

Virtuous Capital: What Foundations Can Learn from Venture Capitalists

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FROM THE MARCH–APRIL 1997 ISSUE

For decades, foundations have been making large grants to nonprofit organizations in the hope of meeting a wide range of society's most pressing and vital needs. In 1995 alone, foundations invested more than \$10 billion in programs dealing with, for example, poverty, homelessness, the environment, education, and the arts. Even as these large sums of money are put to work, however, many people in the nonprofit field are reporting a growing frustration that their programs' goals, although valuable and praiseworthy, are not being achieved. Many social programs begin with high hopes and great promise, only to end up with limited impact and uncertain prospects.

Nonprofit programs begun with high hopes often end up with limited impact.

Forces beyond the control of either foundations or nonprofit organizations account for some of the problems. For one thing, the federal government has scaled back funding for social services, leaving the foundations and nonprofits without an ally they had come to rely on. Furthermore, many leaders of nonprofits are finding that, despite their best efforts, social problems persist and may even be worsening. But part of the difficulty needs to be traced back to the relationship between the foundations and the nonprofits.

Traditionally, foundations make grants based on their assessment of the potential efficacy of a program. Although that approach creates an incentive for nonprofits to devise innovative programs, it does not encourage them to spend time assessing the strengths, goals, and needs of

their own organizations. Thus they often lack the organizational resources to carry out the programs they have so carefully designed and tested. Foundations need to find new ways to make grants that not only fund programs but also build up the organizational capabilities that nonprofit groups need for delivering and sustaining quality.

Many foundations are well aware of the problem and are trying new approaches. In particular, some foundations have been studying venture capital firms and their techniques for guiding their portfolio companies through the early stages of organizational development. The idea makes sense. Clearly, foundations and venture capitalists face similar challenges: selecting the most worthy recipients of funding, relying on young organizations to implement ideas, and being accountable to the third party whose funds they are investing.

To gain a better understanding of just which venture capital practices could be put to use in the nonprofit sector, we brought together a number of leaders of foundations, nonprofit groups, and venture capital firms. Their insights helped clarify for us what foundations can learn from venture capitalists. As Edward Skloot, executive director of New York's Surdna Foundation, puts it, a closer study of venture capital practices can inspire foundations "to make a new set of rules to play by."

The State of Foundation Funding

In the words of former Ford Foundation president Franklin Thomas, philanthropy has seen itself as "the research and development arm of society." In the 1960s, for example, there was a tacit division of labor between foundations and the public sector. Foundations focused on research and development. If new ideas proved successful, the federal government would embrace them and assume responsibility for their widespread implementation through government agencies. Several of the signature programs of President Lyndon B. Johnson's War on Poverty, for example, were developed and tested in demonstrations funded by foundations.

To carry out their R&D role, foundations organize around program development. Grants are given primarily to develop and test new ideas. The grant funds the program demonstration, the evaluation of the early results, and, occasionally, the promotion of the findings to create interest in the program elsewhere. Although this R&D approach has been quite successful in stimulating innovative program ideas, it is clearly not suited to building the organizational strength necessary for the widespread and sustained implementation of those ideas. In the process of making a grant, foundations often overlook the organizational issues that could make or break the

nonprofit. Instead, they fold organizational requirements into the category of routine overhead costs—costs that divert precious resources from the real work of delivering programs. Foundations’ attitudes have long encouraged nonprofit organizations to focus on mission and to regard organizational capacity as worthwhile in principle but a distracting burden in practice. Hence a serious problem for the nonprofit sector: no one is investing in nonprofit organizational capacity.

The lack of support has meant that a number of specific needs at the nonprofits are routinely under-funded. The urgent and neglected requisites of organization building include funds to track the needs of the nonprofits’ clients and how those needs are changing; time for nonprofit staff to plan new programs and processes; training and development for managers; and sound operating systems in the areas of finance, quality, and human resource development. Until those needs are addressed, the impact of programs will be limited.

Identifying Relevant Venture-Capital Practices

It is helpful to compare some of the differences in how venture capitalists interact with their start-up companies and how foundations work with nonprofit organizations. These differences can be the starting point for a process of reflection and change in the nonprofit sector.

Risk Management.

Perhaps the most striking difference between venture capital firms and foundations is in how they manage risk. Many venture-capital investors believe that out of a portfolio of ten investments, only two will be “moon rockets”—ventures that produce a big payoff with a successful initial public offering. The rest may be projects that have a chance of going public someday, projects that will survive but probably won’t issue stock, or projects that will fail outright. If a firm has too many project failures, future investors may be scared off and the venture capital fund itself may fail. It is in response to those risks that venture capital firms have developed many of their organization-building skills.

Foundations generally face little risk when making grants. Far from worrying about losing money, foundations are more likely to worry about not spending *enough*. (Failing to meet the IRS mandate that they pay out 5% of their assets annually means steep financial sanctions.) Because their funds are not at risk, foundations have not had to implement the kinds of controls that venture capitalists use. They rarely tie the compensation and career prospects of their program officers to the performance of grantees. Hence the program officers feel little pressure to learn

and apply organizational lessons on the next round of grants. Unlike a venture capital firm, a foundation can prosper—and even bask in the glow of good works—with little risk of being tarnished by the weak performance of grantees.

Performance Measures.

The venture capital firm and the start-up begin building their relationship around financial and organizational projections, which then act as a set of performance measures. The measures, which can include cash flow, sales, profits, or market share, are continually updated to reflect the start-up company's progress and the market conditions. Clear objectives give the investors and the start-up managers a focus for their working relationship.

Foundations focus on program efficacy; the long-term strength of their grantees takes a back seat.

Like venture capitalists and startups, foundations and nonprofits share a goal: theirs is to improve conditions in the social sectors in which they operate. Although it can be difficult to quantify such goals—for example, when the program is targeting inner-city development—the foundation and the nonprofit usually agree that the problem needs attention. However, foundations do *not* share one important goal of nonprofits. The nonprofit has a very explicit need to keep its organization healthy in terms of staff, revenue, and basic operating systems; the foundation, with its focus on program efficacy and its practice of making one-, two-, or three-year grants, does little to support those long-term goals. The sad irony is that although the nonprofit may serve its clients well in the short term, it may end up lacking the organizational strength it needs to continue its work.

Closeness of the Relationship.

To enhance the prospects for growth and sustainability, the venture capitalist offers a range of noncash, value-added assistance. For example, investors will often take one or more seats on the company's board to help shape strategy. To supplement formal governance, the venture firm's officers engage in extensive coaching and mentoring of the start-up's senior managers. Furthermore, the venture capitalist gets involved in critical hiring decisions, such as the succession that takes place when some of the early founders are replaced with professional

managers. The quality of the venture capitalist's input can be critical to success: *whose* money the start-up gets can be as important as how *much* the company gets or how much it pays for that money.

The bulk of a foundation's work comes even before a grant is made—in screening applications or seeking out new ideas. Once a grant has been made, the foundation assumes an *oversight* role to uncover poor management rather than a *partnering* role to develop capable management and adaptive strategies. Many program officers are reluctant to get involved with their grantees' organizational problems. For example, foundations require periodic financial reports but are unlikely to contribute the services of an expert to work with the nonprofit on financial planning. Most foundations never take a seat on a nonprofit board or act as mentors or partners: in fact, they believe that such involvement would be intrusive.

Foundations assume an oversight role instead of a partnering role that would develop strong managers.

Even foundations that do commit to the capacity building of nonprofit organizations often do so at arm's length. They hire third-party consultants who work on the nonprofit's particular organizational needs, such as back-office systems or professional development. However, because of the foundation's sensitivity about interference, the third-party consultant usually reports back only to the nonprofit. Hence the foundation loses the opportunity to learn about organizational needs or to respond effectively to them in the future. To be fair, the arm's-length relationship between a foundation and a nonprofit is partly due to the large workloads carried by foundation officers. The typical foundation officer handles hundreds of grant requests and scores of actual grants each year, as opposed to the venture capitalist officer, who manages maybe five or six companies at a time. Clearly, this oversize load of grants is something that foundations need to attend to if good organization building is going to take place.

Amount of Funding.

As an industry, venture capitalist firms fund a very small percentage of the businesses that are started each year, but the impact that venture capitalists have on their start-up companies is quite significant. That is because the venture firm, once it has made the commitment, can help

the start-up get the funding it needs to grow. Although the CEO is involved to a degree in fund-raising, he or she can count on venture investors to help raise money for the next stage of growth—and hence can concentrate on managing the growth.

Foundations, too, fund only a small percentage of the thousands of needy nonprofit organizations because there is only a limited amount of funding dollars. However, the common practice for foundations is to parcel out those limited dollars to a much higher number of recipients than a venture business would. The result is that a foundation grant covers only a small proportion of a nonprofit's costs. One foundation officer we spoke with put it this way: "We undercapitalize virtually everything we do." Even when a number of grants are combined, most nonprofit organizations are still starved for general operating support. Nonprofit executives, therefore, are forced to spend a large part of their time raising money year after year; some report spending more than half of their time on fund-raising. Under the circumstances, it is not surprising that many nonprofits are not managed well or that good managers may not be attracted to or willing to stay in nonprofit organizations.

Length of the Relationship.

Venture capitalists usually are engaged with a start-up for five to seven years, and some relationships last even longer. That longevity gives them the time to become intimate with the start-up's organizational needs and to find ways to fill them.

Foundations' grant-making time horizons are much shorter and leave little time for nonprofits to develop products, processes, or marketing plans to exploit a new idea. Of the more than 35,000 grants made in 1995 in the five states with the highest number of foundations, only 5.2% were for more than one year. On average, the multiyear grants were only 2.5 years in length. Many foundations simply state that they will not fund any program for more than two or three years. Most of them believe that to offer support for a longer period would make the recipients overly dependent and that nonprofits should become self-sustaining in that time. That line of reasoning has led to foundations' time horizons being out of sync with those of their grantees, which are trying to build organizations that can sustain programs.

The Exit.

Venture capitalists invest with the understanding that, ultimately, they will sell their stake to a takeout investor. The sale of the venture capitalist's stake effectively ends the formal relationship; it also provides the start-up with an infusion of capital to continue its growth. And,

of course, there can be no sale unless the start-up seems to have a strong organization and a viable future.

The nonprofit world has no such mechanism for passing the baton. Few national foundations want to be takeouts for their peers; because of their devotion to innovation, most want to be in on the ground floor. In some instances, foundations are able to structure a series of milestones to govern the release of installments over the life of a large grant. The nonprofit has to demonstrate a new level of performance—operating in a certain number of sites, for example, or serving a certain number of people. But there is often no logical process for one foundation to step back and the next one to step in.

In other instances, foundations will challenge nonprofit organizations to demonstrate that they can sustain a program after a grant terminates. But unlike businesses, nonprofits cannot expect to have investment bankers and their clients waiting to step in with another infusion of capital. Thus when the grant runs out, nonprofit organizations are left to mount a time-consuming search for funds to cover ongoing operation and expansion of programs.

The Next Step: Venture Capital Ideas at Work

Comparing venture capitalists and foundations can be a useful starting point for a reassessment of foundation practices. Such an assessment may yield a new set of practices that foundations can use to build stronger nonprofits. We would like to suggest preliminary queries for foundations and nonprofits to ponder.

Questions for Foundations.

Foundations can begin the self-assessment by answering the following:

Will our grants give nonprofits the organizational support necessary to achieve program goals?

If foundations and nonprofits agree in advance on organizational requirements in addition to desired program results, the grant has a much greater chance of having a sustained impact. Hopes for sweeping social change will need to be converted into a series of clear interim results that the grantee and the funder can work toward together.

The GE Fund's College Bound initiative provides a good example. The GE Fund established a clear goal for its education improvement program: to double the number of college-bound students at selected public schools in towns with General Electric Company facilities. It indicated that it would be willing to support local schools over the long term—up to five years in one case—if the schools met certain milestones along the way. As long as the principal is leading the school in new efforts and there are signs of improvement, the GE Fund will stay with the school. GE employees are closely involved in mentoring of students and thus add additional value to the grant. Although the work takes longer and involves more foundation effort, the results have been gratifying, with one school boosting the percentage of college-bound students from 25% to 75%.

What internal capacity do we need to build organizational strength at the nonprofit?

Foundation managers and boards will need to reassess their own capacity for a hands-on, organization-centered approach. Many will need additional staff with more experience in organization building to ensure that intelligent bets are made and sound strategies are developed. Foundations can consider recruiting officers with varied backgrounds—in business, institution building, and consulting. The Robin Hood Foundation, for example, has included former management consultants on its staff to help make grants and to deliver management assistance.

In addition to developing in-house managerial expertise, foundations also can give their program officers the authority and the time to respond to the organizational needs of nonprofits. Currently, program officers' workloads are driven by preparation for the next meeting of the board of directors; as a result, program officers have less time to respond to nonprofits. If program officers get more latitude, a closer and more productive bond can be forged between granter and grantee.

Is our grant portfolio too heavy on program innovation at the expense of organization building?

According to the *Foundation Grants Index*, general support grants, which can be used for organization building, represented only about 15% of total grants in 1993—down from nearly 25% in 1980. Program grants, meanwhile, grew from just over 30% of all grants made in 1980 to 45% in 1993. Foundations need to determine whether they are invested too heavily in program support to the detriment of organizational capacity.

A group of Philadelphia-based consultants to nonprofits, the Conservation Company, has recommended that funders begin making a new kind of grant—an *organization grant*. The grants would be something between totally unrestricted general support and highly targeted program funds. They could, for example, specify organizational growth targets, as venture capitalists do with private sector start-ups.

In Boston, several foundations have joined with the United Way of Massachusetts Bay and the Massachusetts Department of Public Health to try a new approach to organization building. They have funded the Common Ground project—an intensive three-year program for 17 multiservice, community-based organizations. The funders consider these organizations essential to improving the prospects of several distressed neighborhoods and have therefore moved beyond the traditional quick fix of an organizational assessment and short consultation. Instead, Common Ground will offer the funded organizations ongoing training and professional development plus longer-term consulting resources to help them implement and sustain new approaches. The funders recognize that it is organizational strength that will ultimately determine how successful the programs are.

Foundations might also consider whether they are too wedded to early-stage funding of programs. Many could give support at later stages, when a program or organization is at a critical juncture and other foundations have already invested and left. Later-stage funding, combined with a focus on building organizational capacity, could help nonprofits sharpen their impact.

Are we close enough to nonprofits to help them build organizational strength?

Just as foundations' program officers are working more closely with nonprofits on program design, so they should be getting closer to nonprofits on organizational issues. The more that funders understand the organizational complexity of nonprofits' work—and shoulder some of the burden and risk—the better positioned they will be to enhance program impact. Hiring a third-party consultant is a step in the right direction but does not enable foundations to understand and fund the appropriate organizational enhancements.

One promising approach is for foundations to create a separate intermediary organization dedicated to specialized, long-term work with grantees. A good example is the New American Schools, based in Arlington, Virginia. NAS, which is funded with grants from corporations, foundations, and philanthropists, was established to give young school-reform programs what

most foundations cannot: large grants over a long period in conjunction with formal and informal assistance to expand. Led by a former IBM executive and a board of corporate CEOs and leading educators, NAS staff members are close enough to their grantees to offer effective consulting support—such as developing a quality assurance program—and to define clear goals for which the grantees can be held accountable. The capacity building is explicitly understood as a powerful way to deliver and expand programs. The depth of the relationship (NAS works with only seven programs) enables NAS to act more like a venture capitalist than like a foundation.

Are there ways for us to experiment with some new types of grants?

Foundations can consider experimenting with alternative approaches to grant making by earmarking a share of their annual outlays for new approaches. For example, foundations could make an unusually long-term grant and see if it results in organizational enhancements and improved programs. Another approach would be to give a few program officers a radically lower caseload to see what they can accomplish with grantees who are eager for a real partnership. Third, foundations might consider partnering with third-party consultants, bringing their capability in-house, and delivering their services along with the grant money.

Questions for Nonprofit Organizations.

Like the foundations that support them, nonprofit organizations need to reconsider their approach to building capacity. Many have been conditioned by the existing grant-seeking process to camouflage their organizational expenses and needs. Nonprofits need to begin articulating compelling organizational strategies and asking foundations to invest in those strategies. Like the foundations, they need to ask themselves a few key questions.

Are we defining our organizational needs for funders?

To get more support for organizational needs, a nonprofit will have to articulate a disciplined plan for using the nonprogram money and show how that money will enhance the impact of programs. Instead of worrying about exposing their organizational weaknesses, nonprofits will have to “sell” those weaknesses by explaining that they know where to strengthen their organizations and how to deploy resources efficiently and strategically to get the job done.

When Family Service America, a Milwaukee-based nonprofit, mounted a fund-raising campaign to help the 250 nonprofits in its membership adopt new community-centered approaches, it didn't pitch a new model program. Instead, it laid out an analysis of the members' organizational

needs—from training and change management to staff recruiting and benchmarking—and got foundations to invest in organization-strengthening programs as a way of driving program outcomes.

Are we selective about which foundations we want as partners?

Although the tendency in fund-raising is to go after any possible grant, getting into an intensive partnership with the wrong venture-type funder is likely to mean wasted effort and considerable angst. Even cash-starved business start-ups are selective about whose venture capital they seek. Nonprofits looking for value-added funding need to communicate clearly where they are trying to take the organization, establish expectations that the funder will share risk and burdens, and create a plan that demands value-added support from a funder. Nonprofits should be wary of foundations that have repositioned themselves under a venture capital banner but lack the capacity, willingness, and patience to do the gritty work.

Are we showing foundations a clear plan that justifies longer-term support?

In order to sustain organizational growth, nonprofits need to look beyond the current round of funding. They should propose that early funders stay with them until they are ready for the next stage of funding. One organization that used that approach is Cooperative Home Care Associates (CHCA), a worker-owned cooperative in the New York City borough of the Bronx that provides health care to the elderly in their homes. The cooperative has proved quite successful: it offers home health aides attractive pay, working hours, and benefits, and it offers the community high-quality services. Because of its success, CHCA wanted to expand its operations and launch a training institute to create new cooperatives. When it approached a previous funder—the Charles Stewart Mott Foundation in Flint, Michigan—CHCA presented a long-term plan for building self-sustaining cooperatives. The Mott Foundation subsequently made a series of renewable grants over a seven year period. Programs such as CHCA's provide a clear incentive for funders to move away from traditional terms of one or two years toward the longer-term grants that can have sustained impact.

The venture capital model emerged from years of practice and competition. It is now a comprehensive investment approach that sets clear performance objectives, manages risk through close monitoring and frequent assistance, and plans the next stage of funding well in advance. Foundations, although they excel in supporting R&D, have yet to find ways to support their grantees in longer-term, sustainable ways. Because organizational underpinnings were not

in place, many innovative programs have not lived up to their initial promise. The venture capital model can act as a starting point for foundations that want to help nonprofits develop the organizational capacity to sustain and expand successful programs.

The venture capital model can show foundations how to help nonprofits build strong organizations.

A version of this article appeared in the March–April 1997 issue of *Harvard Business Review*.

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