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Venture Philanthropy: What Is It and Why Should We Care?

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Agenda – What we will cover

- What is venture philanthropy?
- What are the trends in this area?
- What are the barriers to successfully implementing venture philanthropy programs?

The State of Philanthropy

- There is increased focus on impact across many sectors
  - Corporations are incorporating shared value
  - Investors are looking for financial and social returns
  - Philanthropy is prioritizing solving problems rather than writing checks
- Philanthropy's experimentation and adoption of market-based tools will grow as:
  - Greater appreciation of financing gaps, so funding needs to go further
  - Convergence of business and philanthropy practices among wealth creators
  - Increased tolerance for risk with next gen philanthropists
- New models, such as venture philanthropy, will grow as philanthropy grows
  - US is the most philanthropic nation in the world giving away $470B+ in 2020
  - Over the next 25 years, $60T of wealth will transfer to the next gen and $27T (45%) is projected to go to charitable causes

What is Venture Philanthropy?

- There is no single definition
  - What we are talking about is called, alternatively, venture philanthropy, angel philanthropy, enterprise philanthropy, impact philanthropy, catalytic philanthropy, strategic philanthropy, values-aligned investing
  - These are some of the names that are being used to describe philanthropic models that go far beyond the writing of checks and often take a multi-faceted, long-term view of what it means to invest in solving global and/or local problems
- Venture philanthropists are a new generation of donors using non-traditional tools to direct funds to socially beneficial projects and to maximize impact
- Their charitable programs go beyond traditional grants
- They incorporates elements of:
  - Venture capital
  - For-profit joint ventures
  - Early-stage investing

Why Should We Care?

- Donors want:
  - maximum impact
  - more control
  - long-term involvement
  - a variety of investment/grant options
  - to be with the cool kids
- As government budgets continue to be squeezed and societal needs increase, foundations and individual philanthropists are increasingly blazing new trails in funding models designed to yield social impact as well as a financial return on their investments

What Elements of Venture Philanthropy Will We Discuss

- Grants “with Benefits”
- Recoverable Grants
- Funding For-Profit Companies
- Program Related Investments (PRIs)
- Mission Related Investments (MRIs)
- Hybrid Investment Funds

Impact investing spectrum

Traditional Philanthropy | Venture Philanthropy | Traditional Investing

Philanthropy | Impact First | Thematic | Sustainable | Responsible | Classic investing

Grants	Program-Related Investments	Mission-Related Investments	Opportunities	Risk Management	Competitive/Market-Based Returns
Maximize philanthropic impact; no direct financial returns	Optimize impact by taking into account financial fundamentals, with the possibility of investment return	Return is a key factor, but investment is tied directly to mission/outcomes	Maximize return with social filters, taking into account the potential to move broader-based market	Maximize return with social filters (e.g., no tobacco, alcohol or firearms)	Maximize returns

The changing state of play

Traditional practice

- Philanthropy focused on impact only, not financial returns or other performance metrics
- Following the philanthropic dollars, investors would step in with market-based capital and reap the financial benefits
- **Clear lines divided the philanthropic and investment worlds**

What has changed

Donor approach:

- "More than a checkbook" – blurring lines between philanthropy and investments (more control, greater sharing of upside, and ability to invest in impact cycle)
- **Using many pre-existing tools in new and innovative ways**

The likely future?

Creative solutions to attract and deploy concessionary capital, **including:**

- Venture philanthropy
- Hybrid structures
- Goal of creating end-to-end solutions (bench to bedside)

Nonprofit institutions need to be ready, willing and able to work with these new hybrid funding techniques, or donors will move funds to institutions that can

The building blocks to a venture philanthropy portfolio

- Traditional, philanthropic grants
- Grants with less traditional terms
  - ➢ Funder receives (sublicensable) research license to use funded IP in its field of interest
  - ➢ Funder has follow-on investment rights:
    - If funded IP is spun out to a for-profit, the funder has the right to participate in future financing rounds of the licensee
  - ➢ Funder is granted “March-In” Rights (protects against grantee shelving funded IP)
    - Triggered if grantee does not bring promising funded IP to market within a commercially reasonable timeframe
  - ➢ Funder receives a share of grantee’s revenue from the commercialization of grant-funded IP
  - ➢ Funder and university/research institution jointly own grant-funded IP
  - ➢ Funder controls or has input into the commercialization of grant-funded IP

The building blocks to a venture philanthropy portfolio (cont'd)

- Grants with less traditional terms (cont'd)
  - Charitable dollars to for-profit companies (to advance research or otherwise further charitable purposes)
    - Must exercise "expenditure responsibility"
    - May have other bells and whistles (publication requirement; charity retains right to terminate if (i) there are changes in key personnel, (ii) there is insufficient progress on research/missed milestones, etc.).
  - Recoverable grants
    - E.g., a funder makes a $25M grant to a university to fund drug development. If the drug is commercialized, the university shares its profits over $5M on a 50/50, with the funder's share capped at $25M.
- Program-related investments – made primarily for charitable purposes and not for investment gain (though gain not prohibited) *(discussed further on next slides)*
- Mission-related investments – market-rate or near market-rate investments that further a social/charitable mission
  - Want to be sure Investment Policy allows for considerations beyond financial returns

Program Related Investments (PRIs)

- PRIs are investments made by private foundations to support charitable activities that involve the potential return of capital
  - Can be done by public charities too
  - Same legal standard; reported on Form 990
- Treated as charitable grants for tax purposes
- PRIs include:
  - Below or no-interest loans or loan guarantees to individuals, non-profits and for-profits
  - Convertible notes
  - Equity investments in for-profits, especially early stage spin-outs from universities or research institutions
- PRI key legal requirements:
  - Primary purpose is to accomplish one or more of the charity's exempt purposes
  - Production of income or appreciation of property is not a significant purpose
  - Influencing legislation or taking part in a political campaign on behalf of a candidate for public office is not a purpose

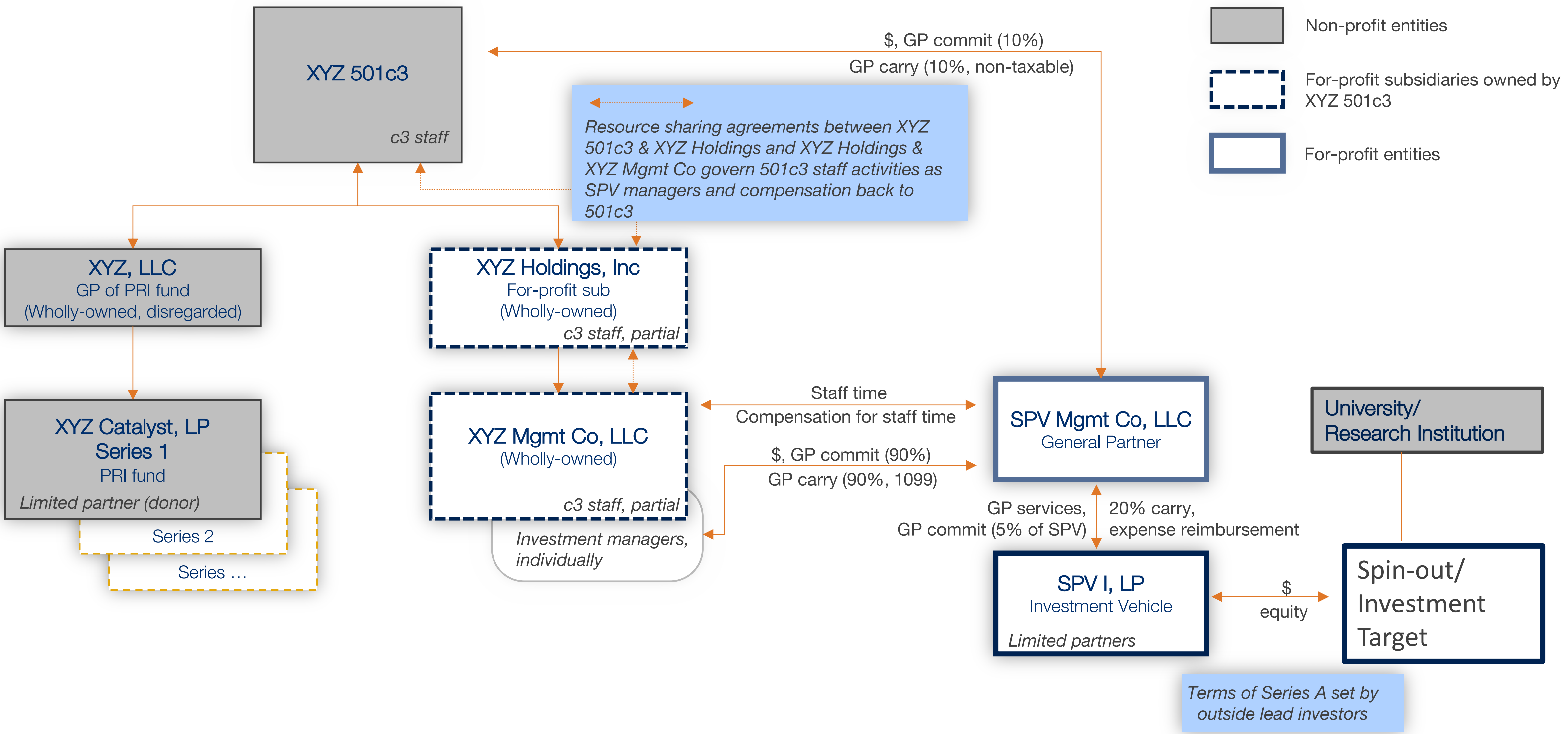
Example of PRIs from Our Practice

- A very common PRI scenario is a private foundation that makes a grant to a university or other research institution, with one of the grant terms being the right for the foundation to invest in any resulting IP that is spun out into a for-profit.
  - Follow-on investment is a right, not an obligation
  - Generally, investment terms would be negotiable at the time of the investment, though may have pre-negotiated discounts
- Client is a private foundation that made a grant to a university for research
  - IP developed with funding was spun-out into a for-profit company
  - The foundation makes a loan and a below-market convertible note to the for-profit company with follow-on market-based investment rights
- A public charity client makes a grant to a for-profit company to fund specific product development efforts, receives rights to IP for research purposes
  - The charity also receives a warrant, exercisable at (c)(3)'s option when certain development milestones are met
  - The exercise price will be an agreed-to percentage off the share value in the most recent investment round
- Client is a (c)(3) public charity that is part of a consortium of research institutions, with client contributing grant funds, researchers, equipment and other shared resources
  - IP developed as part of the consortium's work is spun out into a for-profit initially owned by the researchers who developed the IP
  - The (c)(3) provided a convertible note to the for-profit
  - The note will convert when the for-profit closes its Series B fund-raising round, with the conversion price being a 20% discount off the per share price of the Series B round
  - A for-profit investment fund agreed to make a matching investment on the same terms as the (c)(3)
    - (c)(3) funding, therefore, helped to unlock the initial market-based funding

Hybrid investment funds

- One solution that is attracting interest is the “hybrid investment fund”
- It overlays social impact on the private equity/venture capital model
- Here is how it fits into the development/commercialization process:
  - Using charitable funding, university PI develops IP, which is spun out into a for-profit company
  - PRI and mission-based funders are early-stage investors in spin-out company
  - These funders provide technical assistance and business development expertise to strengthen management team
  - To take spin-out company to next level (through clinical trials, expanding manufacturing capabilities, implementing marketing plan), an impact investment fund puts in capital invested by foundations, family offices and other impact/mission-driven investors
    - The fund can be managed by an affiliate of the university/research institution, a PRI funder or a more traditional fund manager
  - This funding de-risks the IP, demonstrates confidence in the management team and attracts commercial, follow-on funding

Architecting hybrid funds requires care



Using hybrid structures to realize IP value

It’s difficult to measure impact using one metric/balance sheet, because there are different return profiles. XYZ uses three balance sheets:

Problem to solve	• “Prepare the PI”	• “Build the deal”	• “Scale the company”
Why don’t the financial or philanthropic markets solve this problem?	• No financial return • Not on most philanthropic agendas	• Non-market financial return • But also not fully programmatic, so difficult to categorize	• Expensive due diligence • Not an appropriate target for traditional philanthropy
XYZ balance sheets	501c3	PRI funds	Investment funds
Expected return profile	• Programmatic	• Programmatic • Concessionary financial	• Market financial
Example work supported	• Lab-level IP review • “Education” to enable scientific co-founder role	• Launch newcos out of mid-continent labs	• Scale newcos into capital markets

Barriers and Building a Way Forward

- Educate internal stakeholders
  - The development office and internal and external legal team need to understand the concepts and the need for innovation
    - They should be helping you get to "yes" and offering solutions
  - Programmatic teams (especially tech transfer offices if spinning out IP) need to become adept at working closely with funders who want to (you pick the word) control, innovate, consult, meddle…
  - Provide technical assistance to team members who want to use some of these tools
- Find allies on the Board; pull the rest of the Board along
  - Members with VC or private equity backgrounds tend to understand the concepts
  - Explain the need for diversified funding sources
  - Start slow; take baby steps
- Review your internal operations to look for venture-ready projects
- Look for opportunities to partner with more experienced, other philanthropists
  - Tag along or work in coalition with more experienced funders/charities
- Avoid obvious missteps
  - Be careful of conflicts of interest – identify them and deal with them
  - Think of ways to incentivize your team; are traditional compensation models enough, or do you need revenue sharing opportunities, bonus pools, or other options

Questions?

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