

Cover Story

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Wholesome Investing

The idea that you can do good for society and the environment—and still make a healthy profit—is starting to catch on

Even with a single bottom line—the raw pursuit of profit—first-time venture funds struggle to post positive returns. Add in a mandate to combine social good with financial gain, and odds of success would seem daunting enough to keep even the most risk-tolerant emerging manager from attempting a “double bottom line” approach.

Not so. This year, socially conscious venture funds are ramping up at an unprecedented scale. At least seven new and follow-on funds billed as mission-driven investment vehicles are on track to raise about \$750 million this year (see *table*).

Nor are they reticent to spend. From organic school lunch servers to solar battery-charger developers to philanthropically minded online bookstores, social venture funds are bulking up their portfolios at a rapid pace. Few fund managers can brag of big exits. The vast majority, however, maintain that mission-focused funds can produce at least market rate returns—and possibly higher. LPs are increasingly signing on to the premise.

“It’s really peaked in the last six months,” says **David Chen**, founder of **Equilibrium Capital**, a planned \$200 million fund focused on the cleantech and wellness sectors. Since he began raising the fund last fall, Chen has seen a marked increase in interest levels from investors of all stripes in the social venture asset class.

The rise in social venture comes as institutional and accredited investors are putting significantly more money into so-called socially responsible investment (SRI) vehicles. Today, roughly \$2.71 trillion—or 11% of assets under professional management in the United States—are now involved in SRI, according to the **Social Investment Forum**, a trade group.

Private equity accounts for a miniscule portion of SRI investment. As of this year, an estimated \$5.3 billion was under the management of 46 different socially or environmentally screened alternative investment vehicles, including venture, private equity and hedge funds.

But it’s a rapidly growing universe. From 2005-2007, SRI assets increased more than 18%, according to the Social Investment Forum, which defines SRI as an investment process that considers social and environmental consequences of investments in its financial analysis.

The limited partners in socially responsible venture funds tend to fall into three camps, says **J. Gregory Dees**, a professor of social entrepreneurship at **Duke University’s Fuqua School of Business**. There are wealthy individuals, banks and pension funds investing in community development, and foundations looking to incorporate a social mission. Foundations, in particular, are favored LP targets for newly launched funds.

“Social venture funds argue this is a way [for foundations] to kill two birds with one stone,” says Dees. “Instead of making money so you can give money away, here you achieve your mission as you make money.”

Evolving the Model

Considering that foundations comprise an outsize share of the limited partner universe, one might think do-gooder funds would be an easy sell. But history indicates otherwise.

“The early folks who were doing socially responsible investing often got the door closed in their face,” says Dees. The professor once co-wrote a case study for **Harvard Business School** about the travails of **Commons Capital**, the social venture fund launched by angel investor **Woody Tasch** in 1989. Eventually, Tasch convinced the New York-based **Jesse Smith Noyes Foundation** to invest in the fund, but only after scores of others turned him down.

Another early entrant, the **New Schools Venture Fund**, didn’t struggle so much to raise money. However, managers of the fund, which invests in non-profit and for-profit education ventures, did fret over questions of mission. Concerns on the for-profit side came to the fore, says Dees, after public school operator **Edison Schools** acquired **Learn Now**, one of the fund’s portfolio companies. While the acquisition appeared at the time to provide a compelling financial return, Dees wrote in a case study, it was less clear whether it preserved the intended social impact of Learn Now as a quality education provider for students in low-income communities.

Other early efforts in socially motivated investing have involved angels. San Francisco-based angel fund **Investors’ Circle**, launched in 1992, has invested more than \$130 million to date in close to 200 companies and small funds addressing social and environmental issues. Other socially conscious angel networks include Seattle’s **Angels With Attitude** and the **Oregon Sustainability Angels Network**.

In many ways, angel funds—typically backed by wealthy individuals who generally already pursue a social agenda in their philanthropic activities—seem to be an easier match for the mission-oriented investment model than venture capital. Venture, with its reliance on multiple limited partners and large institutional investors, makes for a more complex fit.

Of course, weighing an investment’s appropriateness for fund LPs isn’t a new practice. For decades, VCs have largely steered clear of deals involving sex and gambling, stayed away from rogue regimes and catered to regional LPs with mandates for local investment.

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Steve Hardgrave

Partner
Gray Ghost Ventures

But social venture funds go beyond the longstanding industry practice of avoiding controversial investments. For these managers, the mandate isn't "let's not be evil," so much as "let's invest in what's good," says **Josh Becker**, co-founder of **New Cycle Capital**, a double-bottom line fund in Menlo Park, Calif.

The Deals

There's no universal sector focus or selection criteria for social venture funds, though certain types of businesses do account for a disproportionate share of investment. Food ventures are popular, as organic products fit nicely with social VCs' views on sustainability. Funds have recently invested in such businesses as a sustainable seafood supplier, a purveyor of organic pizza crust, and **Laloo's**, a Petaluma, Calif. goat farm that makes premium goat's milk ice cream.

Clean technology is also a favorite, and social funds have invested alongside traditional VCs in startups developing technologies related to ocean wave energy generation, solar power and green building. Other areas, such as education, microfinance and health care, are drawing increased investment.

Selection criteria vary widely. There's broad variation among social venture funds regarding ROI expectations, exit timelines and metrics for measuring an investment's social good. There's also much debate over which approach will prove to be "sustainable," to borrow a favored term from social venture portfolios.

A central point of contention is whether it's appropriate to accept lower returns when pursuing investments with a social agenda. Naturally, no one in the social venture world insists this will be necessary. Without fail, partners at newly launched funds predict they'll achieve above-market returns. In fund-raising pitches, however, VCs exhibit varying degrees of comfort with the concept that some sacrifice of ROI might be required to maximize social impact.

"Nobody is investing here first for the money," says **Kevin Jones**, principal and co-founder of San Francisco's **Good Capital**, which is raising a \$30 million fund. Likewise, **Mark Finser**, general partner of Sausalito, Calif.-based **TBL Capital** (as in "triple bottom line"), told LPs in TBL's first fund to expect only a positive return.

Venture capitalist and philanthropist **Andy Rappaport**, who invested in New Cycle Capital, says, "A lot of socially responsible funds have this idea that they'll provide a social return, but you'll have to accept a below-average financial return. I disagree. Once you give a business an opportunity to make a below-average return, you make it more likely it will."

Becker, who describes his approach as "very financially motivated," says investors shouldn't accept a tradeoff between profits and social returns. "We see how the social aspects of these companies are becoming a core competitive advantage," he notes. Becker points to businesses that provide health care, financial services and other essentials to underserved populations as particularly attractive.

Still, funding for self-described socially responsible businesses has been stymied in the past because such businesses don't fit neatly in either the mission-oriented world of charity or the ROI-centric realm of venture capital. "One of the problems in the capital markets is any time a VC hears social investment, they think philanthropy," says Steve Hardgrave, partner at **Gray Ghost Ventures**, a social investment fund in the San Francisco Bay Area. As social venture models mature, Hardgrave says he's seeing this mentality change.

While social venture fund managers dispute the notion that mission-oriented investors can't post solid returns, their screening methods do often differ markedly from traditional VCs.

Finser, for example, places a high value on entrepreneurs who are "living the principles" that their companies embrace. He points to **Reem Rahim**, co-founder of **Numi Tea**, a purveyor of organic teas, as an exemplary case. Even when building a tea house near its Oakland headquarters, the company took its commitment to sustainability to heart, Finser says. "They went all the way down to the paint," he says. "They didn't want to use toxic paint, so they dyed the wall with the color of some of their teas."

By contrast, Finser says he recently opted not to invest in a startup that recycled used carpet. He was intrigued by the product, but he got the feeling founders were "in it for the short term" and weren't interested in building a lasting business.

Social venture funds commonly worry about "greenwashing," an industry term used to describe companies that are more concerned about looking socially conscious than actually being so. "You get into greenwashing pretty quickly," says Chen, who says he views a lot of startups that seem to employ the green label as a marketing ploy.

On the opposite spectrum, socially responsible VCs have to contend with companies that are so committed to their social mission that it affects their profits. That was an issue for **Better World Books**, a Mishawaka, Ind.-based company that sells used books and gives a portion of proceeds to literacy causes. "Because they wanted to give away so much of their top-line proceeds, they scared away other venture investors who might have been otherwise interested," says Jones, whose firm invested in the company earlier this year. Better World's founders were willing to give away 10% or more of top-line profits to nonprofit literacy groups, but Good Capital convinced them that 5% made more sense, Jones says. (The company's founders also give away a percentage of equity on a vesting schedule to non-profit literacy groups that make quarterly reports on their progress.)

For the most part, social venture investors prefer deals that attract co-investment from traditional VCs. Becker points to New Cycle's investment in **TerraPass**, which sells carbon credits online to consumers and businesses who want to combat global warming. **TerraPass** also has backing from traditional venture firms **Maveron** and **Nth Power**. Another example is **SneakerVilla**, an inner city retailer that New Cycle backed alongside **Rosewood Capital**.

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J. Gregory Dees
Professor of Social Entrepreneurship

Duke University

Socially Responsible Exits

"Patient capital" is a popular moniker used by funds, including TBL and Investors' Circle, to describe their preference for building standalone businesses that may never sell to another company.

Fat returns are certainly a long-term goal, but delaying an IPO or trade sale may be preferable if it helps a company meet its mission, says **Matt Bannick**, managing partner at **Omidyar Network**. Waiting an extra year or two for an exit may be a secondary consideration, he says, compared to deciding the best path for an organization to have a massive social impact.

Given that social venture funds tend to co-invest with traditional VCs, the patient capital approach can lead to conflict. That's why it's crucial for social VCs to have mission-focused shareholder agreements in place early, says **Paul Richardson**, president of Renewal 2, a socially responsible fund being raised by **Renewal Partners** of Vancouver. Renewal plans to raise a fund of between 30 million and 50 million Canadian dollars that will invest in sectors including green consumer products, social communications and financial services for underserved groups.

"We're sensitive to the fact that not all money is helpful money," says Richardson, noting that traditional VCs have been known to push for quicker exits for companies that could have done better with a longer time horizon. "That's why who you partner with is critical."

When companies do sell, social venture investors take a keen interest in whether the values of the portfolio company will be maintained by its acquirer. VCs point to a few well-known acquisitions as the kinds of deals they like to avoid. High on the most-hated list is socially conscious ice cream maker **Ben & Jerry's** 2001 purchase by **Unilever**, which Good Capital's Jones calls "the classic bad deal."

Despite efforts by Unilever to preserve elements of Ben & Jerry's "crunchy capitalist" mission—such as donating a portion of its profits—culture conflicts marred the integration. Large-scale layoffs, which were anathema to Ben & Jerry's founders, and objections by Unilever brass to the ice cream maker's practice of embracing controversial social causes undermined the merger's success.

Finser says the jury is still out on **Tom's of Maine**, the eco-friendly toothpaste producer recently acquired by **Colgate Palmolive**, and organic beverage maker **Honest Tea**, which sold a 40% stake to **Coca-Cola** in February. He's more approving of the approach taken by dairy products distributor **Organic Valley**, which is carrying out an offering of dividend-paying preferred stock.

Looking Ahead

Concerns about whether an exit meets an ethical standard are premature for the bulk of social venture funds. Few have posted sizeable exits yet. Most newer funds have no exits.

That's unlikely to change in the near term. The next couple of years promise to be more about refining the social venture model than providing short-term profits. Dees predicts continued experimentation, including funds with unusually long life spans and perhaps a socially oriented stock market for companies to go public.

Already, planned life spans of social venture funds vary broadly. Evergreen funds, such as Omidyar Network, face no particular time line for posting returns. Others, such as Renewal 2, intend to return capital on an approximately 10-year horizon, just like a traditional VC fund, but they say they will extend the timeline if it maximizes social impact.

It's unclear which models LPs will favor—or whether they'll favor the social model at all on a large scale. As for new funds, the combination of a popular concept and unproven model will invariably lead to a feast-or-famine climate for fund-raising.

Says Rappaport: "The way these things work, it's difficult to raise money until it's ridiculously easy to raise money. The category, if it doesn't go away, will have to become oversaturated."

SIDEBAR: Socially minded LPs

Foundations and wealthy individuals are the principal limited partners in social venture funds. Pension asset managers have been comparative latecomers, despite a long history of investing in funds focused on regional economic development.

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Josh Becker
Co-founder
New Cycle Capital

West Coast investors have been especially active backers of social funds. Though double-bottom line funds have cropped up in several states, the San Francisco Bay Area is the closest thing to a geographic hub for the movement, with a high concentration of local funds and a plentiful supply of wealthy investors with activist credentials.

"There are a lot of people in Silicon Valley who have made a lot of money and are still relatively young," says **Andy Rappaport**, a general partner at venture firm **August Capital**. "They're looking at their investable capital and saying: 'Why shouldn't I use this to achieve some social returns?'" Rappaport and his wife, Deborah, recently invested a seven figure sum from their foundation in **New Cycle Capital**, a double-bottom line fund based in Menlo Park, Calif.

Even among LPs who favor double-bottom line funds, the asset class represents a small allocation in most portfolios. It's unlikely to exceed 5%, with the typical set-aside between 2% and 5% of a portfolio, says **Michael Lent**, a partner at **Veris Wealth Management**, who works mostly with individuals, foundations and endowments with assets of under \$100 million.

Lent says he has invested clients' money in **Commons Capital**, a Brookline, Mass.-based early stage double-bottom line fund, and he is evaluating several more funds currently in fund-raising mode. Clients, he says, tend to favor firms investing in businesses tied to clean energy, energy efficiency, job creation in poor communities and healthy living.

Some big LPs are eyeing socially responsible investing, too. In February, **Cambridge Associates**, an advisor to institutional investors and high net worth clients, launched a division in February dedicated to mission-related investing, which it described as a "rapidly emerging" sector. Cambridge is also working with three foundations—the **Annie E. Casey Foundation**, the **F.B. Heron Foundation** and **The Meyer Memorial Trust Foundation**—on a campaign called "2% for Mission." The effort encourages foundations to invest at least 2% of their assets above and beyond their charitable distributions in mission-related investments.

On the public pension side, some states, such as California and New York, have set aside hundreds of millions for cleantech investment, a sector favored by socially responsible funds, but none has earmarked capital for socially responsible funds themselves.

Some endowment administrators aren't convinced of the need to incorporate social mission in the for-profit side of the business. When asked about **Harvard University's** interest in double-bottom line funds, **Peter Dolan**, director of private equity at **Harvard Management Co.**, responds: "The university itself is a social good." Maximizing profits in Harvard's private investment, Dolan says, is the best way for the university to achieve its social aims, such as generating financial aid for students.

Social venture models are also unproven, says **David York**, partner at fund of funds manager **Paul Capital Partners**. "We're return driven," he says. "Historically those areas [of socially responsible investing] have been difficult to make money on." —*Joanna Glasner*

SIDEBAR: Social Venture Glossary

In addition to worrying about how to fix the planet, mission-oriented venture investors and entrepreneurs expend considerable energy coming up with new terminology. Here are some of the more popular phrases bandied about in social venture circles.

B Corporation: A type of corporation that meets comprehensive and transparent social and environmental standards. B Corporations embed their values into their corporate governing documents so they can survive new investors, new management and new ownership.

CSR: Short for Corporate Social Responsibility. The idea that corporations should be mindful of how their actions affect their employees, customers, shareholders, community and the environment.

Double Bottom Line: Refers to investors that look at a second bottom line of positive social impact in addition to a first bottom line of financial performance. (*Also see Triple Bottom Line.*)

Fourth Sector: Also referred to as a for-benefit organization. Organizations driven by social purpose that seek to be financially self-sustaining and may be profitable. They fall somewhere between traditional companies and charities.

Greenwashing: The act of misleading consumers regarding the environmental practices of a company or the environmental benefits of a product or service.

LOHAS: Lifestyles of health and sustainability. Entrepreneurs, particularly in sectors such as organic foods and personalized medicine, talk frequently about targeting the fast-growing market of LOHAS consumers.

Social Entrepreneur: A person who recognizes a social problem and uses entrepreneurial principles to organize create, and manage a venture to make social change.

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Renewal 2

Sustainable: A process or business that can go on indefinitely without harming the environment or depleting natural resources. For example, solar power is sustainable, while fossil fuels are not.

Triple Bottom Line: In the private sector, a commitment to corporate social responsibility and measuring economic, environmental and social impact of investments. The TBL approach is also referred to as "people, planet and profit."

Source: *Wikipedia, VCJ reporting*

SIDEBAR: Grading exits from SRIs

For socially conscious investors, a successful exit requires more than simply selling a portfolio company for a big return. They also look for a social return, seeking reassurance that the company will continue to pursue its mission after it's acquired or publicly traded.

So far, the record for socially responsible returns is mixed. Some values-conscious companies have generated huge ROI, but have seen their social agenda take a hit post-exit. Others have kept the corporate mission intact, but provided more modest returns.

Below, we take a look at some of the better-known exits in the space, grading them on both financial and social returns.

Ben & Jerry's

Business: Ice cream maker known for premium flavors and “crunchy capitalist” corporate culture.

Exit: Sold to Unilever in 2000 for \$326 million

Financial grade: A

Unilever’s offer, when tendered, represented a 25% premium over Ben & Jerry’s stock price.

Social grade: D

Unilever took steps to maintain the values associated with the Ben & Jerry’s brand, including setting up a social mission department to assess the ice cream maker’s social and environmental performance. However, culture clashes, including layoffs two years after the merger, marred the integration.

Tom’s of Maine

Business: Makes toothpaste and body care products without artificial or animal ingredients.

Exit: Colgate-Palmolive purchased an 84% stake in 2006 for about \$100 million.

Financial grade: B-

Considering Tom’s was posting annual revenues around \$50 million in 2006, according to press reports, the offer was modest from the perspective of price-to-sales ratio. However, Tom’s claimed that it could grow faster with Colgate’s distribution and marketing muscle.

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Andy Rappaport
General Partner
August Capital

Social grade: TBD

Founder Tom Chappell said at the time of the acquisition that he would continue to run the brand and that none of the company’s approximately 170 jobs would be lost. The company also continues to run a program supporting nonprofit dental clinics and dental health education. But several social VCs question whether combining with a publicly traded, bottom-line-focused conglomerate such as Colgate-Palmolive was a wise move for the mission-oriented company.

Learn Now!

Business: A for-profit education management company operating K-12 public schools.

Exit: Acquired by for-profit public school operator Edison Schools in 2001 for approximately 1.4 million shares.

Financial Grade: C

It looked like a good deal at the time, with shares of Edison riding high, but conditions quickly changed. Edison shares peaked around \$38 in February 2001, but nosedived weeks later amid below-expected revenue growth. The company was taken private two years later for \$1.76 a share.

Social Grade: D

LearnNow was wrestling with the need to balance the aggressive growth demanded by for-profit investors with its commitment to providing quality education for students in low-income communities, writes Duke Professor Greg Dees in his case study on the transaction. “Whether [the acquisition] preserved the intended social impact of Learn Now is a question I think that has been widely debated,” he says.

Organic Valley

Business: The Cooperative’s “Organic Valley” label is the nation’s largest farmer-owned certified organic brand, encompassing approximately 801 organic producers. It primarily produces dairy products, but also eggs, juices, produce, soy products and meat.

Exit: The co-op is completing an offering to raise \$7.5 million through a sale of Class E, Series 1 preferred stock for \$50 a share. The stock carries a cumulative dividend of 6%, with a minimum investment of \$5,000.

Financial Grade: B-

In the past, Organic Valley has been profitable, but margins have been low. In 2005, the most recent period for which data is available, revenue was \$242 million and net income was \$2.5 million. The share sale provides capital to expand and meet unexpected expenses, but won’t provide a big payback to co-op members.

Social Grade: A

Cooperative members maintain control of Organic Valley because Series E shares have no voting rights. Only holders of Class A Stock—agricultural producers who are members of the cooperative—have voting power. —*Joanna Glasner*

By Joanna Glasner, Senior Editor

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