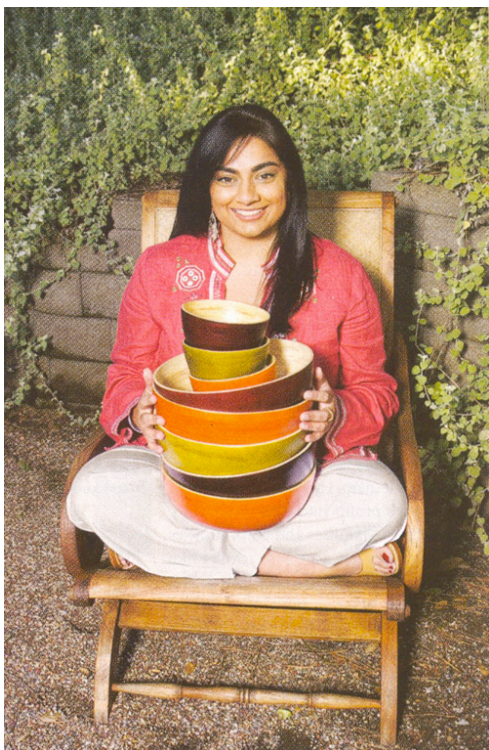


Do-Gooder Finance

How a new crop of investors is helping social entrepreneurs.

From: Inc. Magazine, February 2008 | By: Nitasha Tiku Raising Funds



These days, doing good is good business, right? Tell that to the venture capitalists. When they hear about a for-profit company driven by a social mission, their refrain is still the same: "You need to focus more on profits. How are we going to get our 30 percent returns?" Banks often sing the same tune; few are willing to back ventures with unconventional business models, at least not without exorbitant interest rates or risky personal guarantees. Tim Freundlich, a director at the Calvert Foundation, which invests in companies that do community development or poverty alleviation work, first noticed the problem in 2000, when venture firms were all too happy to invest in high-tech start-ups with no profits but do-gooder companies still had to bootstrap growth. "There was an abject lack of expansion capital," says Freundlich. "Companies reinvested their profits and grew really slowly. Or they relied heavily on family, friends, and credit cards. When you do that, your chances of failure are higher."

What, then, should socially minded entrepreneurs do if they're trying to create planet-saving, world-changing, and yes, moneymaking enterprises? There's a burgeoning market of investors and lenders that actually seek out companies that pursue social goals. Over the past five years, at least 15 social venture funds have launched, with the goal of investing in companies that are interested in more than profits. In 2006, Freundlich co-founded Good Capital, which has raised \$4 million of a planned \$30 million fund. Banks are getting into the game as well. New Resource Bank, a community bank in San Francisco, lends to companies with sustainable practices; the bank opened in 2006 with about \$25 million in capital and now has assets of more than \$130 million.

Socially minded investors tout their funds as "patient capital." They're not looking to flip companies as quickly as traditional venture firms are, and they're willing to wait if selling threatens to dilute a company's social mission. David Berge, managing member of Underdog Ventures, a social venture firm in Island Pond, Vermont, says the firm aims to sell its stake in the companies in its first fund within seven to eight years, with a possible two-year extension. Typical VCs favor a five- to seven-year exit.

But make no mistake: Social investors have to deliver to their partners. Berge expects each of the six companies in his first fund to yield returns of about 15 percent a year--market rate for expansion capital. Good Capital, which plans to close its first deals early this year, will expect double-digit returns from its for-profit investments, though it also lends to nonprofits, which will bring down total returns. And New Resource charges interest rates based on risk, just like a regular bank.

There are, however, some major differences between this new crop of funders and their more traditional brethren. For one, social VCs are willing to consider unusual models. Though traditional VCs are excited about most things green, they're still pursuing the usual high-tech, high-return investments. That's great for solar-energy and biodiesel start-ups, but an entrepreneur who imports fair-trade goods or has a nonprofit arm--and thus has lower margins initially--may be out of luck. A great way to end a meeting with a traditional investor or banker is to say, "Oh, by the way, I give away 10 percent of my profits to charity."

Priya Haji learned that when she sought a line of credit for World of Good, which imports fair-trade products like wood-and-bone spoons from Tanzania and lacquered bowls from Vietnam. Haji puts 10 percent of the company's profits into a nonprofit arm, which helps the families and communities of her suppliers get access to things like clean water and computer labs. The model won Haji first place in the Global Social Venture Competition, run by several business schools, in 2005. It also helped her raise more than \$300,000 in prize and seed money. But Haji also wanted a line of credit, because it's common practice for fair-trade companies to pay half the cost of each purchase in advance. She tried traditional banks, but they weren't interested because she didn't have a three-year track record. "For them, it didn't make sense," Haji says. "There's a consumer-driven demand for this kind of ethical consumption, but the debt markets don't understand that."

So Haji courted social lenders, many of which are willing to work with early-stage fair-trade companies. RSF Social Finance, for example, sometimes lends to companies even if 30 percent to 40 percent of receivables come from one customer. (Most banks prefer a maximum of 20 percent.) That's a boon for organic or fair-trade companies, many of which have a single big account with Whole Foods (NASDAQ:WFMI). In 2006, Haji reached a deal with three lenders: RSF, Root Capital, and Shared Interest. Since then, she says, revenue has more than doubled.

Traditional VCs often pressure entrepreneurs to jettison their do-gooder roots, but social investors take the opposite approach. Berge, Freundlich, and other social investors want to make sure that their portfolio companies maintain their social missions as they grow. Underdog Ventures, for example, required all the companies in its first fund to donate a portion of their equity to a nonprofit. And if a company wants to change its social mission, it needs Underdog's approval first.

That's one reason Charlie Crystle sought out Underdog when he started his second company. His first one, a software firm called Chili!Soft, was backed by VC giant Draper Fisher Jurvetson. The company was acquired for \$70 million, in 2000, but Crystle was pushed out before the sale and felt that some stockholders, including many employees, didn't get a fair share of the proceeds. "I felt like we built a transaction rather than a company that would have a lasting positive impact," he says. With his next try, he wanted to do things differently.

In 2001, Crystle co-founded Lancaster, Pennsylvania-based Mission Research, which sells fundraising software to nonprofits. Organizations with annual budgets under \$25,000 can get the product for free. Despite Crystle's track record, traditional investors didn't much care for the idea of giving away the product. Nor did they like Crystle's plan to give a 20 percent stake in the company to charity. They didn't even like the idea of targeting nonprofits in the first place. So Crystle turned to Underdog, which in 2006 led his first round of outside financing, investing \$300,000 for a 5 percent stake. Crystle says revenue increased 60 percent in 2007, and he expects it to grow another 200 percent this year.

Underdog provides more than patient capital. "If I go to Underdog and say, 'I want to make a donation of software to Third World countries, and I need that to be in Spanish, French, and Chinese,' David gets to work and thinks about it instead of saying, 'Why are you wasting your time?' " says Crystle. That help is crucial for Crystle. "I focus on building my business and building revenue," he says. "But it's not the reason I get up every morning and go to work."

For more about the banks and VC funds that are financing do-gooder companies, listen to a podcast with Inc. reporter Nitasha Tiku, at www.inc.com/keyword/feb08