Using private investor capital to increase NGO impact

Executive summary

A report produced as the result of an ongoing collaboration between Zurich and Population Services International (PSI) aims to facilitate more frequent and meaningful engagement between NGOs and impact investors via investments of private investor capital – investments that deliver both social impact and a financial return.

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There is already significant interest among stakeholders as to how NGOs and impact investors can work closer together. While a variety of literature on the topic exists, certain questions remain unanswered.

The opportunities for investments that offer both social impact and financial return may appear small and fragmented from the investor's perspective. Yet there are many large NGOs that achieve impact at scale. Could large institutional investors engage with NGOs to accelerate the pace at which impact investments are made at scale, and enhance NGOs' capacity to deliver impact? At the same time, among NGOs there is a limited understanding of how to use private investor capital to increase impact. Could NGOs think beyond investments in independent social enterprises to financing models that employ private investor capital within the NGO? If so, how could these models work?

We engaged NGOs, investors and donors through structured interviews, workshops and informal dialogues to gather their insights. The report presents the results of these discussions through a framework that should help NGOs and investors speak a common language and better understand various financial models through which they can engage with each other.

This framework is based on the underlying premise that all NGOs have a mission to deliver impact, and that there are specific levers they can pull, or actions they can take to increase the impact they can deliver. We learned that NGOs typically face four main funding challenges that prevent them from achieving maximum impact, as shown in the box on the following page.

"How can private investor capital address some of the funding challenges NGOs face?"

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Shortage: There are limited donor resources available and many NGOs are competing for these resources.

Accessibility: The risks involved with performance-based contracts – where a donor makes payments to an NGO only after achieving specific outcomes – can often be too high for NGOs.

Timing: The unpredictable nature of donor resource flows can leave NGOs without the necessary resources to implement projects at the time when impact would be greatest.

Restrictions: Donors often require NGOs to spend according to previously-agreed upon budget lines, limiting the flexibility with which NGOs can operate to deliver optimal impact.

The framework provides a lens through which it is possible to understand how private investor capital could potentially address some of these funding challenges. This framework is based on the recognition that unlike donations, private investor capital must return principle when borrowed, in addition to generating returns for investors. While this may be obvious, it represents a fundamental shift in operations for many NGOs. Our framework addresses this challenge. It outlines the various financing models that NGOs can adopt in order to use private investor capital. These models are categorized according to how they provide returns to the investor – for example through untied future donations, or from income generated by assets.

Model 1: Using donations to pay back investors

- Model 1a – Borrowing to fund immediate project needs: NGOs use private investor capital in the form of working capital loans to fund immediate project needs, and use future donations to pay back principle to the investor, along with any returns in the form of interest. This model addresses the 'timing' challenge.
- Model 1b – Sharing risks of performance-based projects: NGOs use private investor capital to implement projects and donors pay returns to investors once the NGO has achieved previously-agreed performance targets. Through this process, investors share some of the risks associated with traditional performance-based contracts with NGOs, thus addressing the challenge of 'accessibility.' This model includes, for example, development impact bonds (DIBs).

Model 2: Using income generated from dual-purpose assets to pay back investors

- Model 2a – Generating income and impact through the monetization of dual-purpose assets: NGOs use private investor capital to develop, strengthen or scale up internal assets that can be 'monetized' to generate income outside the project. This might include distribution networks, tools and knowledge, or insight about 'bottom-of-the-pyramid' consumers. The income these monetized dual-purpose assets generate can be used to pay investors returns, and any remaining profits re-invested in NGO projects. As such, this type of model addresses the 'shortage' challenge.
- Model 2b – Funding immediate project needs: NGOs use working capital loans to fund immediate project needs, similar to Model 1a, but in this case monetized dual-purpose assets enable NGOs to acquire the loan by generating an income stream that can be used to pay back investors. This model addresses the 'timing' challenge.

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Model 3: Using income generated from independent social enterprises to pay back investors:

- Model 3a – Developing and scaling up social enterprises: NGOs use private investor capital to invest in developing or scaling up fully-independent social enterprises; businesses generating both profits and social impact. The income generated from the social enterprises can be used to pay investors' returns. Depending on the NGO's share of the enterprise, remaining profits can be reinvested in NGO projects. This model addresses the 'shortage' challenge.
- Model 3b – Funding immediate project needs: NGOs take working capital loans to fund immediate project needs and use income generated from social enterprises fully or partially owned by the NGO to pay back investors. This model addresses the 'timing' challenge.

The individual NGO's circumstances and mission determine which financial model could be used. The gap between an NGO's need for funding and the supply of funds available to it dictate its specific challenges and the appropriate financing models.

NGOs need to consider several key factors before deciding which, if any financial model to use. Points to consider include:

- Can the NGO manage financial distress if unable to pay back a loan?
- Is the NGO prepared for possible tension arising from any trade-off between profit and impact?
- As a result of diverting resources toward profit-generating activities, will the NGO need to address real or perceived mission drift?
- Is the NGO prepared for necessary changes to its organizational culture?
- Does the NGO have, or can they reasonably acquire the business planning, management and accounting skills to successfully manage profit-generating ventures supported by private investor capital?

When considering any investment with an NGO, investors may need to adopt additional processes beyond those that support their standard investment analysis. Points to consider include:

- Does the investor have non-standard financing structures to align incentives and minimize tension between profit and impact?
- Is the investor aware of the reputational risk it may face if an NGO defaults on a payment and the investor seeks recourse?
- Has the investor outlined options to de-risk investments, such as first-loss capital, donor guarantees, and corporate structures that place the charitable mission first, without violating any fiduciary duties?
- Does the investor require the NGO to demonstrate its ability to deliver impact via historical performance records?
- Is the investor able to capture portfolio diversification benefits from returns that are only minimally correlated with capital markets?

Donors play a significant role in influencing the successful implementation of many of the financial models proposed here. Although we do not present specific recommendations for donors in this report, we believe they should play an integral role in the dialogue around impact investment. Considerations for donors include:

- Is the donor willing to pay retroactively for impact generated by NGOs that used private investor capital (under Model 1a)?
- Is the donor willing to pay investors a return when outcomes are achieved in exchange for increased efficiency and lower risk (under Model 1b)?
- Is the donor able to shift from a reporting approach focused on line items in a budget and inputs to monitoring outcomes achieved (under Model 1b)?
- Is the donor willing to allow assets originally funded by donations to be 'monetized' or used to produce economic returns (under Models 2 and 3)?
- Is the donor willing to engage in new models to promote greater financial sustainability in development, even if this creates tension between impact and profit?

Over the longer term, private investor capital has the potential to complement existing

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NGO funding sources to unlock significant value by tapping into NGOs' experience and expertise. However, it is likely that the required 'ecosystem' will take time to develop and mature. General barriers to success include NGOs' discomfort with the concept of borrowing money, or losing control over assets, and the associated risk of financial distress. Additionally, many NGOs lack 'for-profit' business skills, capacities, infrastructure and organizational culture required to operate profitable business models.

Similarly, investors would not want to be in a position where they are forced to collect from an NGO that defaults or otherwise fails to meet expectations. Investors are also concerned about the processes and legal structures that will need to be put in place to deal with any tension arising from trade-offs between impact and profit.

Overarching enablers for growth include the continued standardization of governance mechanisms, performance metrics, and financial and legal structures to enable investors and NGOs to engage in these models at scale. An immediate next step is ongoing engagement among all participants to continue to test and prove models in situ. It is hoped that the framework presented here will provide an appropriate context to learn and further the discussion. But we feel that meaningful impact can only come from taking action and implementing solutions.

When NGOs play a significant role in helping to build tomorrow's model of impact investment, the rewards are many. NGOs will be able to become more resilient to stress related to funding challenges, and increase the efficiency and effectiveness of their operations to deliver greater impact. Investors will be better able to achieve their responsible investment goals. It could also allow investors to tap into types of assets that are uncorrelated with the wider capital markets, thus increasing portfolio diversification. Finally, donors will have the opportunity for their committed resources to go further and have a greater impact. We hope that this report provides a foundation for NGOs and investors to work together to use private investor capital to address some of the world's greatest social challenges.

About this report

In September 2013, Population Services International (PSI) and Zurich Insurance Company Ltd formed a team drawn from both organizations to explore how NGOs could use private investor capital to deliver increased social impact. The core project team worked together through a three-month engagement process, receiving direction from one steering committee led by representatives from both PSI and Zurich.

The full report, 'Using private investor capital to increase NGO impact: a framework and key considerations to facilitate engagement,' is available at www.zurich.com and www.psi.org

Disclaimer and cautionary statement

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