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# VENTURE PHILANTHROPY INVESTMENTS[1]

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**ABSTRACT**

Consideration of social and environmental values is not a new concept in finance, but Social Finance and Social Investments have become prominent following the crisis. Based on empirical surveys, the social approach has been incorporated into the strategy of venture capital funds, however, the ratio of target companies with a social focus is still limited in actual placings. Since social impact is considered side by side with expected financial return for the selection of companies, the composition of future management has been given more emphasis, for instance, are they capable of a comprehensive vision not limited to business objectives. They provide non-financial support in the period of an investment; joint goal setting and coaching entrepreneurs are the most frequent features.

*JEL codes:* O35, G24, P18

*Keywords:* social finance, philanthropy, venture capital investments

## 1 INTRODUCTION

The global financial crisis of 2007 had a negative impact on a significant part of our world. As a result, 10 million unemployed people had been registered in the US by 2010 (up from less than 2.5 million earlier), while almost 5 million had lost their jobs in Europe. Thousands of families had lost their reserves, 5 million in the US and 2 million in Europe had fallen below the poverty line (*Benedikter*, 2011). The necessity for socially focused financial services and investment had become obvious, as opportunities to move forward for those living in poverty or extreme poverty had been scarce.

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Although many institutions of Social Finance came into being or gained in strength after the crisis, those types of financial services have a long history. Socially responsible investments (SRI) already appeared at the beginning of the 17th century; religious leaders, for instance, rejected investments that were questionable from an environmental or moral aspect (*Hutton* et al., 1998). Social microcredits were launched in the second half of the 1970s initiated by Muhammad Yunus providing low amount unsecured loans (*Morduch*, 1999; *Futó* et al., 2016).

Social finance is a comprehensive concept, which means more than simply channeling funds to projects of social and environmental improvement. The term 'social finance' is an indication that an investor will not only consider financial return but also the totality of social and financial benefits (*Moore* et al., 2012). Its objective is to provide resources for spreading social and environmental innovation (*Pradhan* et al., 1998). This area is constantly growing and is given more and more attention both in the business sector and the world of science.

The purpose of this study is to introduce philanthropy venture capital and to analyse market experience Prior to that, I am discussing the concepts of social finance and sustainable finance.

## 2 SOCIAL AND SUSTAINABLE FINANCE

The UN 2030 Agenda for Sustainable Development was published in 2015, in which 17 sustainable development goals with 169 targets were proposed. For instance, efforts must be made to promote gender equality, to reduce inequalities between countries, to tackle climate change or to protect and rebuild the ecosystem (UN, 2015).

Economy and finance are responsible for promoting the achievement of the goals through active commitment by actors and institutions. You can often hear it is a topical issue, but it is more than that. It is unavoidable that markets behave and act responsibly and sustainably.

Investors that consider financial profit in their decisions only are at level zero (0.0) of sustainable finance, i.e., social or environmental aspects do not appear. Level one of sustainable finance means investors still strive to maximize their profit but they abstain from undesirable investments. Take, for instance, the religious leaders in the 17th century mentioned above, or a recent example of excluding from investment targets companies with a reputation of employing child labour or enterprises of the tobacco industry.

At level two (2.0) of sustainable finance, social and environmental effects are in focus. It means from a certain aspect that market players internalise external ef-

fects by considering ESG (Environmental, Social and Corporate governance) factors for their decisions. For instance, the installation of a polluting process would have a negative effect on a company's reputation.

At "advanced level' (3.0) of sustainable finance social benefits are in focus; it has the same or even higher weight in decisions than financial gain. (*Schoenmaker–Schramade,* 2018). Emphasis is not only on stockholders' value creation, a wider group of stakeholders as well as social and environmental values are involved.

**Table 1**
**Levels of sustainable finance**

| | Shares (Capital) | Bonds | Banking instruments |
|---|---|---|---|
| Sustainable finance 0.0 | | | |
| Sustainable finance 1.0 | Exclusion | Exclusion | Exclusion |
| Sustainable finance 2.0 | ESG integration | | |
| Sustainable finance 3.0 | Impact investments | Social and green bonds | Impact lending Microcredits |

*Source:* Based on Schoenmaker and Schramade (2018)

The scheme of microfinancing/microcredits launched in Bangladesh has developed into a global movement by now. Its objective is to grant poor people financial services (mainly loans) to build their businesses. In that way they have an opportunity to increase their income and leave poverty behind.

Social Impact Bonds (SIB) can be regarded financial instruments which allow market financing (Pay-for-Success contracts) to mitigate difficult social problems (e.g. helping the homeless or preventing the relapse of criminals). They typically identify target areas that traditionally belong to the scope of the government sector (Copper et al., 2016). If a targeted project fails, investors will lose part or even the whole of their investment. But they can realise a profit if it succeeds.

The concept of impact investment was launched in 2007 when the Rockefeller Foundation invited financial leaders and philanthropists to discuss what kind of investments are necessary for improving the positive impact of social and societal investments (*Höchstädter–Scheck,* 2015). Social impact investing means investments resulting in social or environmental benefits in addition to financial profit.

Both the number of impact investments and organisations engaged in impact investing are continuously growing. According to a survey by the Global Impact Investors Network, over 50 percent of organisations made their first investments in

the last decade (GIIN, 2020). But almost a quarter of the participants in the survey had already made impact investments before 2000. According to the survey, those investments have increased by 10 per cent on average over the past 5 years, but if you take Schoenmaker and Schramade's estimations (2018), a mere 1 per cent of financial instruments or investments have reached level 3.0 of sustainable finance.

## 3 PHILANTHROPY VENTURE CAPITAL

Investment targets are typically social enterprises. They have social/societal goals in their focus (unlike classical profit orientation). They strive to find ways to operate sustainably and to change harmful environmental processes.

Earlier, social enterprises could traditionally obtain funds from foundations[3], typically in the form of non-reimbursable subsidies/donations. (*Kerlin,* 2010). *Lett* et al. (1997) made efforts to direct the attention of the leaders of foundations to the methods of venture capital (hereinafter: VC) practices they should apply. For instance, risk management and the closeness with their target enterprise is different for foundations (philanthropists). While VC run high risk, since typically 2 out of 10 investments may result in high profit, the risk of foundations often is that they cannot find a sufficient number of target enterprises (there is no profit expectation). While for VC, one of the key features of success is that they provide more than simple monetary contribution, foundations filter opportunities at the beginning, but after the money has been disbursed, there is limited monitoring only. The length of the relationship is also different. A VC typically invest for 5 to 7 years, while foundations expect new developments within a shorter time; they expect positive results typically after 2.5 years on average (Lett et al., 1997).

Social investment and philanthropy venture capital are similar concepts, still, there are important differences between them. Both are committed to some social goal, but the latter does not only provide monetary contribution but also services. They are also committed to the strategy of a target company, to the extent of playing an active part in setting it out (John, 2006).

*Roundy* et al. (2017) assessed the differences between traditional and social investors based on a series of interviews made with three groups of market players. In total, 31 investors were included in the research, 17 of whom were impact and 14

3 In international comparison foundations are dominant in funding North American enterprises. In Western Europe it is the EU while in Eastern Europe, in addition to the EU, international aid plays a major part (Kerlin, 2021). On the other hand, social enterprises in South America, Asia and Africa have strong links to banks, so they often obtain funds from market players.

non-impact investors (according to own declarations). In addition, 11 entrepreneurs who received capital from impact investors were also asked.

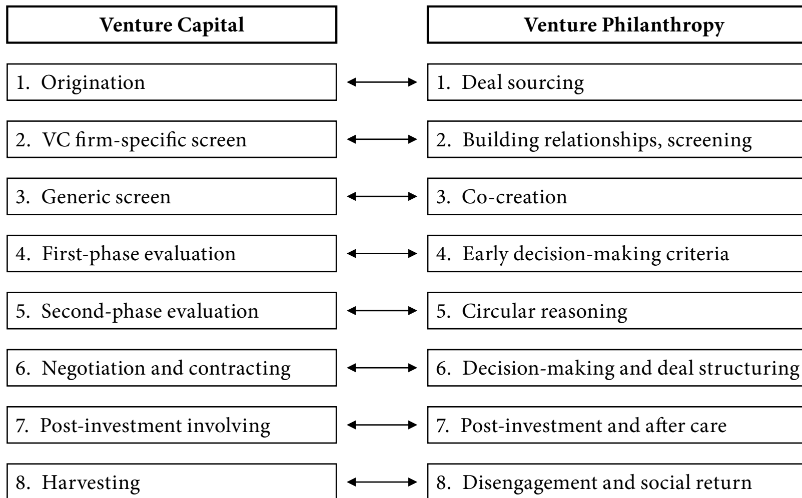
According to Roundy et al. (2017), impact investors emphasised they were different because not only ROI (Return on Investment) but also SROI (Social Return on Investment) played a part in their investment decisions. Thus, an impact investor is willing to sacrifice some financial return if they can also achieve social benefits. According to entrepreneurs, if they sought to find traditional investors, the investment IRR should reach 60%. But if, according to the business plan, it only reaches 18% side by side with positive social impact, they should turn to an impact investor.

Due to the issue of principal - agent, managers of traditional venture capital funds are committed to considering financial return only. Investors expect profit from the assets they manage, and if asset managers do not select investment targets properly, they can lose their jobs. On the other hand, social value creation is important for a traditional philanthropist. For instance, you can regard financial return to be –100% (i.e., complete failure), because they do not expect any repayment, but in return there should be at least 100%-times improvement in welfare or in the environment. (Roundy et al., 2017). Impact investors, for instance, are committed to job creation in backward regions or to the promotion of the spread of clean technologies. In that way, the aspects of financial return are somewhat pushed into the background (although they remain an important principle of consideration), so that the goals identified could be achieved. Another important difference compared to traditional investors is that VC may be termed 'patient capital' or the investments may be regarded as 'slow money'. They do not think in the short term; they are also willing to rely on longer return (Roundy et al., 2017).

### 3.1 Differences in the process of decision making and of investors

According to Roundy et al. the differences of the selection process already appeared, which *Gordon* (2014) analysed in detail. Gordon's research (2014) included four case studies of 4 philanthropy venture capital funds; his assessment was based on 21 interviews (made with top executives, key managers, and the founders of the target companies). As you can see on Figure 1, the process of investment decision making is quite long even for traditional venture capital investments. Investors want to have a good knowledge of the target company and its market environment; the contract is drafted following several rounds of discussions. Each step is an effort to reduce the asymmetry of the information. Next, I am comparing the investment processes of the two types according to Gordon (2014), *Fried–Hisrich* (1994) and Lovas (2015).

**Figure 1**
**Investment process of traditional and philanthropy venture capitalists**




*Source:* Own design based on Gordon (2014), *Fried and Hisrich* (1994) and Lovas (2015)

While venture apitalists (hereinafter: VC) look for target enterprises at general start-up events or wait for future partners to show up, philanthropy venture capitalists (hereinafter: VP) explicitly target existing social enterprises or charity organisations.

The second step of VC is a general screening of all offers received and selecting the ones that meet the basic criteria identified by the VC. After finding a potential target company, VP look for the potential connection to it for working together. VC also provide professional assistance in addition to funding, but a VP provide more, their collaboration is more active.

As the third step for VC, a business due diligence takes place including, for instance, the company business plan and the entrepreneur's or management's track record. In the third step VP focus on joint social or environmental value creation and expect the entrepreneur (or the organization) to play an active part, (while this phase for VC practically means the collection of data).

After that, VC investment managers make an evaluation to find out if it is worth continuing the assessment and submitting the given proposal to a higher-level investment council. Step 4 by VP is similar, as it is there that financial and social criteria are compared whether it is worth going further and proper blended value creation can be achieved.

In step 5 of VC legal and financial due diligence is executed; in the case of VP it is joint assessment, a common learning process. A philanthropist team also learn from a potential investment target, for instance, specific knowledge relating to the field and gain insight into the organisation itself.

Next, VC and the target company agree on the terms and conditions of their contract (it is a sincere process of discussions due to the strong asymmetry of information) and phase 6 of the VP investment process works in a similar way.

The post-investment phase 7 differs in the two cases, because VP participate in the work of the target organisation more actively. They also communicate more frequently, particularly at the beginning. The last phase differs in the length of time, as social/environmental benefits take more time to appear, while VC prefer short term return ('as soon as a VC enter the gate, they already look for the exit").

The quality of the management, of the team is extremely important for both a traditional and a philanthropy venture capitalist since they "invest into the person" rather than into the enterprise. If a company leader does not only consider financial return but also social value creation is in focus, such a dual value aspect is more of a challenge, it requires more knowledge (training). (*Tracey–Phillips*, 2007). Analysing European and American philanthropy VC investments, *Scarlata* et al., (2017) have found that the executives of the target companies for both traditional and philanthropy VC had similar qualifications. However, he underlined a difference: in traditional VC target companies more managers had degrees in business/economics or engineering, while qualifications in human resources or management were more typical in the other case.

## 4 EMPIRICAL EXPERIENCE OF INVESTMENTS

Social and impact investments are spreading in the operation of traditional venture capitalists as well. Often a traditional venture capital fund will expand its portfolio to focus on social or environmental value creation. *Cetindamar* and *Ozkazanc-Pan* (2017) analysed the investments of 8 American companies that advertise themselves as philanthropy funds or philanthropy investors. Their actual investment structure, however, did not confirm it. According to the findings summed up in *Table 2*, seven of the fund strategies included mixed goals and there was only one where social goals were identified.

**Table 2**
**Distribution of investments placed by social funds**

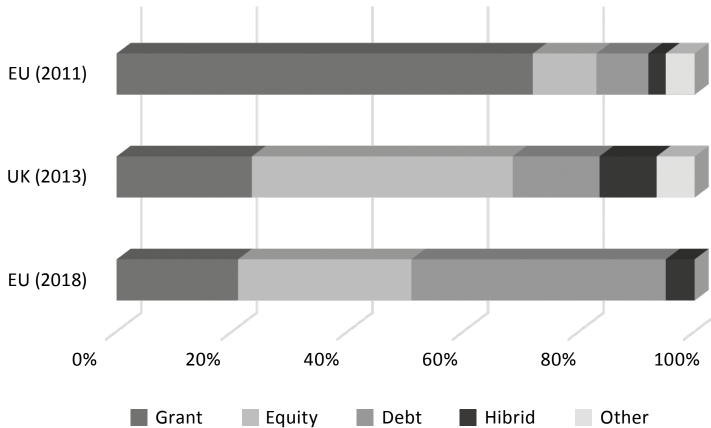
| Names of VC impact investors | Dominant logic of goals/ends | Total no. of investees | By social logic | Total investment amount (in M$) | by social logic | Social logics (value %) | Dominant logics |
|---|---|---|---|---|---|---|---|
| **Accion Venture Lab** | Mixed | 13 | 5 | 34.99 | 18.5 | 52.9% | Balance |
| **City Light Capital** | Mixed | 6 | 0 | 35.47 | 0 | 0.0% | Financial |
| **DBL Investors** | Mixed | 26 | 8 | 211.65 | 109.85 | 51.9% | Balance |
| **Elevar Equity** | Mixed | 9 | 6 | 62.64 | 54.99 | 87.8% | Social |
| **Gray Ghost Ventures** | Mixed | 9 | 2 | 13.14 | 1.82 | 13.9% | Financial |
| **New Schools Venture** | Social | 1 | 1 | 26.06 | 26.06 | 100.0% | Social |
| **Omidyar Network** | Mixed | 60 | 26 | 222.15 | 95.18 | 42.8% | Balance |
| **SJF ventures** | Mixed | 40 | 10 | 74.11 | 12.49 | 16.9% | Financial |

*Source:* Cetindamar and Ozkazanc-Pan (2017:9)

With respect to the number and value of placings, the social rate was quite low for some funds with one fund engaged in financially focused placing only. The fund advertising itself as socially focused was really involved in social investments but it only completed one in the period analysed. Regarding placings on the basis of the focus identified, 3 were financial, 2 social and 3 balanced, i.e., aiming at both goals. The findings of Cetindamar and Ozkazanc-Pan (2017) show that social goals did not play such a part in placing practice as in strategic planning.

The funding structure, or more exactly, the way of funding by investors calling themselves philanthropy funds is more nuanced. In some cases, they actually provide non-reimbursable funding but traditional equity-based fund raising also often appears.

**Figure 2**
**Distribution of funding instruments of funds in the European Union (EU) and in the United Kingdom (UK)**

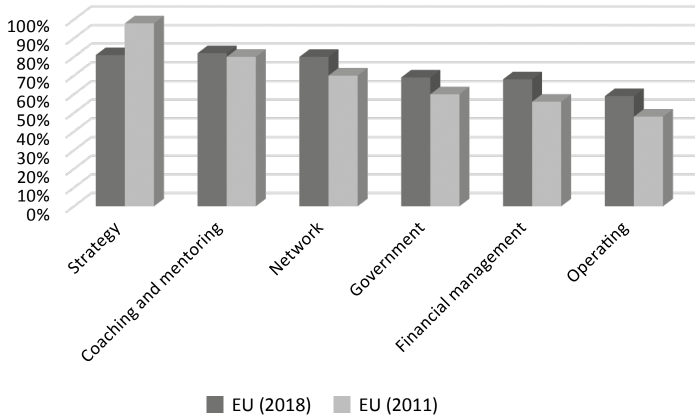



*Source:* Own design based on *Spiess-Knafl–Aschari-Lincoln* (2015), EVPA (2012) and EVPA (2018)

While subsidies were dominant 10 years ago, their ratio has diminished significantly (Figure 2). Loans and equity-based funding are the most common ways of funding. From the aspect of social value creation, the more advantageous forms are the 'more patient' ones, i.e.,, the ones that are available for the target company for several years, they need not be repaid, or the results proved in a year or two. Shares are long term investments, so they can be deemed a suitable way of funding if an environmental or social project is to be implemented, which requires several years. Equity-based funding is decisive not only in Europe (Figure 2). According to a 2013 survey in Asia, shares appeared in 90% of investments. Loans are also important, as loans characterised every second investment (*Bammi–Verma*, 2014).

The nature of target enterprises greatly influences what kind of funding is selected. 5-year-old and older companies usually receive subsidies (by logistical regression: its chance is three times of traditional financing). 4-year-old and younger ones receive traditional financing, because funds also provide them with active support (Spiess-Knafl–Aschari-Lincoln, 2015). The chance of failure is higher for start-up companies, so providing funding as well as active control may help them avoid potential pitfalls.

**Figure 3**
**Most frequent non-financial support by European funds**
**(ratio of funds providing a given kind of support)**




*Source:* Own design based on EVPA (2012) and EVPA (2018)

Regarding subsidies and other financial instruments, an important difference of philanthropy venture capital is the added value they provide in non-financial support. Their significance has somewhat changed over time (Figure 3), but they still play a major part. One can see on *Figure 3* that almost all investors played an active part in designing strategy 10 years ago, the ratio has now declined by about 20%. It is still an important factor, but it is not deemed necessary in every case. Investors do not only take part in setting out strategy but also in control (4th in order) and in operation (6th in order). The part played by financial management, more specifically, assistance provided there has gained in value. 10 years ago, half of the funds (56%) reported they assisted entrepreneurs in that area, the ratio has grown to over two-thirds (68%) over the past years.

In contrast to "traditional" venture capital, philanthropy provide non-financial contribution by involving third parties, for instance, volunteers or other organisations on a pro-bono basis (*Mityushina* et al., 2019).

## 5 MEASURING SOCIAL/SOCIETAL BENEFITS

Since economic utility is an explicit goal of such investments, they are different from donations. One can find several alternatives for the term and for the indicators of social/societal benefits in the literature. Based on the study of almost 300 periodicals dealing with the topic, *Rawhouser* et al., (2019) have found that "social

performance" is used most frequently (about 40 articles), "societal or environmental impact" also appear in many cases (about 20 articles) while the use of "social values" is less frequent (10 articles).

**Table 3**
**Categories of measurements of social/societal impact**

| | Multi-sectoral | Sector specific |
|---|---|---|
| **Findings** | Actual goals (e.g., labour safety, employee health, etc.)<br>Indirect measurements (e.g., satisfaction)<br>Estimated from specific company activity (e.g., re-cycling)<br>Databases of environmental impact | One or several social benefits (e.g., effect of fair trade on coffee plantations in Nicaragua) |
| **Process** | Databases of social indices<br>Impact and factors influencing rating<br>Analysis of product life cycle with respect to environmental impact | Individual actions (e.g. public good provided by hospitals, community loans by banks) |

*Source:* Own design based on Rawhouser et al. (2019)

Social performance and social benefits are discussed in the studies from several aspects. For instance, the performance of investment funds is rated compared to a given ESG rating (*Naffa–Fain,* 2020), or the performance of green bonds indices is compared to other bond indices. According to Rawhouser et al. (2019), most studies are multi-sectoral, i.e., they compare different industries too, or they focus on activity, i.e., how a change in environmental rating affects performance. Result-based analysis also often appears in multi-sectoral studies. It is assumed that some company indicator (e.g. employee safety or recyclability of the products) can be used to measure and compare societal values. Rawhouser et al. (2019) have found fewer examples of sector specific analysis of operations. These studies apply a narrower interpretation of societal impact, for instance, to what extent the factories of a company have installed devices to reduce emission or what kind of public good is provided by a hospital. (Categories are summarised in *Table 3*). Number four of them focus on sector specific results, for instance, the ones modelling the increase of societal wellbeing.

Two types of value creation can be measured at social enterprises and the target companies of philanthropy investments. On the one hand, social value is, for instance, if access to healthcare improves for the disadvantaged or if work conditions improve. On the other hand, economic value is the value of the prod-

uct manufactured or the service provided. While the former measure is fairly subjective, and mainly represents internal values, the latter is easier to measure. Their mixture, socio-economic value is based on the economic value, but it also contains social elements. It may mean reduced government expenditure or higher tax revenues thanks to the activities of social enterprises (*Emerson–Cabaj*, 2000).

SROI (Social Return on Investment) is an indicator to measure socio-economic value, which is spreading quickly. Measuring financial profit is simple compared to social return. The expected cashflow of a company can be drawn up by estimating revenues and expenses and an estimated value can be established. The formula for measurements is the following:

$$SROI = \frac{NPV(Benefits)}{NPV(Investments)}.$$

SROI is typically expressed as a ratio, for instance, 3:1 means each pound produced by a given investment results in 3 pounds of social/societal return.

The SROI introduced by REDF (2001) is a traditional cost-benefit analysis and an estimate of social benefits based on the former. Several important assumptions and agreements must be made for a cost-benefit analysis: how long is the project, or more exactly, the period of the SROI analysis; what is the return used for discounting or how to treat inflation. A most important one is how to define societal value, for instance, what can be deemed a reduction of social costs. (*Ryan–Lyne*, 2008).

REDF (2001) introduced the methodology of measuring SROI, and it was tested by NEF (2004). NEF (2004) underlined in the methodology of SROI that it consisted of several steps including, for example, mapping other stakeholder values or effects. Although SROI is similar to a cost-benefit analysis, there is an important difference: it focuses on the so termed third sector and aims to involve stakeholders in each phase by stakeholders' assessment of the service (*Millar–Hall*, 2013).

The 7 steps of measuring SROI are the following (*Nicholls* et al., 2009): 9).

- involve stakeholders,
- understand change,
- identify important factors,
- evaluate important ones only,
- do not demand too much,
- be transparent, and finally
- verify your results.

Social enterprises are more and more expected to measure their social performance and SROI is (or can be) a tool for that. SROI can be of many kinds; it can

represent the result of a whole enterprise, but it can also refer to the processes of one entity of an organisation. Its timeline can be manifold, too: it can be retrospective, analysing actual results or based on predictions (*Dacin* et al., 2010).

Although there is great pressure on social enterprises to identify their SROI, or to apply other tools, that does not often occur as shown by many practical examples. For instance, you should display self-esteem or confidence as a financial figure. It is another difficulty if SROI uses assumptions that are not part of company operations or are incompatible with them. For instance, they should have financial indicators verified by records. Lacking those, SROI is much less reliable. (Ryan and Lyne, 2008). The application of financial indicators for social enterprises, particularly start-ups or small size enterprises is no advantage, on the contrary, it can be a disadvantage. They are costly because they require time and specialised knowledge.

## 6 SUMMARY

Social investments are gaining momentum side by side with “traditional” investments focusing on financial return alone. Responsible or sustainable operations are expected of most companies these days.

I studied venture capital investments with particular emphasis on philanthropy investments. Traditional and philanthropy venture capital investments also differ in the investment process. An important difference in the process preceding the investment is that a philanthropy VC focuses more on potential collaboration and the composition of the team. The period of closing the investment is also different, since traditional investors typically expect quick financial return, but social and environmental effects take more time to appear, so philanthropy VC think in longer terms.

However, it has turned out from an empirical study that finance focused investments are still the majority of investments advertising themselves as philanthropy. Studying a 10-year period, however, there is a difference in funding structure. While subsidies used to be the majority of social investments earlier, “traditional” funding means (equity and loan-type sources) have been gaining momentum by now. Thus, investments that are sustainable both socially and financially have appeared.

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