revenues raised—and helps each organization develop a strategy map and a balanced scorecard with distinct performance measures. (See the exhibit "Translating Social Objectives into Action" for an illustration.)

The map shows the outcomes the nonprofit strives to achieve for its constituents; the critical processes that will create the desired social change; the skills, capabilities, and motivation of the employees who perform those processes; and an efficient system for managing the nonprofit's financial resources. The map and the scorecard provide the organization with both a strategy management system and a comprehensive reporting framework through which it is held accountable by New Profit.

Growing and governing the social enterprise. Most nonprofits attempt to keep their administrative expenses low and focus narrowly on short-term financial performance. As a result, they fail to build capabilities in strategy, leadership, fund-raising, performance measurement, and organizational development. To break this pattern, New Profit, like most active investors, supplies the organizations in its portfolio with ongoing resources and strategic support.

A New Profit partner serves on each nonprofit's board and becomes a day-to-day adviser, helping the leadership team refine its social change model, recruit talent, and develop its board. New Profit's

YEAR UP:
The Nonprofit Capital Market at Work

Gerald Chertavian, a Harvard MBA and successful entrepreneur, founded Year Up in Boston in 2000 to train young, low-income, at-risk urban adults for careers in the mainstream economy. Among its early investors was New Profit, which added Year Up to its portfolio in 2005. By 2007, Year Up had opened sites in Providence, Rhode Island; New York; and the District of Columbia and established working relationships with more than 80 corporate partners. That year, Chertavian sought a one-time capital infusion to support an ambitious five-year growth plan. He obtained it by issuing what he called an "initial partnership offering," in which he sought to raise $18 million in $1 million units. He modeled his fund-raising document on a regular financial market initial public offering prospectus, promising not a financial but a social return to his "investors."

Year Up wanted the money up front so that by 2011, it could have eight fully operational offices across the country, serving 1,600 students annually. Year Up promised to supply investors with periodic reports from its performance scorecard, including students' starting salaries, average time to find employment, corporate partners' satisfaction with their apprentices, student retention, and staff recruitment and retention. Response to Year Up's IPO was strong, and it closed with an oversubscription of two units. Half the units were purchased by contacts and friends of Chertavian, with the other half coming from new donors. By 2009, Year Up had used its capital infusion to expand operations into San Francisco, Chicago, and Atlanta, and it has plans to open an eighth location soon.

No corporate board would approve capital investments solely on the basis of the amount of money and hours of employee time required.

portfolio organizations also benefit from unique access to high-level strategic advisers via a partnership with Monitor Group, which provides up to two dozen senior consultants per year to coach the nonprofits' CEOs in strategy development and growth planning.

New Profit's own board, composed of investors and thought leaders in the field, uses the same tools to measure the growth and effectiveness of the fund itself. The members track the fund's progress against its goals with a balanced scorecard. The New Profit scorecard includes measures regarding the performance of portfolio organizations, such as compound annual growth rates in revenues raised and lives touched, organizational effectiveness scores, and quantitative assessments of social outcomes achieved.

"The days of rewarding me with mere pats on the head are over."

CARTOON: ROY DELGADO

Sustaining the Change

Encouragingly, a few previously passive financial intermediaries in the social sector are now following the active funding examples set by EMCF, New Profit, and Robin Hood. United Way, Combined Jewish Philanthropies, and the Boston Foundation are building capabilities for funding enterprises that deliver measurable social change and for assessing the subsequent performance of those enterprises.

Another promising sign comes from the U.S. government, which in 2009 established the Social Innovation Fund, an initiative that aims to support proven approaches to improving the economic opportunities, education, and health of the country's low-income citizens. In July 2010 the fund granted $50 million to 11 organizations, including EMCF and New Profit, that it believed had a successful track record in identifying and expanding high-performing, innovative nonprofits.

This positive trend would spread even further if corporations and their foundations became better partners with the philanthropic organizations they support. No corporate board would approve capital investments solely on the basis of the inputs required for the project, such as the amount of money to be spent and hours of employee time needed. Yet executive teams and boards accept exactly that information as the basis for their companies' philanthropic spending. Corporations and their foundations should follow the lead of the new nonprofit intermediaries we've described and insist on metrics of the social return from their charitable giving.

The ultimate prize is a social capital market that delivers real impact for the dollars donors contribute. The discipline of such a marketplace would motivate nonprofit leaders to adopt clear models for creating social impact, provide a solid framework for measuring and reporting performance, and help nonprofits develop the leadership and management capabilities they need to achieve their missions. Capital and talent would flow away from the inefficient and migrate toward the most effective, enabling the best to grow in scale and impact to create a stronger and more dynamic social sector.

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