

## **Philanthropic Venture Capital: Venture Capital for Social Entrepreneurs?**

By Mariarosa Scarlata, Luisa Alemany Gil  
and Andrew Zacharakis

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## Philanthropic Venture Capital: Venture Capital for Social Entrepreneurs?

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### Abstract

Since social entrepreneurship is a relatively young activity, resource-rich actors, like Philanthropic VCs, have considerable influence over how the space matures (Nicholls, 2010b). The resources and strategic advice that PhVCs provide their SEs shape an institutional logic for the domain. As such, PhVCs enhance legitimacy of the emerging area of social entrepreneurship. This monograph's main contribution is to delineate the current state of PhVC, identifying differences with traditional VC financing, and identify areas of future research. In particular, this work responds to Nicholls (2010b) and Austin et al.'s (2006b) call for research on what types of finance SEs have access to. More specifically, we focus on understanding what PhVC is and how its social value creation investment logic makes it different from traditional VC, opening avenues for future research in this area.

# 1

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## Introduction

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Philanthropic venture capital (PhVC) is an innovative funding model available for social enterprises (SEs) which provides a blend of performance-based development finance and professional services to organisations with a primary social mission. PhVC seeks to maximize the social impact of the investee through the provision of capital and value-added activities, as typically done in traditional venture capital (VC) financing. The main difference between PhVC and traditional VC lies in the investment goals. Whereas traditional venture capitalists (VCs) work to grow each of their portfolio companies and ultimately seek a large financial return upon a liquidity event (most often an Initial Public Offering [IPO] or acquisition), PhVC have both economic and social goals. Specifically, philanthropic venture capitalists (PhVCs) work to develop self-sustaining SEs assuming that sustainability facilitates long-term organizational survival, growth and ultimately maximization of their impact on society (Letts et al., 1997).

The importance of SEs has been growing both in the professional and academic sectors over the last decade (Bosma and Levie, 2010; Harding, 2007, 2004; Roberts and Woods, 2005). In particular, Bosma and Levie (2010) report the average rate of social entrepreneurial

activity across the countries participating in the Global Entrepreneurship Monitor amounts to 1.8 percent of the total adult population; within the United Kingdom, Harding (2007) reports that the rate was 3.3 percent in 2006. While explaining social entrepreneurship trends, Cox and Healey (1998) indicate that in Europe, SEs have a key role in welfare and environmental policy innovation, whereas Mair and Seelos (2007) as well as Prahalad (2006) argue that in developing countries, social entrepreneurship tends to address compelling social problems, such as hunger, disease and education, through the application of innovative and cost-effective methods to traditional solutions. At the research level, Short et al. (2009) show that the publication rate of research articles on social entrepreneurship, subject to a double-blinded review process, has increased by 750 percent between 1991 and 2009.

On the academic side, the bulk of research has sought to define what an SE is and how it differs from traditional commercial ventures. In doing so, social entrepreneurship has been presented as a new model of systemic social change (Bornstein, 2004; Nicholls, 2010b), the solution to government failures in welfare provision (Aiken, 2006; Bovaird, 2006), a new market opportunity for business (Prahalad, 2006), a model of political transformation and empowerment (Alvord et al., 2004), and a space for new hybrid partnerships (Austin et al., 2006a).

Despite the growing importance, SEs still struggle to secure external sources of finance. SEs must deal with the Pareto assumption that achieving a social and/or environmental return inevitably reduces economic returns for investors. Financial economists suggest that investments can only be differentiated based on their risk-return profile with social or environmental factors being presented as externalities (Arrow and Fisher, 1974; Freidman, 1962). This, in turn, leaves no room in that research sphere for the existence of investments in organizations with social aims, such as SEs. Also, the inability to get financing might constitute the single biggest barrier to establishing an SE (Bank of England, 2003). Other research also finds that access to finance is the main barrier to SEs' growth (Harding, 2007; Smallbone et al., 2001; Conaty, 2001).

PhVC helps overcome the financing access problem, because it combines a for-profit focus on efficient use of economic resources with the

nonprofit proposition on social value creation (Austin et al., 2006a). Rather than providing funds to single projects with a short-term investment period, as typically done by foundations or government grants, PhVC commits to long-term funding in order to build the capacity of the SE to become sustainable, grow, and ultimately maximize its social impact. However, the mere provision of capital is not enough for sustainability and growth; financial resources must be accompanied by the provision of value added activities and a high level of PhVC strategic engagement. For instance, PhVCs typically sit on the board of the SEs they back and advise the entrepreneurs on how to grow.

Since social entrepreneurship is a relatively young activity, resource-rich actors, like PhVCs, have considerable influence over how the space matures (Nicholls, 2010b). The resources and strategic advice that PhVCs provide their SEs shape an institutional logic for the domain. As such, PhVCs enhance legitimacy of the emerging area of social entrepreneurship. This monograph's main contribution is to delineate the current state of PhVC, identifying differences with traditional VC financing, and identify areas of future research. In particular, this work responds to Nicholls (2010b) and Austin et al.'s (2006b) call for research on what types of finance SEs have access to. More specifically, we focus on understanding what PhVC is and how its social value creation investment logic makes it different from traditional VC, opening avenues for future research in this area. We do not cover how PhVCs raise their funds as we are interested in the relationship between the philanthropic investor and the SE.

The monograph is structured as follows. First, a definition of PhVC is proposed. Second, an overview of financing available for social entrepreneurs is discussed focusing on those characterized by a level of investor engagement. Third, data on the PhVC sector in the United States and in Europe is presented in terms of age of the sector, legal form of the PhVC firm, capital under management and location of portfolio organizations. Forth, investment practices implemented in PhVC are identified according to the different phases of the investment process in traditional VC and further research opportunities are identified. Last, the paper draws conclusions and implications for academics and practitioners.

## 2

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### Philanthropic Venture Capital: Definition

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The PhVC industry emerged in the late nineties (Letts et al., 1997) in the United States, quickly spreading to Europe. PhVC is a financing model available for social entrepreneurs that channels financial resources from donors/investors to SEs and, like conventional investors, focuses on an efficient, market driven process of value creation. Although social entrepreneurship research is still in a pre-paradigmatic status (Nicholls, 2010b) resulting in a lack of consensus on the meaning of the term (Dacin et al., 2010; Nicholls, 2010a,b; Short et al., 2009; Zahra et al., 2009), social entrepreneurship is here defined as “*any innovative action that individuals, organizations, or networks conduct to enhance or reconfigure existing institutional arrangements to address the inadequate provision, or unequal distribution, of social and environmental goods* (Nicholls, 2009, p. 755).” To this definition, we also add Robinson (2006) as well as Emerson and Twersky’s (1996) view that social entrepreneurship happens when economically sustainable ventures through the adoption of market-based approaches generate social value. As such, social entrepreneurship is not bounded by the legal form the organization undertakes: SEs can be legally structured as nonprofit or for-profit enterprises.

While trying to estimate the importance of SEs, Bosma and Levie (2009) report that the average rate of social entrepreneurship activity across all of the 49 countries participating to the Global Entrepreneurship Monitor in 2008 is 1.8 percent of the total adult population, ranging from 0.1 percent in Guatemala to 4.3 percent in the United Arab Emirates, with slightly higher rates in developed economies. In 2006, 3.3 per cent of the UK adult population of working age were involved in activities with a community or social goal (Harding, 2007). On the academic side, Short et al. (2009) count 152 research articles on social entrepreneurship over the period 1991–2008, with an increase in the publication rate of 750 percent over the 18-year time span of their sample versus 62 percent over a 15-year period of entrepreneurship articles (Busenitz et al., 2003).

Nevertheless, access to external sources of finance for SEs is problematic. The Bank of England (2003) reports that SEs tend to access external finance through grants and donations. The main issue of this particular model is that the funding is project specific, with capital being deployed over short periods of time (typically one year). This means that SEs are on a continuous fundraising cycle in order to support existing and new projects. The Bank of England (2003) also indicates that SEs are reluctant to borrow because they prefer to direct all their resources to their cause rather than paying interest. Traditional business angels and VC do not finance SEs because these ventures cannot provide adequate rates of economic return (Bank of England, 2003).

While SEs can be both for or nonprofit, Miller (2008) argues that one of the most important barriers to external finance is the legal structure of SEs. Nonprofit SEs cannot access equity markets due to the non-distribution constraint. Nonprofits “*are barred from re-distributing net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees* (Hansmann, 1980, p. 838).” At the same time, banks are often unwilling to make loans to nonprofit organizations because of their slim operating margins, uncertain funding, and inexperience with loans or finance generally, as well as their lack of assets that can be used as collateral. In the case of for-profit SEs,

Dees and Anderson (2003) identify a compelling skepticism related to the conflict between pursuing a profit, which is associated with wealth and self-interest, and serving a social objective, which many believe belongs to the public realm. This is also confirmed by Clark and Ucak (2006) who find that one of the most difficult aspects of running a SE is raising money from people who may or may not value the commitment to the social mission.

Historically, the PhVC approach gained its footing during the dot.com boom of the late nineties when it began to be discussed mainly in American professional philanthropic circles (Edelson, 2004; Emerson et al., 2000; Gose, 2003; Morino Institute, 2000; Morino and Shore, 2004; Porter and Kramer, 1999; Ryan, 2001; Tuan and Emerson, 2000). In an article by Greenfeld et al. (2000, p. 48), the authors explain that *“many of today’s tech millionaires and billionaires are applying to philanthropy the lessons they have learned as entrepreneurs. One solution has been the founding of philanthropic venture capital funds which use the same aggressive methods as VC firms, whose money typically comes with technological expertise and experience at running lean, efficient organizations. This new breed of philanthropist scrutinizes each charitable cause like a potential business investment, seeking maximum return in terms of social impact.”*

PhVC attempts to correct the problems of grant-making foundations (Letts et al., 1997). Foundations follow a project-driven funding approach addressing a specific social problem rather than creating a sustainable SE. This in turn often leads to mission drift: social entrepreneurs and nonprofit managers, in most cases, raise money from one funder at a time, developing a fundraising strategy that is customized for each funder’s program and grant-making strategy. SEs and nonprofits thus adapt their narratives and organizational activity to meet the criteria required to obtain funding rather than fulfilling their original organizational objectives (Moore, 2000). Project-specific support also tends to be focused on reimbursement of actual expenditures, net of any income the SE might generate. This leaves little room for incentives to build reserves or a sufficient asset base that could be used as collateral for expanding the organization’s activity, nor flexibility

to fund the core business and to support its capacity building.<sup>1</sup> As a consequence, SEs tend to be undercapitalized with social entrepreneurs continuously scrambling for funds instead of focusing their activity on the achievement of the organization's social mission and on the development of long-term solutions to the social needs the SE seeks to address (Larson, 2002; Letts et al., 1997).

Project-driven support is not the only criticism of traditional project driven grant-making. The major objective of traditional grant-making activity lies in solving the most pressing social problems by spurring the scalability of the social projects they select for funding. From the point of view of foundations, social projects are thus required to have good prospects of replication beyond the original recipient organization in a cost-efficient manner (Locke and Roberson, 1997). Although many organizations have succeeded in developing solutions to a particular social problem, their efforts have not been broadly disseminated, adopted or brought to scale (Morino, 2000). For most donors, philanthropy is about spending resources rather than an efficient allocation of funds. There is a need for follow-on financing to scale these solutions.

Additionally, the selection of recipient organizations by grant-makers is traditionally based on need rather than on the achievement of performance targets (Walker, 2004). Grant-makers are inclined to meet legal requirements of money spent for social programs (which in the United States need to be at least 5 percent of the total assets of the foundation) rather than in efficiently signaling the social value created by the programs they support. The emphasis is placed upon the act of the transaction with value being defined in terms of that transaction itself and not in terms of what long-term value is generated thanks to the transaction (Porter and Kramer, 1999). This relates to the problematic issue of social impact assessment. Although measures of social return have been proposed, each grant-maker tends to use and continuously develop its own metrics of social impact assessment, making

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<sup>1</sup>Based on Honadle and Howitt (1986) organizational capacity building is defined as the organizational ability to survive and to successfully apply skills and resources to pursue its goals and to satisfy the stakeholders' interest.

it difficult to compare results and identify the most successful fund provider.

Letts et al. (1997) asserts that grant-making foundations should use an innovative approach to better address the organizational and financial needs of nonprofit organizations. Realizing the success of innovative companies during the dot.com boom and recognizing that VC investors largely contributed to bringing ideas to scale, Letts et al. (1997) proposed the implementation of VC investment practices to the traditional grant-making activity of foundations. The combination of two key elements of the VC investment model, meaning: (a) long-term investments, with funds deployed over a multi-year period of time; and (b) strategic engagement to help nonprofit organizations in scaling their social impact and have a stronger social benefit. But what is exactly VC and how is it structured? In the following section we will briefly present the VC investment model. Then, based on that, we will explain how VC shapes PhVC.

## 2.1 Venture Capital

Scholars in the finance and entrepreneurship fields have investigated VC financing. Amit et al. (1998) view the role of VCs as financial intermediaries with a competitive advantage in environments where informational asymmetries are prevalent. VCs develop specialized abilities in selecting and monitoring entrepreneurial projects with the purpose of maximizing return on capital. VCs support entrepreneurial firms with little or no track record and limited access to more conventional sources of capital such as bank debt. The competitive advantage acquired through specialization allows VC firms to generate returns and raise follow-on funds (Kaplan and Schoar, 2005). Amit et al. (1998), Gompers and Lerner (2001), Gupta and Sapienza (1992), Wright and Robbie (1996), amongst others, define VC as an intermediated investment which focuses on the provision of equity and/or debt financing to young, privately held firms. These firms are often at their start-up or growth stage of development and VC funding is used for product development, prototype testing, test marketing and working capital (Sahlman, 1990).

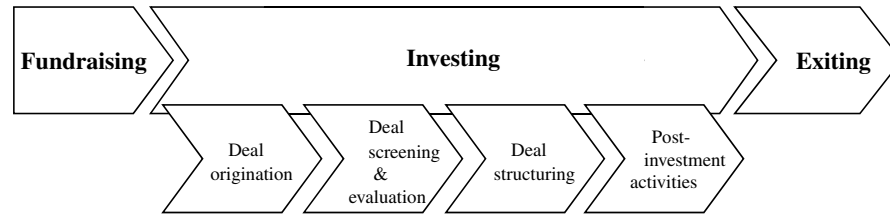


Fig. 2.1 The venture capital investment process.  
*Source:* Scarlata (2011).

Figure 2.1 illustrates the VC investment model. It is composed of three different stages: fundraising, investing, and exiting (Gompers and Lerner, 2001). In the fundraising phase, the VCs, called General Partners (GPs), raise capital from different limited partners (LPs), such as pension funds, endowments, corporations and sovereign wealth funds, amongst others. In the investing phase, VCs deal with a high level of asymmetric information in the form of adverse selection while identifying which ventures to back. Within the investing phase, Tyebjee and Bruno (1984) further identify four phases: deal origination, deal selection, deal structuring, and post-investment activities. Considering that entrepreneurial actions are difficult to observe, Chan (1983) argues that the risk for adverse selection can be minimized in the origination of deals through a search strategy that enables VCs to learn about the quality of the entrepreneurs and of their venture. In the structuring phase of deals, VC contracts are designed to reduce the risk for opportunistic behavior by the entrepreneur through a combination of incentives, covenants, and participation provisions.

Once the terms of financing are negotiated, VCs focus on adding value to maximize economic return. To do so, capital invested in new portfolio ventures is accompanied by non-financial resources such as strategic advice, mentorship, and access to the VC firm's network, aimed at increasing the likelihood of success while simultaneously protecting the interests of the VCs. If the backed venture is able to grow, it increases its economic value and ultimately, increases the financial return for VC investors. Thereafter, the goal becomes converting existing investments to cash and to divest all investments by the end of the life of the fund, which ranges between 7 and 10 years. The classical

view of a successful VC exit is that a VC acquires an equity stake in a start-up, help grows its revenue, preparing it for the next stage, that can be selling it to other investors, either financial or strategic, or in the best case scenario, to the public market through an IPO. As investments yield cash or marketable securities, distributions are made back to the LPs rather than reinvested in new ventures.

## 2.2 Philanthropic Venture Capital

Letts et al. (1997) argue that the VC model depicted in Figure 2.1 can be applied to PhVC as PhVC and VC investors share similar challenges: selecting the most worthy recipients for funding, relying on young organizations to implement new ideas, and being accountable to third parties whose money they are investing. Porter and Kramer (1999) argue that just as for-profit VCs screen and select new investments from a larger pool of proposals, foundations should identify the most socially productive grantees. This would enable foundations to signal the social value they are creating: *“The value created in this way extends beyond the impact of one grant: it raises the social impact of the grantee in all that it does and, to the extent that grantees are willing to learn from one another, it can increase the effectiveness of other organizations as well”* (Porter and Kramer, 1999, p. 124).

Traditional grant-making activity, and more generally, financing of SEs needs to change in order to survive in the long-term and help recipient organization survive as well (Letts et al., 1997). PhVC deals with and corrects the short-term, project-driven approach of traditional grant-financing. The main assumption underlying the PhVC’s logic of social return maximization is that, like in VC, return is maximized if the organization is able to grow. Prospects for growth are related to sustainability and achievement (Letts et al., 1997). Also, as explained by Nicholls (2010b), business and commercial models are central to social entrepreneurship. PhVC builds on the perceived benefits of market-driven entrepreneurship and applies it to the financing of organizations addressing social problems. Through a combination of economic sustainability obtained through the implementation of market-driven approaches and growth, PhVC brings the discipline

and the accountability of VC into the social sector. As such, PhVC is structured around the three investment phases presented in Figure 2.1.

Nevertheless, Letts et al.'s (1997) definition of PhVC as the application of the VC model to traditional grant-making activity focuses just on one specific type of philanthropic financier, grant-making foundations. This definition is too narrow; it should include other organizations that: (a) invest in organizations with a primary social aim, and (b) are highly engaged in the strategic management of their investees. The PhVC industry has seen the rise of other social investors not related to the activity of grant-making foundations, such as Impetus Trust in the UK, Oltre Venture in Italy and Acumen Fund and Good Capital in the United States. Impetus is a public charity investing in nonprofit SEs across the UK and established by former VCs; Oltre Venture and Good Capital are for-profit companies investing in both for-profit and nonprofit SEs; Acumen Fund is legally structured as a public charity and it purely invests in for-profit SEs.

In this monograph, we broaden the definition of PhVC by noting the similarities of VC and PhVC. Both are shaped by asymmetric information in its investment process. Thus, PhVC can be defined as an intermediated investment in SEs that have the potential to become sustainable, grow to scale and maximize their social impact.

# 3

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## The Landscape of Social Entrepreneurial Financing

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Nicholls (2010a, p. 74) argues that “*academic work on social investment to date suggests that the topic has yet to be recognized by scholars as a distinct and legitimate field of research*” and that this can be explained by a lack of epistemological boundaries and institutional structures of the social investment sphere. Embracing an institutional perspective, Nicholls (2010a) argues that the boundaries of social investment can be identified based on *investment logics* (i.e., the outcome of placing capital), and *investor rationalities* (i.e., the objectives of placing capital). Concerning *investment logics*, Emerson (2000) criticizes the Pareto optimality assumption, based on which achieving a social and/or environmental return inevitably reduces economic returns, and argues that all investments produce a combination of social and economic returns. However, there is a question of degree. Therefore, as Emerson (2000) argues, we can categorize investments as having one of three possible investment logics. Investments can either focus on the pursuit of (a) only social and/or environmental return, (b) only economic return, or (c) a combination of social and economic return, namely blended value or double-bottom line. When applying this framework of analysis to investments in SEs, the possible investment logics that drive such

investment can only be (a) or (c), reflecting the primarily objective of social return maximization. Emerson (2000) also identifies the level of investor engagement as another component of the institutional logic of investments, with investors that can have a hands-on or hand-off approach.

By integrating investment logics and investors' level of engagement, the four investment models depicted in Figure 3.1 can be identified. First, when the investment logic of social and/or environmental value maximization is pursued and investors' approach is characterized by a low level of engagement in the recipient organization, we can identify traditional grant-making activity. This is typically provided by operating foundations or governments and forms the bulk of social giving (Oster, 1995). Second, when investments are characterized by the pursuit of a combination of social and economic returns, and investors are highly engaged in their investments, we can identify PhVC. Third, when the investment logic is economic return maximization and investors tend not to be engaged with the management of the recipient organization, we can identify traditional forms of credit provision. Last, when investment logic is driven by economic return considerations and investors are highly engaged with their investees, traditional VC investing can be found.

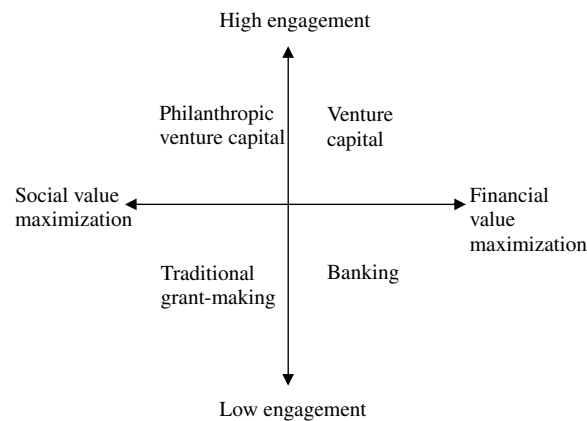


Fig. 3.1 Financing model based on primary interest.  
 Source: Elaboration based on Emerson (2003).

For what concerns *investors rationalities*, Nicholls (2010a) argues that social investments can be driven by means-ends, values-driven, or systemic rationalities. Social investors with a means-ends rationality focus their provision of capital on efficient processes and measurable outcomes; this corresponds to the investment logic of maximization of the return on capital. Value-driven social investments typically map onto an investor rationality of pursuing returns consistent with personal values and beliefs. Systemic purposes refer to a deliberate combination of means-ends and values-driven rationalities which lead to blended returns.

### 3.1 Typologies of PhVC Investments

Integrating Nicholls (2010a) with Emerson's (2003) perspective and focusing on the landscape of social investments characterized by the primary pursuit of a social return on the investment and a high level of investor engagement available for SEs, nine typologies of PhVC options available for SEs can be identified, as indicated by Table 3.1.

Among social investments with *means-ends* rationality and a *financial logic* Nicholls (2010a) identifies clean-tech and energy investments as prime examples of an investment logic maximizing return on capital, while still targeting organizations that have positive environmental externalities. For example, E+Co, a PhVC firm based in the United States, is an example of the provision of capital and engagement to clean energy businesses. The E+Co philosophy deals

Table 3.1. Typologies of philanthropic venture capital investments.

Investor rationalities	Investment logics		
	Financial	Blended	Social
Means-ends	Clean energy investments	Bottom of the Pyramid investments	Social VC
Systemic	Impact investments	SE initiatives	Catalytic philanthropy
Value-driven	Community development venture capital	High engagement philanthropy	Social change investors

Source: Elaboration based on Nicholls (2010a).

with, and solves for, the demand for clean and affordable energy in developing countries under the belief that this demand can be satisfied by local entrepreneurs. The mitigation of climate change united with the E+Co's enterprise development services and capital empower entrepreneurs to provide clean energy solutions to the energy poor, reducing poverty in developing countries while generating economic returns for investors. Further research could investigate the boundaries between clean-tech investors falling into the PhVC investment sphere, thus having a means-end rationality of accountability for environmental results and economic return for investors, and clean-tech investors whose primary purpose lies in the maximization of the return on capital while dealing and exploiting environmental problems to accomplish their returns objectives. Clearly, while both typologies of investors pursue economic return, their investment logic diverges. Looking at how the different logics and objectives interact in all the three investment phases of the model (thus, fundraising, investing, and exiting) of clean-tech investors could provide insights into the motivations of those investors that are interested and equally driven by economic and non-economic objectives.

Among investors with *means-ends* rationalities and *blended value* creation investment logic, Bottom of the Pyramid (BoP) investors can be identified. The BoP investor space emphasizes the ability of free markets to accomplish the social goal of reducing poverty among people that live with less than 2.5 dollars per day. Investing in organizations that address the needs of poor people can eradicate poverty and simultaneously be profitable (Prahalad, 2006). The BoP market is estimated to be worth 15 trillion dollars per year on a global basis (Wall, 2006). The main assumption underlying investments in the BoP segment is that poor people are resilient, creative, and value-conscious consumers (Prahalad, 2006). However, as Karnani (2007) states, this assumption is a romanticized view of the poor that does not help them as it places little emphasis on legal, regulatory, and social mechanisms to protect the poor as vulnerable consumers. Acumen Fund, established in 2001 in the New York area with the support of the Rockefeller Foundation, the Cisco Systems Foundation, and three individual philanthropists, seek to create a world beyond poverty by investing in SEs, emerging

leaders, and breakthrough ideas (Acumen Fund, 2012). Acumen Fund uses philanthropic capital in the form of loans and equity investments that yield both financial and social returns and any financial return that investees create are reinvested into new ventures addressing poverty needs. Further research in this area could analyze the institutional underpinnings of impact investors' activity in BOP markets and how these facilitate the process through which the poor can escape poverty. In addition, since impact investors tend to operate in poor environments which tend to be characterized by weak institutional environment (Powell, 2008), future research could investigate the role of PhVC firms as institutional entrepreneurs. This could, in turn, inform on the mechanisms through which markets can be created and shaped in poor regions as well as on the social performance of SEs backed by such investors and their abilities to correct for market failures.

Social VC investments are characterized by a means-ends investor rationality and a social investment logic. These investors finance for-profit SEs and social VC firms tend to be structured as for-profit entities (Scarlata and Alemany, 2011). Social VC investments are intended to both provide attractive economic returns to investors and to provide market-based solutions to social and environmental issues. Also, not being subject to the non-distribution constraint that typically characterizes nonprofit organizations and grant-making foundations, economic value in the form of profits can be delivered back to investors in the social VC fund. Good Capital, a U.S. based PhVC firm, uses market based approaches to address social issues in the U.S. by accelerating the flow of capital to enterprises that create innovative, market-based solutions to inequality, poverty, and other social problems (Good Capital, 2012). Good Capital balances the social commitment and activist orientation of the philanthropic world with the risk taking and rigor of the investment and business world. Elaborating on this, future research could examine and compare the risk-return profile of social and traditional VC investment and the risk-taker behavior of social VC investors. In addition, co-investments and syndication practices in investments by traditional and social VC investors could be analyzed: would traditional and social VC investors be willing to invest together in a deal that maximizes social impact and at the same time provides attractive

economic return? How much do co-investments between traditional and social VC contribute to the creation of a capital market that does not purely focus on the accountability for economic value creation? How do different investors with different logics interact in such a market?

*Systemic* investors with a *financial investment logic* are referred to as impact investors (Nicholls, 2010a). Impact investments are intended to create positive impact beyond financial return. As such, they require the management of social and environmental performance in addition to financial risk and return. Investors and investments range broadly, across sectors and objectives. A variety of investor types participate, including development finance institutions, foundations, private wealth managers, commercial banks, pension fund managers, boutique investment funds, companies and community development finance institutions. These investors operate across multiple business sectors, including agriculture, water, housing, education, health, energy and financial services. Bridges Ventures, based in the United Kingdom, is an example of an impact investor that delivers both financial returns and social and environmental benefits. Founded in 2002, Bridges Ventures manages the Bridges Social Entrepreneurs Fund which “*aims to address the funding gap often faced by fast growing social enterprises looking to scale. Seeded by the Bridges Charitable Trust in 2008, the fund was launched in August 2009 and has raised nearly £12m for investment in scalable social enterprises delivering high social impact and operating sustainable business models*” (Bridges Ventures, 2012). Further research on impact investors could assess the contribution of such investors in the sustainability of the backed social enterprises, as well as the latter’s ability to impact the community they are embedded in. *Systemic* investors with *blended value investment logics* are referred to as SE initiatives (Nicholls, 2010a). These are investments that explicitly create both social and environmental outcomes as well as financial ones. SE initiatives typically back SEs active in the health and social care sectors through providing investment to help new SEs start up and existing ones grow and improve their services. Nicholls (2010a) reports that SE investments are developed mainly in the UK and in the United States. An example is equity investments in a Fair Trade company, “*where the outcome of the investment benefits both parties in*

*social and environmental terms (brand value for the investor, community building for the investee) and both can extract financial returns too (dividends for the investor, capacity building capital for the investee)* (Nicholls, 2010a, p. 82).” Future research could address the involvement of such SEs in the environments they are operating and how they help in building a community space within such environments. Understanding how such SEs utilize power, influence as well as resource mobilization and how they spur them through the investment obtained by SE initiatives could provide insights into how they shape and are shaped by their institutional environment.

Catalytic philanthropy, introduced by Kramer (2009), is identified when investors’ rationality is *means-end* with a *pure social investment logic*. It responds to the question of identifying the methodologies to catalyze a campaign that achieves measurable social impact. Catalytic philanthropy focuses on donors’ success factors compared to their peers, noticing that success does not depend on the amount of money spent, but rather the actions that are significantly different from those who were less effective or even failures. Kramer (2009) identifies four peculiar characteristics of catalytic philanthropy: (1) donors have to acknowledge their responsibility for achieving social results; (2) mobilization of a campaign for change by stimulating cross-sector collaborations and mobilizing shareholders to create shared solutions; (3) use all available tools in terms of corporate resources, investment capital, advocacy and litigation; and (4) create actionable knowledge. ARK, a UK based PhVC firm established in 2002, deploys capital and strategic services based on the principles that investment activity has to be catalytic, sustainable and measurable (ARK, 2012). ARK sticks to the financing of an SE supporting it with an appropriate mix of local, national and supranational partnerships, to ensure that backed ventures act as a catalyst for long-term, systemic change. Further research could dig more into catalytic philanthropists’ definition of systemic change, how this ties with their social capital, and ultimately, how effective they are in assessing the long-term effects on the community they are embedded in.

In the *value-driven* rationale, investments with *financial* logic are identified as community development institutions. Community

investments provide equity capital to businesses in underinvested markets and populations, seeking market-rate financial returns, as well as the creation of good jobs, wealth, and entrepreneurial capacity. Community development institutions focus on investments in deprived areas of developed countries and are mostly present in the U.S. and in the UK (Nicholls, 2010a). The Community Venture Capital Association (CDVCA) in the U.S. was formed in 1993 and incorporated as a nonprofit organization in 1995. CDVCA promotes the use of the tools of VC to create jobs, entrepreneurial capacity and wealth to advance the livelihoods of low-income people and the economies of distressed communities. It makes equity investments in businesses in economically distressed areas in the country and around the world from seed to expansion stage. Utilizing a number of legal structures, from for-profit corporations to nonprofits, CDVC funds are mission-driven organizations that benefit low-wealth people and communities while working to earn solid economic returns (CDVCA, 2012). Future research around value-driven rationales could analyze the effectiveness of spurring entrepreneurial capacity in areas characterized by poverty and crime, and how such entrepreneurial activity contribute in changing the status quo. Further analysis could assess whether investments in for-profit SEs perform better or worse than nonprofit SEs both at the social and economic level.

High-engagement philanthropy is a new form of philanthropic giving with *value-ends* investor rationality and *blended value investment logic*. It tackles the flaws in traditional grant-making activity of operating foundations that are not actively involved in the management of the backed organization. Often this engagement takes the form of strategic assistance, which can include long-term planning, board and executive recruitment, coaching, help in raising capital, assuming board roles, accessing networks, leveraging relationships to identify additional resources, and facilitating partnerships. Within this category are foundations that invest only in nonprofits and, thus, seek a pure social return on their investment. Fondazione CRT in Italy moved into high engagement philanthropy in 2006, mainly concerned with promoting economic development (Fondazione CRT, 2012). Future research could examine and compare the effectiveness of traditional and high

engagement forms of philanthropy in an effort to understand which funding model is best able to accomplish the social mission of creating organizations that can grow to scale. In addition, the analysis of the grantees' perspective on such a new form of philanthropic financing could provide insights into the challenges that such funding option faces.

Social change investments respond to *social and environmental investment logic* with *value end investor rationality*. As such, social change investments seek returns exclusively for the investee/beneficiary. This is often formalized in social movements or the advocacy campaigns of SEs. Nicholls (2010a,b) explains that one reason for the increasing importance of such investments may be the decline in support for political parties as vehicles for social change. Also, it may be because forms of political campaigning are now increasingly accepted as legitimate uses of charitable funds. Ashoka, founded in 1981, is leading a profound transformation in society by investing in the citizen sector. Rather than leaving societal needs for the government or business sectors to address, Ashoka invests in social entrepreneurs that are creating innovative solutions, delivering extraordinary social results, and improving the lives of millions of people. Ashoka's mission is to identify and promote new programs that advance the advocacy field, using its long history and broad geographic reach to lead the transformation of the citizen sector and shape it over several years and beyond (Ashoka, 2012). Further research could investigate how resources and capabilities are combined by SEs backed by social change investors and how different combination models affect national policy-making. In addition, it could be interesting to understand how social entrepreneurs backed by these investors act as institutional entrepreneurs but at the same time act as building blocks of the social sector.

Digging more into the investment logics, level of investor's engagement and rationalities of the different typologies of PhVCs presented in Table 3.1 provides a fruitful avenue for future research. More particularly, by identifying and examining the characteristics of PhVC capital providers, a better understanding on the process underlying the formation of PhVC firms and the choice of the typology of PhVC investment could be gained. Value theory (Schwartz, 1992) could shed light on the

motivations that push individuals and/or organizations in providing capital to different typologies of PhVC firms adopting different investment models, as depicted in Table 3.1. Social network theory (Barnes, 1954) could further help in explaining the relationship between PhVC capital providers and PhVC firms' founders, as well as in assessing the relationship between the PhVC firm's founders and the social and economic success of the firm. A quantitative study could explain the interplay of logics and rationalities in field formation in PhVC and the effects on collective identification.

Elaborating on the work by Tracey et al. (2011) who use new institutional theory to explain how new organizational forms emerge, understanding how bridging institutional entrepreneurship applies in PhVC and how individual, organizational, and societal level institutional processes shape PhVC can be an area of interest for future studies. Further, stewardship theory (Donaldson and Davis, 1991) which recognizes a range of non-financial motives for managerial behavior that include the need for achievement and recognition, the intrinsic satisfaction of successful performance, respect for authority and work ethic could be further employed to understand the relationship between capital providers to PhVC firms and PhVC investors within those firms. New theoretical developments may be also attained by applying upper echelon theory (Hambrick and Mason, 1984) to examine the relationship between PhVC investors' rationalities and level of engagement in portfolio organizations. This could also shed light into the differences between investment activism of VC and PhVC investors and its effects on performance of backed organizations.

In addition, as shown by prior research, entrepreneurs are both constrained and enabled by the institutions in their environment (Bruton and Ahlstrom, 2003). Also, across countries and economic systems, cognitive and normative institutions as well as regulatory institutional environment have been shown to shape the nature of an industry (Bruton et al., 2010; Bruton and Ahlstrom, 2003). It would therefore be interesting to understand whether normative factors influence and set the boundaries of the different typologies of PhVC models, thus affecting the typology of models that are more common in some countries than others, as well as their institutional drivers. If that were indeed

the case, research could also assess if any specific type of institutional forces drive certain typologies to be more successful, both at the social and economic level in a particular country than another. On the other hand, elaborating on Davis and North (1971) based on which organized groups have the power to pressure or lobby for institutional change, future research could investigate the institutional entrepreneurial activity of different typologies of PhVC firms while creating, shaping, and influencing a PhVC market for capital.

# 4

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## Philanthropic Venture Capital: Current Status

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The amount of capital currently present in the PhVC market is difficult to estimate. First, no comprehensive database of PhVC firms exists either in the U.S. or in Europe, the two regions where PhVC is most developed. In Europe, the European Venture Philanthropy Association (EVPA) founded in 2004, lists European organizations practicing PhVC, where practice is defined as the “provision of capital with a long-term investment horizon to charities or SEs that are primarily seeking a social return rather than a financial return on the investment, and make a credible effort to measure social value” (European Venture Philanthropy Association, 2011a). In addition, as explained in the previous chapter, PhVCs must take an active role in the management of the SE, assessing, developing, and supporting the SE’s capacity building. As such, EVPA provides a forum within which European based PhVCs can network, exchange ideas and debate best practice. EVPA’s diverse types of membership include PhVC funds, grant-making foundations, private equity firms, professional service firms, philanthropy advisors and business schools. In 2011, the association counted 32 PhVC members (European Venture Philanthropy Association, 2011a), with overall investments amounting to €1 billion (European Venture Philanthropy Association, 2011b). The U.S. has no counterpart to the

EVPA. Rather, some 23 PhVC firms are listed as a subset group within the National Venture Capital Association. The NVCA does not capture total amounts invested by these organizations. On top of that, a new figure has been developing in the last couple of years, the Philanthropic Business Angel, although no data or research has been conducted so far. Just as is true with traditional business angels, Philanthropic Business Angles are private individuals that do not report data. Thus, it is very difficult to estimate the amount of their investment.

In an effort to identify organizations that fall into the PhVC field, Scarlata and Alemany (2010) built a database of PhVC firms active in Europe and in the U.S. Based on their data, a total of 74 funds are active in the two regions, 38 in Europe and 36 in the U.S. PhVCs firms in the two regions tend to be structured as nonprofits, spanning mainly between the legal structure of an operating grant-making foundation, which has a single major source of funding (usually gifts from one family or corporation), and a public charity, that must get at least one third of its support from gifts, grants and fees, and not more than one third of its income from investments. Few PhVCs are for-profit organizations. This might be related to the public perception that making a profit should be disentangled from pursuing social objectives. Data about the period of establishment of PhVC firms confirm that the industry is relatively new. Seventy-four percent of PhVC funds were created between 1998 and 2008, with annual growth rates of 15 percent in the U.S. and 22 percent in Europe. PhVC firms are unwilling to publicly disclose the amount of money they manage and the amount invested in portfolio organizations. This, in turn, makes a direct estimate of market size hard.

The difficulty in measuring the value of the PhVC industry relates to the absence of a unified market or exchange platform for social investments which in turn arises from the absence of clearly marked boundaries. As Hartzell (2007, p. 3) states, *“the process of putting together a share issue and of setting up the subsequent trading mechanisms remains haphazard and uncoordinated. Despite this, ethical businesses raising share capital have chosen to make their own arrangements rather than list on the existing markets, which are too focused on financial and not enough on environmental and social returns.”*

If trying to grasp the amount of money that could be available in the PhVC sector, Morgan (2010) reports that, when considering sectors as housing, rural water delivery, maternal health, primary education and financial services, and the portion of the global population earning less than \$3000 a year, the BoP segment of the PhVC market alone offers the potential over the next 10 years for invested capital of \$400 billion to \$1 trillion and profit potential of \$183 to \$667 billion on a global scale. Scarlata and Alemany (2010) report that 40 out of the 46 funds where data is available, representing 74 percent of the active funds in the PhVC industry manage up to \$10 million each.

#### **4.1 PhVC in the United States**

Data collection for PhVC firms whose headquarters are registered within the U.S. was based on information provided by the NVCA section on PhVC in the year 2008. To control for undercoverage error, the NVCA list was integrated with information by Morino Institute (2000) which reports a list of organizations that adopt a highly-engaged funding model. Since firms presented by Morino Institute (2000) include a diverse range of models supporting social entrepreneurial initiatives, such as network of funders, a correction for ineligible units was required. As a result, both NVCA (2008) and Morino Institute (2000) list of firms engaged in financing of organizations with a primary social mission was compared with the information provided by the investor itself on its web pages to check whether it was deploying capital as well as value-added services. Last, other PhVCs not mentioned by NVCA (2008) or the Morino Institute (2000) were identified by analyzing the members of the board of directors of previously recognized PhVC firms, resulting in a total population of 36 American PhVC firms.

Table 4.1 shows the demographics for U.S. PhVC firms. Data show that 22 percent of firms started to adopt the PhVC approach before the dot.com boom. However, the bulk of organizations (47 percent) emerged during the internet boom. Ninety-four percent of American PhVCs are nonprofits, with a relative majority being public charities (41 percent) and operating foundations (36 percent). Only two PhVCs were identified as for-profit entities. Seventeen percent structured as

Table 4.1. Demographics of U.S. PhVC firms.

Yr. founded	<i>N</i>	%	Legal structure	<i>N</i>	%	Capital managed	<i>N</i>	%	Geographic investment focus	<i>N</i>	%
Pre-1994	8	22	Public charity	15	41	\$0–10M	6	17	Within U.S.	30	84
1995–2000	17	47	Foundation	13	36	\$10.1–100M	11	30	Emerging	3	8
2001–2004	6	17	Donor advised	4	11	>\$100M	3	8	Global	3	8
2005–2008	5	14	Trust	1	3	N/A	16	44			
			Other nonprofit	1	3						
			For-profit	2	6						
Total	36	100	Total	36	100		36	100		36	100

a donor advised fund with a unique donor contributing cash or assets to a public charity that sponsors and sets up the fund, trust, or other forms.

To estimate the size of the PhVC market in the U.S., we measured capital under management. However, as mentioned in the previous section, a big portion of PhVCs do not report such information and for those that do, data indicate that the PhVC firms are relatively small, with the majority having capital under management less than 100 million USD. Analyzing the PhVCs' portfolio of investment by geographical focus shows that American PhVCs tend to focus on investments within their own country. For example, New Schools Venture Fund considered a successful example of PhVC firm, established in 1998 by social entrepreneur Kim Smith and VCs John Doerr and Brook Byers, is based in the Bay area and invests in education entrepreneurs who are transforming public education in the U.S. Another example is the Chicago Public Education Fund, founded in 1999 as a VC fund for public education in the Chicago public education system. It invests in well-managed, high-impact programs that improve school leadership and student achievement system wide.

## 4.2 PhVC in Europe

PhVCs active in Europe were identified through the European Venture Philanthropy directory (European Venture Philanthropy Association, 2008) and also through John (2006) report "Venture Philanthropy: The

Table 4.2. Demographics of U.S. PhVC firms.

Yr. founded	N	%	Legal structure	N	%	Capital managed	N	%	Geographic investment focus	N	%
Pre-1994	3	8	Public charity	13	34	\$0–10M	15	40	Within own country	29	76
1995–2000	11	29	Foundation	17	45	\$10.1–100M	8	21	Eastern Europe	2	5
2001–2004	15	39	Donor advised	0	0	>\$100M	2	5	Africa	4	10
2005–2008	9	24	Trust	0	0	Not reported	13	34	Global	1	5
			Other nonprofit	1	3				N/A	2	3
			For-profit	7	18						
Total	38	100	Total	38	100		38	100		38	100

evolution of High Engagement Philanthropy in Europe.” As done when identifying American PhVC firms, the board of directors of previously identified firms were also analysed to minimize undercoverage.

Different than in the U.S., Table 4.2 indicates that in Europe, PhVC firms were mainly established after the burst of the internet bubble. Also, Table 4.2 shows that in the period 2005–2008, more PhVC firms were started in Europe than in the U.S. Just as in the U.S., European PhVCs tend to be structured mainly as grant-making foundations, with a main donor shaping the investment approach of the organization. For instance, the LGT Venture Philanthropy Foundation was established by the Royal Family in Lichtenstein in 2007 to raise the sustainable quality of life for less advantaged people in the developing world. Fondazione Dynamo was created in 2003 with the efforts of a group of financial executives intending to contribute to philanthropic development in Italy, through the financial, technical and managerial support and promotion of new social ventures able to operate according to efficiency, autonomy and sustainability criteria. On the other hand, 34 percent of European PhVCs are structured as public charities and there are more PhVCs structured as for-profit than in the U.S. Oltre Venture in Italy, Bridges Community Ventures in the UK, and SOVEC in the Netherlands are some examples.

Concerning capital under management, European PhVCs are smaller, with most firms less than USD 10 million. To this respect, Nicholls (2010a) reports that in terms of the size of deals being made within the social investment market, there is a concentration on smaller

investments typically up to USD 400,000 across a range of grant, debt and quasi-equity (grant availability is particularly concentrated up to around USD 80,000). Larger investments tend to be debt and there are relatively few deals in excess of USD 800,000. There is some evidence that suggests that this is the consequence of demand-side issues rather than a lack of investment capital. As in the case of American PhVC firms, European funds exhibit a strong focus on backing SEs that are located in the same country as the PhVC firm. This signals a commitment of PhVCs to focus on poverty and social needs in the communities they operate in, acting as a substitute for government initiatives when government fails to address such issues. For example, Impetus Trust, founded in 2002 as the first venture philanthropy organization in the UK, focuses on capital provision as well as engagement in portfolio charities or SEs which are uniquely headquartered in the UK and alleviate poverty in the country. Eastern European funds tend, instead, to invest in a broader area than their own country and include other countries in the region that formerly constituted a unique nation. NESst Venture Fund, started in 2001 and headquartered in Budapest (Hungary), is an international nonprofit organization working to solve critical social problems in emerging markets by developing and supporting SEs that strengthen civil society organization's sustainability and maximize their social impact. Last, few PhVCs invest in Africa, and only one of them claims to invest globally.

# 5

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## Investment Practices: Philanthropic Venture Capital vs. Venture Capital

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The analysis of investment practices and process followed by PhVCs is based on empirical research conducted in late 2008 by Scarlata (2011). According to Gill and Johnson (1991), in an ongoing developing field, theory can be the outcome of research. Being that the PhVC movement is a recent phenomenon both in the U.S. and in Europe and that it is under researched, qualitative and inductive research is considered the most appropriate approach. As such, stemming from Letts et al. (1997) definition of PhVC as the application of the VC model to the financing of SEs, the identification of PhVC investment practices was based on an initial review of the VC literature.

The research was based on a series of semi-structured interviews to have a qualitative understanding of how the PhVC investment practices are similar or different from that of VC. Interviews were conducted with seven PhVCs through March to May, 2008. Of the seven interviewed PhVCs, four were located in the U.S. and three in Europe. Interviews were then content analyzed.

A key feature of content analysis is the reliability of the dimensions and variables identified, *“given that a goal of content analysis is to identify and record relatively objective (or at least intersubjective)*

*characteristics of messages, reliability is paramount. Without the establishment of reliability, content analysis measures are useless* (Neuendorf, 2002, p. 141).” Reliability in content analysis is defined as agreement among coders about categorizing content (Krippendorff, 2004); specific issues in content analysis reliability thus involve the definition of concepts and their operationalization which needs to be evaluated by different coders.

After an initial coding by the interviewer of the PhVCs, two additional researchers were asked to perform the coding task. Coders other than the lead author required a three hour training session to familiarize them with the content being analyzed. As Riffe (2005) explains, the purpose of training sessions is not to pre-code material but to increase the coders’ comfort level with the content being analyzed. The inter-coder reliability was estimated using two indicators. First, the simplest coder reliability test — the overall percentage of inter-coder agreement — was considered. Based on Riffe (2005), the minimum standard acceptable level of agreement for reliability is 80 percent. The estimation of the inter-coder percentage of agreement was done using the software Nvivo 8.0 which, after the first inter-coding phase, gave a value of 99.9 percent.

Second, as simple agreement might over-inflate reliability because the chances of accidentally agreeing increase as the number of coders decreases, Cohen (1960) kappa was included in the analysis. Cohen (1960) kappa assumes nominal-level data and has a range from 0.00 (agreement at chance level) to 1.00 (perfect agreement). Accordingly, a result of 0.74 was obtained.<sup>1</sup>

Once dimensions and variables were assessed as reliable, results from the interviews were used for the development of a questionnaire which was sent to the entire identified population of American and European PhVCs. The aggregation of data collected from these sources ensures triangulation, minimizing bias from the author or from the methodology used, and construct validity (Saunders et al., 2007). Forty complete responses were obtained, corresponding to a 54 percent response rate.

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<sup>1</sup> Based on Landis and Koch (1977), values of 0–0.20 indicate slight agreement, 0.21–0.40 fair, 0.41–0.60 moderate, 0.61–0.80 substantial, and 0.81–1.00 as almost perfect agreement.

As reported by Scarlata and Alemany (2010), the responses obtained do not suffer from non-response error, indicating that non-respondents are not statistically significant different from respondents.

In the following parts of this section the paper will follow the process depicted in Figure 2.1, and focus on the investing and exiting phases of the investment model which involve a relationship between the investor and their investees. Fundraising, on the other hand, focuses on the relationship of the investors with their capital providers.

## 5.1 Deal Origination

Broadly speaking, there are two types of deal origination in VC: passive and proactive (Tyebjee and Bruno, 1984). Passively, VCs either receive unsolicited proposals from entrepreneurs or through a referral process. Based on observations made in the early to mid-1980s, Tyebjee and Bruno (1984) find that unsolicited proposals from the entrepreneur typically generate from cold calls and the usual response from VCs is the request of a business plan. Proactively, Sweeting (1991) reports that the most widely used criteria by VCs are the search for new deals through their network of contacts or ventures held in the existing portfolio; origination through referrals from other VCs, while used, appears to be of lower importance. In such a way, VCs are able to receive good potential deals as they become more informed thanks to the role played by the referrer. At this stage VCs usually know much more about the quality of the source by which the deal is referred than about the quality of the referred deal itself. Most of the referrers are reluctant to recommend an entrepreneur to VCs unless they are confident that the entrepreneur is a good candidate for VC. VCs are, thus, assuming that the quality of the source of the deal, which they know, can be a proxy for the quality of the deal, which is unknown.

Findings presented in Table 5.1 indicate that PhVCs rely primarily on passive means for deal origination, submissions via website, by mail, referrals or attending conferences.

*We also take proposals in the form of business plans.  
We receive them from the entrepreneur, our professional  
network, you know, when people get to know what you*

Table 5.1. PhVC deal origination.

Source	Method	
<i>Passive Origination</i>		
Social entrepreneur	PhVC web page	52.5%
	Mail	37.5%
Referrals	Business network	42.5%
Other	Conferences	12.5%
<i>Active Origination</i>		
Network	Network of philanthropic investors	95.0%
	Organizations in existing portfolio	92.5%
	Network of VCs	80.0%
	Other referral partners	95.0%
In residence programs	Incubation	50.0%
	Ad-hoc creation of SE	42.5%
Other		27.5%

The sum of the categories does not amount to 100 percent as respondents were allowed to choose multiple options;

Source: Scarlata (2011).

*are doing, what you are looking for, and the involvement you have in your investments, you start receiving deals.*  
(PhVCs B)

The New Schools Venture Fund explicitly states: “*Due to volume, inquiries will only be considered when submitted online; we are unable to respond to phone calls* (New Schools, 2011).”

*We always have a call for proposal on our web pages so that social entrepreneurs can always apply for funds.*  
(PhVCs C)

The second group of passive methods was proposals received through referrals arising from the PhVCs’ network of contacts, including personal acquaintance, consultants, and/or prior/existing investees. This is also the most used method of passive deal flow for VCs (Tyebjee and Bruno, 1984). Referrals are used by 42.5 percent of PhVCs. A total of 12.5 percent of PhVCs mentioned other passive methods for deal origination than those proposed in the questionnaire, more specifically, conferences attended with other purposes than seeking out new deals.

*We seek investments; we initially did a lot of outreach. Now we still do some outreach and we still do some of outgoing research but we now have a lot of people who know about that and they send us deals. (PhVCs A)*

Proactive deal origination tends to happen through the PhVCs network, which is used by more than 90 percent of PhVCs (see Table 5.1). Ninety-five percent of PhVCs proactively seek out new deals either by contacting their network of philanthropic investors or through other network partners. The PhVCs proactive search of new investments was described as an active process requiring networking and identification of those organizations that are working toward the attainment of social goals and impact and that fit with the PhVC investment strategy:

*Active search happens in a variety of ways. We generally set an investment strategy, we first determine the areas both geographically and in terms of the type of work these organizations are doing and we would like to invest in and then we try to get to know who the players are, the people who are doing good work, who are doing it for scale and would like to grow. Those are the organizations we work with. It's a combination of networking and talking to people. We talk to the people to find out who is making an impact. (PhVCs A)*

On average, 50 percent of PhVCs incubate SEs to test their suitability in the fund's social strategy and 42.5 percent create an ad-hoc SE in the event of no suitable SE being found. This is seen as one of the possible consequences of the PhVCs' own research. If a suitable investment candidate cannot be identified in the investment arena, the PhVCs might decide to scout for a social entrepreneur willing to carry out the PhVCs' idea:

*"We have done that a couple of times and probably the best example is [name of the company that was incubated] that develops charter school facilities. We thought that there was a real need for the charter school organizations we invested in. We found an entrepreneur to*

*write the business plan and then funded the company to fulfil their needs. We financed the social entrepreneur with a grant and the organization was incorporated as a nonprofit.”(PhVCs B)*

PhVCs also mentioned the use of other proactive search methods such as conducting their own research, attending conferences with the explicit purpose to seek out new deals, networking with public agencies and seeking new investment proposals through consultants. However, results show that these methods are only marginally used.

Deal origination suggests a number of research opportunities. First, the PhVC's network seems to be very important in both passive and proactive methods. In the case of VC, Hochberg et al. (2007) find that better-networked VC firms experience significantly better fund performance. Similarly, the portfolio companies of better-networked VCs are significantly more likely to survive to subsequent financing and eventual exit. The question in PhVC thus becomes does the strength and power of the PhVC's social network lead to stronger deal flow and better performance? Also, Inkpen and Tsang (2005) show that social capital dimensions of networks affect the transfer of knowledge between network members. How does the individual PhVC's social capital influence his ability to build his social network? Is social capital more or less important in PhVC than traditional VC?

A second possible avenue for future research could be the investigation of the institutional power of investors in PhVC funds in the origination of deals and their subsequent selection. If the PhVC firm is established by one main investor, as in the case of a private grant-making foundation adopting PhVC practices, the investor may not only provide leads to deals, but also actively participate in the decision making process, leaving PhVC fund manager little room for independent decision making on the selection of investments. Then, the question becomes understanding whether the same fiduciary duty that holds between VCs and their investors describes PhVC as well?

Third, do traditional VCs refer SE deals to PhVCs? If so, are these deals “lower” in terms of expected risk-adjusted return and higher for

PhVCs in terms of social return? If traditional VCs do funnel deals toward PhVCs, it would be interesting to understand the traditional VC's decision process. What are the antecedents of VCs deal origination when they receive investment proposals in SEs? If VCs seek to invest in ventures to earn a high economic return, how does it come that they receive proposals to invest in SEs? Developing a theoretical model of PhVC investments based on their differing utility functions and economic and social payoff structure could provide insights into the validity of the Pareto assumption.

Proactive search through incubation, which was identified through content analysis, despite being used by an average of 50 percent of PhVCs, is infrequently used. This might be a signal that PhVCs actually consider the option of having entrepreneurs in residence programs but the current situation only allows them to do so in selected cases. Understanding the conditions under which these programs are implemented could be an avenue for future research. Grounding the discussion around contingency and resource dependence theories, an understanding of the institutional settings under which SEs are created by PhVCs, both at macro- and micro-level, and how investors are involved in the creation of the new social venture could offer a new vision on the investment logics of PhVC investors.

As reported in Scarlata (2011), PhVCs' use of passive and proactive deal origination practices do not differ based on the profile of the respondent, legal structure of the PhVC firm or location. However, European and American PhVCs tend to differ in the frequency of use of network of philanthropic supporters as well as organizations in the PhVCs' portfolio. These tend to be mostly used by American PhVCs. Future research might try to understand why US PhVCs are more likely to use their network? Is it because they have more developed networks? Is it a function of how strong the ties are? Whatever the cause, it seems like a missed opportunity for European PhVCs.

## 5.2 Deal Screening and Evaluation

Results reported in Table 5.2 present the selection criteria used by PhVC investors.

Table 5.2. Deal screening variables used by PhVCs.

Dimension	Variable	% of Very important	Mean (rank)	Median (rank)	SD (rank)
<i>Human capital</i>					
	Social entrepreneur	90.0	6.82	7.00	0.55
<i>Potential</i>					
	Social impact	55.0	6.33	7.00	0.89
	Financial sustainability	27.5	5.80	6.00	1.07
	Scale	40.0	5.70	6.00	1.47
<i>External environment</i>					
	Social market served	42.5	5.85	6.00	1.29
	Market size	10.0	4.78	5.00	1.56
<i>Activity of the organization</i>					
	Business strategy	40.0	6.17	6.00	0.81
	Credible and sustainable revenue model and/or credible, sustainable funding model	27.5	5.40	6.00	1.55
	The SE is achieving clear outcomes with a significant number of people	42.5	5.28	5.00	1.66
	Technology	—	3.18	4.00	1.74
<i>Assessment of the deal</i>					
	Fit in the portfolio	35.0	5.23	6.00	2.02
	Deal terms	7.9	3.71	4.00	1.92
<i>Other</i>					
		7.5	3.17	4.00	2.34

1-7 scale: 1, “never used”; 4, “sometimes used”; 7, “Always used”.

Source: Scarlata (2011).

Results indicate that the PhVCs’ selection process focuses on the following dimensions, reported by their respective rank:

- (1) *Human Capital* measured by the experience of the social entrepreneur and of the management team.
- (2) *Potential* measured by the social impact the SE is estimated to be able to create.
- (3) *External environment* considering the type of social market the SE is targeting.
- (4) *Activity of the organization* in terms of the business strategy pursued to achieve the SE’s social mission and, thus, maximize its social impact.
- (5) *Assessment of the deal* measured by variables indicating the fit in the existing portfolio and the terms of the deal.

Concerning the *Human capital* dimension, PhVCs emphasize the experience of the social entrepreneur and of the management team. The *Human capital* dimension receives the highest importance among those proposed in the survey, with an average rating of 6.82, and 90 percent of PhVCs considering it as a very important variable for screening. In particular, enthusiasm and the ability to lead an organization toward the accomplishment of its social mission are critical:

*[...] a special focus [is] on the social entrepreneur and the ability to pursue the social mission via a well defined social strategy. We want social entrepreneurs who are enthusiastic about the mission of their social enterprise.*

*(PhVCs D)*

*The social entrepreneur is the one who develops the social mission of the organization and is the one who can identify which social markets to play in to achieve that mission and how to solve potential problems within the organization and face external ones. (PhVCs B)*

A number of potential research questions arise. Zacharakis and Meyer (1998) find that traditional VCs believe that the entrepreneur is the most important criteria when screening deals, but their actual decision policies focus more on market factors. Using a decision exercise with the five factors that PhVCs identified would confirm whether the entrepreneur is indeed the most important factor or not. It could be that PhVCs have deeper insight into their decision policies than traditional VCs because they are not as experienced due to the relatively short time the industry has existed. Shepherd et al. (2003) find that decision insight was stronger for less experienced VCs. PhVCs may also have a stronger focus on the entrepreneur because of the dual definition of success, social impact and financial return. Future research should investigate how PhVCs use the entrepreneur decision factor. Research could also examine how PhVCs evaluate the SE's human capital. Smart (1999) finds that traditional VCs use three methods, (1) work samples where the VC quizzes the entrepreneur on a number of "what if" scenarios; (2) reference checks on people who can attest to the entrepreneur's capabilities; and (3) fact based interviews to assess the entrepreneur's

past performance. Considering that the PhVC model has its roots in the traditional VC model, one would expect a similar process. The question becomes whether the same process is effective when looking at an SE that is focused on a social mission rather than a financial return.

The *Potential* dimension is measured by the three components of the social return investment logics of PhVCs: economic sustainability, growth through economies of scale, and social impact. Based on results, the *Potential* dimension receives a median importance score of 6.33, with 41 percent of PhVCs rating it as very important. Looking at its components, social impact is the most important variable within the *Potential* category driving the selection process. As one of the interviewed PhVCs claimed:

*So, in order to make an investment we must look at a couple of things. [...] Then, I think what is most interesting is: will these companies be able to materially impact the lives of at least one million people making less than four dollars a day? We estimate through their financial expectations in their business plans how many customers they are going to serve in a 5 to 10 years period and we are able to estimate what their expectations are. Sometimes it is a bit earlier depending on the stage of development and the targets achieved by the investment. Are they really serving people in the low income bracket? There are some companies for whom 10 percent of their customers are 10 percent of the base of the pyramid: that is not enough for us. (PhVCs E)*

*Potential* for social impact is followed by *financial sustainability and scalability*. Results show that PhVCs look for SEs with good prospects of becoming self-sufficient and thus surviving in the long-term. This finding could be of key importance in the post-investment and exiting phase of PhVCs investments while understanding how PhVCs enable SEs to achieve sustainability. An analysis of estimation of social impact and risk-adjusted returns could offer a better understanding of the kind of information PhVC request before going into the due-diligence phase.

The *external environment* in the form of market that, according to Zacharakis and Shepherd (2005), is non-additive with the human capital in place in VC backed firms appears to be less important to PhVCs. This is compatible with Austin et al. (2006a) argument based on “*the market selection mechanisms in social enterprises tend to be less powerful and act over longer periods of time*” Austin et al. (2006a).” In particular, the size of the market is considered as very important by only 10 percent of PhVCs. A decision exercise might be a good tool to see if the PhVC’s stated decision policy is congruent with their actual decision policy. The selection phase of PhVC investments suggests questions related to the structural, normative, and cognitive aspects of the PhVC decision making process, understanding whether the characteristics that the PhVC asks SEs to exhibit in order to receive its backing are actually in place in those SEs that garner PhVC backing.

Among the *Organizational activity* dimension, the business strategy implemented by the social entrepreneur to pursue the social mission is of key importance. Concerning the internal funding model, one PhVC claimed:

*Traditionally, social enterprises have mixed income streams; grants, donations, services etc. There is an element of sustainability within the criteria we consider in our selection process. Our mission is to improve the sustainability conditions of social enterprises and working on the missing 50% of unsustainable income related to the grants they are still receiving in such a way that the income of the organization is 100% earned income although we know that in social enterprises this may not ever happen, but we work in getting toward that (PhVCs B)*

Survey results indicate that the dimension *Assessment of the deal*, measured by the variables *Fit in the portfolio* in terms of investment strategy concerning sector and stage of development of SEs, as well as *Deal terms* are considered of low importance, confirmed by the very low percentage of PhVCs rating them as very important (35 percent and 7.9 percent, respectively).

As a further step, Scarlata (2011) indicates that a significant difference between the importance of the variables “*Social market served*,” “*Deal terms*,” and “*Scale*” and the location of PhVCs exists. More specifically, European PhVCs tend to rate both “Social market served” and potential for “Scale” lower than their American counterparts; on the contrary, “Deal terms” are far more important for European than U.S. PhVCs. This can be explained by the different institutional settings of the PhVC field in the two regions in that European PhVCs present the highest proportion of for-profit PhVC firms as opposed to the high presence of nonprofit PhVCs in the U.S. and the conceptualization of the PhVC model applying to grant-making foundations.

Considering that there are stated differences in decision criteria between U.S. and European PhVCs, a decision experiment could test to see if there are differences in actual decision policies. Institutional forces appear to explain differences in actual decision policies between traditional VCs from U.S., Korean and China (Zacharakis et al., 2007). Thus, decision experiments could deepen our understanding of how PhVCs select SEs to back and whether there are country differences.

### 5.3 Deal Structuring

The deal structuring phase of PhVC investments is analyzed in terms of: funding instrument, valuation methods, and contractual provisions. As mentioned by Scarlata and Alemany (2010), both on an aggregate level and by backed SEs’ stage of development, grant financing is the most widely used financial instrument by PhVCs. Table 5.3 indicates that 73 percent of PhVCs use grants to back SEs, with 34 percent using equity financing. Various types of debt financing are used which might be related to Wedig et al. (1988) argument of a low use of debt in the social sector due to the related high risk of bankruptcy.

The type of financial instruments varies by stage of development. While the current research categorizes the types and frequency of instrument use, the question of which types lead to better outcomes is unanswered. Future research should look at not only the type of instrument, but also type of PhVC and see if difference can explain performance outcomes.

Table 5.3. Financial instruments used by PhVCs by stage of the backed SE.

Financial instrument	Overall	Early stage	Expansion stage	Maturity stage
Grant	72.7%	77.4%	64.5%	62.5%
Equity	34.3%	32.3%	38.7%	31.3%
Quasi-equity	27.8%	25.8%	25.8%	31.3%
Underwriting	10.8%	16.1%	16.1%	6.3%
Subordinated loan	8.6%	12.9%	12.9%	12.5%
Senior debt	8.3%	9.7%	12.9%	12.5%
Unsecured loan below market rate	8.3%	6.5%	9.7%	12.5%
Unsecured loan at market rate	8.1%	6.5%	6.5%	6.3%

The sum of the categories in column *% of use* does not amount to 100 percent as respondents were allowed to choose multiple options.

Source: Scarlata (2011).

Sixty-one percent of PhVCs do not perform any valuation of the SEs they select. Of those PhVCs using valuation methods such as multiples (more than 25 percent) or the discounted free cash flow (DCF) method (more than 19 percent), 16 percent use both as a way to better estimate and confirm the fair value of the organization. Furthermore, the frequency of use of these two valuation models as well as their combined use show that PhVCs who put a valuation on an SE follow the behavior of traditional VCs (Manigart et al., 1997). Into the Other response category, PhVCs listed valuation methods based on the estimation of the potential social impact or on legal issues. Again, future research might test whether following a valuation method leads to better outcomes. Moreover, Manigart et al. (1997) identify differences in the use of valuation methods across European countries; Manigart et al. (2000) find differences in the pre-investment valuation and the valuation methods used by VC investors in the US and in a sample of four European countries. Does the same hold while analyzing PhVC deals, namely, are there any differences in valuation methods between U.S. and European PhVCs? Also, are there differences in use by the type of PhVC firm?

Considering that the majority of PhVCs do not put a valuation on the firm, we tested to see if there was a correlation between valuation method and financial instrument. The only significant correlation was negative between “no valuation technique” and equity financing.

Table 5.4. Percentage of PhVCs using Entrepreneur' binding provisions, renegotiation and liquidation clauses.

Contractual provisions	% of use	% of use with equity	Correlation equity and provision
Anti-dilution	20.0	63.6	0.73***
Liquidation preferences	17.1	45.5	0.50***
Drag-along	16.7	50.0	0.53**
Tag-along	13.3	50.0	0.65***
Vesting	11.4	27.3	0.38**
Pre-emption rights	10.0	54.8	0.33*
No transfer rights	46.7	25.0	-0.27

The sum of the categories in column % of use does not amount to 100 percent as respondents were allowed to choose multiple options; \*\*\*significant at the 1% level; \*\*significant at the 5% level; \*significant at the 10% level; elaboration based on Scarlata (2011).

From a contractual point of view, findings show that few PhVCs use standard VC contractual provisions. Only 20 percent of respondents use anti-dilution which was the most commonly used term (see Table 5.4). However, the use of provisions increases dramatically if PhVCs receive equity in return for their investment. As Scarlata and Alemany (2010) argue, a strong substitution effect between contractual provisions and trust is found in PhVC, particularly when portfolio organizations are structured as nonprofits. In this case, the moral hazard risk of the pursuit of self-interest is minimized by the organizational form itself, which imposes the reinvestment of any profit the organization creates to the organization itself. Also, when analyzing the relationship between the level of trust and the typology of financial instrument used, results indicate a maximum significant negative coefficient in the case of the use of equity. This suggests that the importance of trust when traditional marketable instruments are used is marginally decreasing.

An analysis of the contractual agreement characterizing PhVC investments could shed more light on the stewardship services provided to SEs. This could be integrated with an understanding of the mechanisms through which trust between the PhVCs and the backed social entrepreneur are built and how they impact the success of the financing program both in terms of improving sustainability and in creating social impact. Also, by investigating and connecting the selection

and structuring phases, we could gain a better understanding of the trust-formation process.

## 5.4 Post-Investment Activities

In an effort to increase the value of the portfolio companies post-investment, VCs conduct intense monitoring and perform value add activities. Amongst others, VCs act as mentors, are involved in the strategic management of the venture, and provide access to their network. In the following, we present the monitoring and cooperative activities that characterize the PhVC investment model.

### 5.4.1 Monitoring

PhVCs engage in formal and informal monitoring. We captured three types of formal monitoring: board seat, staging financing, and formal reports. We observed a number of informal monitoring activities, most notably informal meetings. Just over 38 percent of PhVCs use formal methods, whereas 41 percent use informal methods. Among formal techniques, 42 percent of PhVCs require a board seat and 37 percent retain the right to establish the SE's board composition. While being interviewed, one PhVCs claimed:

*[...] in our first investment we do take a seat on the board, we are not looking to take over a company but we are looking for some sort of control so we can protect our investment and then being in a position to help the company to overcome their obstacles to growth. (PhVCs C)*

Table 5.5 presents the level of importance attributed by PhVCs to each monitoring variable. PhVCs place the highest value on informal monitoring activities.

Results on importance were also corroborated in terms of frequency of use of formal and informal monitoring criteria (see Table 5.6) throughout the year using a 1–12 scale, with 1, “*once a year*”; 2, “*semi-annually*”; 3, “*quarterly*”; 6, “*bi-monthly*”; and 12, “*monthly*”. However, stage financing was not included in the options as the technique implies the provision of additional funds to backed organizations

Table 5.5. Importance of formal and informal monitoring by PhVCs.

Dimensions	Variable	% of Very important	Mean	Median	SD	Min	Max
Formal monitoring	Board seat	52.6	6.16	7.00	1.08	4.00	7.00
	Reports	47.4	6.03	6.00	1.19	2.00	7.00
	Stage financing	27.8	5.03	5.50	1.89	1.00	7.00
Informal monitoring	Informal meetings	65.8	6.47	7.00	0.89	4.00	7.00

1–7 scale: 1, “never used”; 4, “sometimes used”; 7, “always used”;

Source: Scarlata (2011).

Table 5.6. Frequency of use of formal and informal monitoring by PhVCs.

Type of monitoring	Variable	% of Monthly	Mean	Median	SD	Min	Max
Formal	Formal meetings	17.6%	4.38	3.00	3.73	1.00	12.00
	Reports	—	2.12	3.00	0.96	1.00	3.00
Informal	Informal meetings	69.0%	9.34	12.00	4.10	2.00	12.00

1–12 scale: with 1, “once a year”; 2, “semi-annually”; 3, “quarterly”; 6, “bi-monthly”; and 12, “monthly”.

Source: Scarlata (2011).

depending on the attainment of milestones that generally are fixed over a longer span than a year. In addition, the temporal frequency of using formal monitoring through board seat was addressed asking about formal meetings with the portfolio company’s social entrepreneur or management. Table 5.6 shows that informal monitoring, besides being the most important monitoring variable, is also characterized by the highest frequency of use with 69 percent of PhVCs having informal meetings with backed social entrepreneurs monthly, and on average, having one informal meeting every month and a half. On the contrary, formal meetings happen once every three months, and reports are required twice a year. Some snippets from PhVCs interviews further explain the findings:

*For our first investment, they have reported to us how many pounds of books they had from XXXX, how many employees they have that live in long term neighbourhoods or how many pounds of carbon they offset (PhVCs B)*

*Each company we support has to send us quarterly reports with traditional business metrics including variables such as strength of the management team and capacity of achieving social impact (PhVCs C)*

*We also use the online data system [...] that helps us collect up-to-date [...] data from the organizations and their performance, how they are doing and their plans for the future in terms of scale and philanthropy needs for sustainability (PhVCs D)*

No significant differences were found with respect to the rating attributed to each monitoring activity, nor to its frequency of use and the profile or respondents, the location of the PhVCs or its organizational form.

Findings on monitoring suggest that PhVCs behave as stewards of organizations they back. Based on stewardship theory, managers are viewed as interested in achieving high performance and capable of using a high level of discretion to act for the benefit of shareholders and the external environment (Donaldson and Davis, 1991), which in the case of PhVC is society. They are essentially good stewards of corporate assets, loyal to the company, pursuing a higher purpose than profit. Managers are driven by a sense of duty toward the organization and society which induces them to engage in course of actions that may be seen as personally unrewarding (Etzioni, 1961). The assumption that managers have a wide range of motives and behaviors beyond self-interest is the rationale for arguing that goal conflict may not be inherent in the separation of ownership from control. Using the stewardship model, insider-dominated boards are favored for their depth of knowledge, access to current operating information, technical expertise and commitment to the firm. Stewardship theory predicts that shareholders can expect to maximize their returns when the organization structure facilitates effective control by the management. To this respect, one PhVC stated:

*Being involved on a board level isn't something we are necessarily striving for. It is about assisting the*

*organization to meet their strategic roles. We would not even get involved with them unless we believe we are comfortable with the social entrepreneur and the strategic goals of the organization.*

Based on this, formal monitoring, either through board seats, staging of financing, or formal reports, is no end in itself, but is a means of information procurement for decision-making of stewards (PhVCs), so that they can help social entrepreneurs better improve the organizational strategy toward the current social mission. While the results suggest that PhVCs follow a strong stewardship perspective, a number of research questions arise. First, would a more formal control system similar to the agency perspective common in traditional VC lead to better performance? Specifically, are backed SEs who are more formally monitored more likely to scale and become sustainable? Second, while PhVCs report that they have frequent informal contacts with their backed ventures, is this really a function of the “halo” effect? Since PhVCs know that they should, are they overinflating their actual involvement? Third, does the stewardship model prevail over certain structures, like grants whereas more formal monitoring occurs when the PhVCs take equity or quasi-equity? To answer these questions, future research can follow several approaches. First, as done by Sapienza and Gupta (1994) in the case of VC, a matched study between PhVCs and their backed social entrepreneurs would confirm the types of monitoring activities. It would also help track which type of involvement leads to greater SE success. Second, a direct analysis of PhVC contracts, as mentioned in the deal structuring phase, would indicate what types of formal monitoring that are mandated. Then, surveys would confirm whether social entrepreneurs are fully complying with the contract or whether PhVCs are enforcing the provisions.

#### 5.4.2 Cooperation

Compatible with cooperative activities characterizing VC deals, Table 5.7 shows that the most important cooperative activity in PhVC is the provision of strategic advice to backed SEs. This result supports

Table 5.7. Rating of cooperative post-investment activities.

Dimension	Variable	% of Very important	Mean (Rank)	Median (Rank)	SD (Rank)	Min (Rank)	Max (Rank)
<i>Strategic</i>							
	Strategic advice	69.2%	6.36	7.00	1.16	2.00	7.00
	Board seat	52.6%	6.16	7.00	1.08	4.00	7.00
	Governance advice	28.9%	5.76	6.00	1.10	3.00	7.00
<i>Networking</i>							
	Access to future investors	57.9%	6.29	7.00	0.98	4.00	7.00
	Syndication	28.9%	5.66	6.00	1.28	2.00	7.00
	Other	5.0%	1.74	1.00	1.69	1.00	7.00
<i>Supportive</i>							
	Financial and accounting management	25.6%	5.79	6.00	0.98	4.00	7.00
	Human resource advice	23.1%	5.56	6.00	1.19	1.00	7.00
	Marketing and communication	28.2%	5.36	5.00	1.39	2.00	7.00
	Legal services	12.8%	4.41	4.00	1.76	1.00	7.00
	IT consultation	5.3%	4.08	4.00	1.57	1.00	7.00

1–7 scale: 1, “never used”; 4, “sometimes used”; 7, “always used”;

Source: Scarlata (2011).

Timmons and Bygrave (1986) suggestion that one of the most important contributions of a VC is to act as an advisor.

Concerning the networking dimension, syndication practices appear to be very important to a marginal percentage of PhVCs, while the PhVCs support as a way for backed SEs to access their social network of future funders seems to be of primary importance. As such, PhVCs appear to be stewards of the SEs they back in terms of providing business and strategic guidance, and more specifically:

*...generally speaking, each organization we work with will have a [name of private equity firms] mentor that works with the chief executive. They will have monthly or even more frequent meetings where they discuss the main strategic problems of the organization. You see, there is a certain way that these organizations think about the market, cash flow and revenue. [Name of private equity firm] offers a fresh perspective on the ways of looking at the organization. We provide capital, strategic and managerial support to established non-profit*

*social enterprises and help in scaling up their business. In some cases, we would advice organizations to move away from a particular market focus, or we would ask them to focus internally on their operations. With one of the organizations in our portfolio, we asked them to focus on their internal operations and they moved from a situation of stable revenues to one of increasing revenues. (PhVCs B)*

As a confirmation of the stewardship services provided to portfolio SEs, PhVCs use their social network to provide non-financial services through strategic partners or pro-bono experts. Results presented in Table 5.8 show that both strategic and networking roles are mainly provided by PhVCs. More particularly, new partners for syndication purposes as well as new potential investors are sought by the PhVCs in more than 94 and 78 percent of the cases, supporting the idea that PhVCs' main activity consists of providing backed SEs access to the PhVC's network. Marketing and communication, IT consultation, and particularly legal services are mainly provided as outsourced services, indicating the need for the PhVCs to develop a network with external specialized service providers. Again, a matched study of PhVCs and their backed SEs would confirm that these are the types of value added

Table 5.8. Internal provision of cooperative post-investment activities.

Dimension	Variable	Only internally	Only externally	Both
<i>Strategic</i>				
	Strategic advice	89.5%	7.9%	2.6%
	Governance advice	81.3%	15.6%	3.1%
<i>Networking</i>				
	Access to future investors	94.3%	2.9%	2.9%
	Syndication	78.8%	18.2%	3.0%
<i>Supportive</i>				
	Financial and accounting management	60.0%	37.1%	2.9%
	Human resource advice	58.3%	38.9%	2.8%
	Marketing and communication	43.8%	56.3%	—
	IT consultation	14.3%	56.3%	—
	Legal services	6.7%	93.3%	—

Source: Scarlata (2011).

activities the SEs want from their PhVCs. It may also be a good idea to see how these activities match with traditional VCs (see Timmons and Sapienza, 1994). Further questions related to this area could address the issue of how partnerships between PhVCs and private sectors players are created to fulfill the stewardship role of the PhVC investor. As shown in this study, PhVC firms tend to provide cooperative activities to backed SEs through external partners willing to support organizations with social aims by making their expertise available for them. Further, it could be investigated how different funders provide different post-investment activities and how this influences the ability of the SE to become sustainable. Last, analyzing the structure and the composition of the board of PhVC backed SEs could offer insights into the behavioral characteristics of investors and investees.

## 5.5 Exit

The exit phase of the VC investment process enables investors to realize returns and signal their quality. The same might hold for PhVC investors. However, 52.5 percent of respondents have yet to exit from any investment. PhVCs are patient investors because the majority expects to be involved with the venture for more than 3 years (see Figure 5.1). Cumming and MacIntosh (2002), amongst others, report that the average investment period for a VCs ranges between 3 and 6 years.

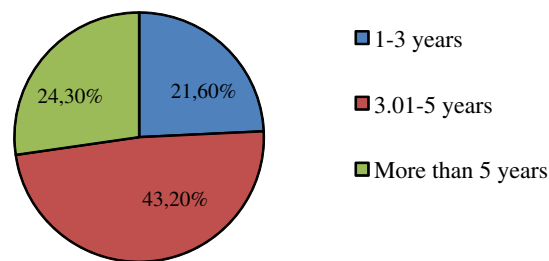


Fig. 5.1 Percentage of PhVCs by duration of investments.

The sum of the categories does not amount to 100 percent as respondents were allowed to choose multiple options;

Source: Scarlata (2011).

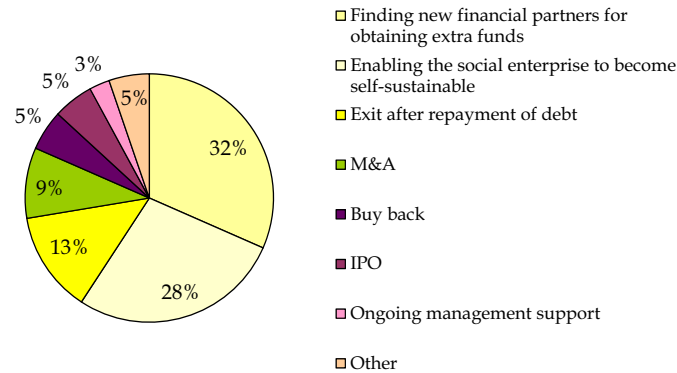


Fig. 5.2 Typology of exit by expected percentage of use.  
*Source:* Scarlata (2011).

In terms of exit strategies, Figure 5.2 shows that PhVCs expect to exit from investments after finding a new funding PhVC partner for the SE. PhVCs thus act as network providers of funding opportunities for portfolio organizations, allowing them to have the PhVC stamp of approval and send a strong signal to investors active in subsequent phases of enterprise development. The second most popular exit strategy is waiting until the SE has become sustainable (28 percent of PhVCs). Few PhVCs use M&As, buybacks, or IPOs, widely used in VC exit strategies (Cumming and MacIntosh, 2002), which tend to be applied only when the SE is structured as a for-profit entity. Furthermore, PhVCs include in their exit strategies the possibility of stopping funding but continuing to support the organization through strategic and management advice. This is particularly relevant and distinctive from VC, supporting the stewardship services and behavior of PhVC investors.

Research on this phase of the investment process should address the issue of return realization by PhVC investors. This, in turn, raises the question of measurement of social return and the contribution of the PhVC investor in the value creation process. How do PhVCs measure social value? Are PhVC backed SEs sustainable? Effects and effectiveness of the VC investment model to the financing of SEs, as opposed to other forms of philanthropic or market oriented forms, could shed light on the need of PhVC investors' existence.

Exiting an SE is subjective. As the PhVC industry matures, important research should examine what constitutes a sustainable ongoing SE. Is it just a function of scale and finding new sources of capital, such as new donors, to continue the SE's operations? Is it just when the PhVC decides to reallocate investments to new SEs? With such fuzzy boundaries describing an exit, it becomes very difficult to decipher when an exit is successful and when it is a failure. Until the industry establishes some norms, it will be difficult to prescribe best practices which might improve overall PhVC effectiveness.

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## Conclusions

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This monograph presents the investment practices adopted by PhVC investors. PhVC is an innovative and increasingly important funding model that applies the VC practices and techniques to the financing of SEs (Letts et al., 1997). As such, it is a financing option available for social entrepreneurs that provides capital and strategic involvement to SEs in an effort to spur their sustainability, allowing organizational growth, and ultimately maximizing their social impact.

After proposing a definition of PhVC, we discuss different investment approaches adopted in PhVC aiming at the creation and maximization of a social return on the investment. To do so, we follow Nicholls (2010a) discussion around investment logics and investor rationalities and integrate it with Emerson (2000) discussion on investor's involvement. We thus identify nine PhVC models reflecting a high level of investor engagement and different investment logics and investor rationalities. The paper then moves into an empirical descriptive analysis of PhVC in the U.S. and in Europe and identifies investment practices. To do so, building on Letts et al. (1997) definition of PhVC, the paper analyzes the PhVC investment process contrasting it with that characterizing traditional VC. The research details the deal origination,

selection, structuring and post-investment activities in PhVC as well as exiting. Results suggest that in the pre-investment stage of the model, PhVCs rely on their network while proactively seeking new deals, similar to practices in traditional VC. Different from VCs, however, PhVCs place more emphasis on the human capital dimension while selecting investments than on the market. Market mechanisms appear to be less important in the PhVC decision-making process. This supports Austin et al. (2006b) argument that organizations with social aims tend to operate in those environments where the market is less hospitable and favorable. From a contractual perspective, trust is typically substituted for contractual provisions used in VC. At the same time, PhVCs monitor the progresses of the SEs they back and retain board seats. PhVCs, thus, act as stewards of the SEs they back rather than principals. Results from the cooperative activities indicate that PhVC mainly act as strategic advisors, as in VC, and facilitate the access to future funders. A summary of the main findings contrasted with VC practices is presented in Table 6.1.

From an academic perspective, this study responds to Austin et al. (2006b) and Nicholls (2010a) call for research on the investment

Table 6.1. Summary of main findings on the PhVC investment model.

	VC	PhVC
Investment thesis	Maximization of economic return of investment	Maximization of social return of investment through sustainability of portfolio organizations
Deal origination	Mainly proactive, through referrals from third parties	Mainly proactive, through referrals from donors or portfolio organizations
Deal screening	Quality of management team, potential financial return	Quality of management team, potential for social return
Post-investment	Monitoring through formal meeting and board representation	Monitoring mainly at informal level
Exit	IPO, trade sale, follow-on investments; duration of investment period: 5 years	Follow-on investments, the social enterprise has become economically sustainable; duration of investment period: 5 years

behavior of PhVC firms. Our main contribution lies in the identification of the differences between traditional VC and PhVC which provide insights into unexplored areas for future research. As such, academics could elaborate on the results obtained here to further dig into the PhVC investment model and understand its efficacy. Digging into some of these subjects will bring more light to the young but growing field of PhVC and financing for social entrepreneurship. In addition, we contribute to the emerging literature on investments in social enterprises by identifying what investment models are currently adopted in such a market, identifying relevant players based on investment logics and investors' rationality. Opportunities for future research in this area are also proposed.

From a practitioner's perspective, this paper provides social entrepreneurs a better understanding on who PhVC investors are, what they look for, how to approach them, and what to expect from this new form of investment. Also, those interested in setting up a PhVC firm or moving into this industry have a guideline on current practices adopted in such a space.

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