FUNDING SOCIAL ENTERPRISES

These profiles illustrate how four diverse social enterprises have secured seed- and early-stage philanthropic and investment capital to build their organizations. In addition, the profiles include advice and perspectives on fundraising, negotiating, and blending capital from the entrepreneurs and funders.

Photo: Rural China Education Foundation - 2007 Global Fellow

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FIRST BOOK

A Nonprofit with Revenue-Generating Activities Goes Global

Overview

Enterprise: First Book

Target Geography: Global

Sector: Education

The Problem: More than 1.3 million classrooms and programs in North America serve children in low-income communities. While research confirms that access to books is central to learning, program budgets for new books and educational resources are inadequate. As a result, educators cannot create rich learning environments, establish useful curriculum, or give children in need supplemental materials to boost their learning experience.

Bold Idea: First Book looked at these inequities and saw the need and possibility for a systemic solution to increase access to books at the base of the pyramid. It brings a private sector lens to a nonprofit model by combining a large, formerly disaggregated market with a low-margin supply chain solution. Since its founding in 1992, First Book has formed a network of over 87,000 classrooms and community-based programs. It leverages the power of this market to negotiate lower book prices with publishers, elevating the network's educational program quality and increasing access, relevancy, and breadth of books and materials available to low-income children.

Legal Structure: Nonprofit; U.S. 501(c)(3) organization

First Book's original model was a traditional volunteer network, raising funds and awareness about the need for access to quality books and identifying school programs focused on low-income communities at the grassroots level. In 1997, it launched the First Book National Book Bank to aggregate books contributed by publishers from their excess inventory. Eligible schools and programs pay only a small shipping and handling fee of roughly USD 0.50 per book, and the clearinghouse annually distributes more than 9 million books to children in need. In 2005, First Book launched the First Book Marketplace to offer high quality, award-winning new books exclusively to programs and schools serving children in need at prices 50 to 90 percent below retail, thanks to the purchasing power of First Book's network. Both the Marketplace and the Book Bank are self-sustaining enterprises, with all costs covered by generated revenue.

First Book decided to be a nonprofit after examining many factors. First, the organization wanted to collaborate, rather than compete, with publishers to prove that there was a market-based solution to serve low-income populations. Second, educators were most concerned about books' price points, and First Book as a nonprofit could negotiate lower rates along the supply chain, from shipping to legal services. Finally, being a nonprofit allowed First Book to have control over its triple bottom line, benefiting the organization, educators and children, and publishers.

Children in need and educators gain access to affordable high-quality books and educational materials, as well as a responsive content partner in First Book. Publishers benefit from a new market, and though their profit margins per book are slimmer than retail, they gain incremental profits at low risk, and are engaged in the creation of new, culturally relevant content.

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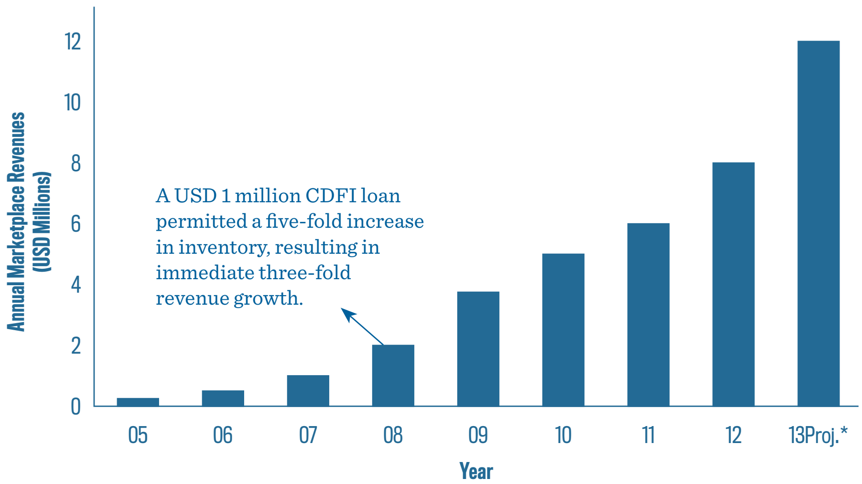
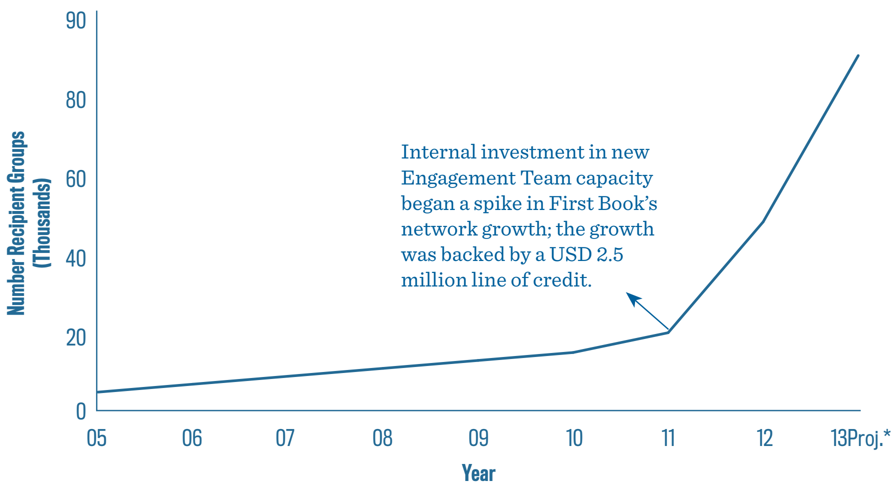
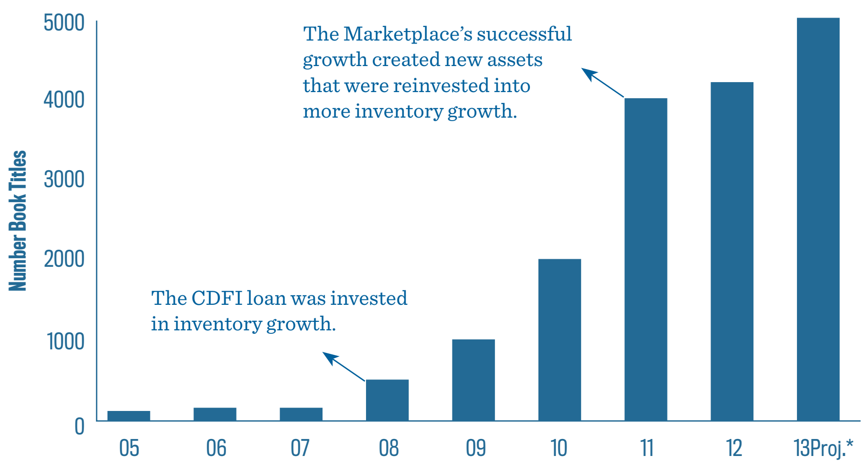
GROWTH IN ANNUAL FIRST BOOK MARKETPLACE REVENUES



GROWTH IN RECIPIENT GROUPS



GROWTH IN TITLES OFFERED BY FIRST BOOK



*Projected numbers for 2013.

Source: Echoing Green, First Book

Growth and Funding Timeline

First Book has put its funding toward different uses. It has diversified revenue generation across the organization's activities and funding sources.

From 1992 to 2008, First Book was fully funded by philanthropic capital—corporate contributions, individual donations, and a few foundation grants. For example, it used a series of grants from the Molina Foundation for general operating expenses to double its network and increase use of the First Book Marketplace.

In 2008, First Book Marketplace's three-year pilot had confirmed all of the original business plan's assumptions. First Book received its first USD 1.5 million loan after eight months of extensive interviews and analysis by three community development finance institutions (CDFIs).[1] The loan was made with conservative projections to ensure success: revenues for 2008, 2009, and 2010, respectively, were budgeted at USD 1.2 million, USD 2.5 million, and USD 3.7 million. They instead grew to USD 2.1 million, USD 3.4 million, and USD 4.7 million, resulting in an early repayment. First Book used the loan to increase inventory, which directly supported its long-term sustainability plan.

In 2011, First Book received a USD 2.5 million line of credit from SunTrust's Not-for-Profit Banking Division. It has yet to use the line of credit and may do so in its upcoming expansion.

[1] Community development finance institutions, or CDFIs, are specialized, mission-driven financial institutions that create economic opportunity for individuals and small businesses, quality affordable housing, and essential community services throughout the United States.
For more: http://1.usa.gov/1terFfg

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Outlook

First Book has distributed over 100 million new books and educational resources. In 2013 it committed to reaching 10 million children worldwide by 2016 with the books they need to read, learn, and succeed. Over the next three years, First Book will expand its efforts globally, reaching classrooms, school programs, and nonprofit organizations in India, South America, Egypt, Kenya, and elsewhere, beginning with promoting books that are already available on the First Book Global Marketplace.

First Book's inventory growth and global expansion, as well as outreach and the new technological capacity needed to deal with the amount and types of content they offer, will all require new capital.

Takeaways

- First Book took the time to consider which legal structure would result in the best outcomes for its network of educators, business partners, and other key stakeholders—and how each structure would affect the company's ability to achieve its desired triple-bottom line.
- Part of its success and growth has come from its discipline in measuring and iterating service delivery, just as any for-profit business would.
- Diversified funding sources from programs identified in response to gaps in the publishing market and low-income educational sector have helped secure First Book's sustainability and increase its impact.
- The best-matched loan providers for First Book had a clear mandate or history of serving nonprofit organizations. The lenders put the organization through rigorous financial testing as with any lendee, so First Book's sound financial management proved important.

Perspectives: Fundraising

Enterprise | Kyle Zimmer, President and CEO, First Book

How do you communicate a unified vision to both investors and grant makers? For donations, we must appeal to donors' particular interest in our cause. They want to make a difference with a group that shares their worldview or targets a cause that matters deeply to them. We work hard to build transparency into these relationships so that donors are aware of our challenges as well as our successes.

For investors, it can be a greater priority to connect the successful elements of our business to our cause, so they know that they can count on a good business track record, a sound business plan, and an effective team that will likely achieve the social mission and respect investors' financial goals.

As an example of how we blended these approaches, First Book approached a wide range of investors in 2011–12 for a second capital raise to build out our technology capacity in preparation for growth, after we were not able to refinance our first loan (despite paying it

Fundraising, negotiating, and blending capital from the perspectives of the social entrepreneurs, impact investors, and grant funders.

back early). While talking to potential investors, we found that because the impact investing space was so new, potential philanthropic funders were skeptical of our revenue generation and charging for services to populations in need, while for-profit funders were skeptical of our nonprofit status.

To help us solve this funding problem, KMPG helped us prepare an offering memorandum to market the hybrid First Book Marketplace to mid-size banks for a loan, which ultimately led to our line of credit from SunTrust. So for us, the funding solution at the time was to go the for-profit route and market our viability as a typical revenue-generating company.

Corporate Supporter | Brian Jones, Director, KPMG Corporate Finance LLC

How did you help First Book communicate a unified vision? KPMG Corporate Finance LLC was drawn to First Book because we saw that its strong financial profile and ability to scale set it apart from traditional nonprofits. We had known about the organization from KPMG LLP's longstanding relationship with First Book as a corporate sponsor. Our chairman at the time recommended that our capital advisory unit help First Book after learning it was seeking to scale its operations.

The main point we communicated during First Book's capital raise in 2011 was just standard practice in raising capital from financial institutions: stress test standard financial metrics upfront, such as debt service coverage ratios, which will be included in loan documents.

Many larger banks have internal groups focused on lending to nonprofit organizations because they understand the social value created by these clients. We approached these groups, in addition to soliciting interest from regional banks that welcomed the opportunity to help a local organization with direct social value.

Our messaging of the First Book opportunity to loan officers also included a social angle. We said, "Wouldn't this organization be great to work with?" The social mission was part of the offering memorandum, in addition to First Book's sound financial profile and business plan. Because First Book isn't a typical bank lendee client, it takes a certain advocate inside the bank to understand its social and financial value. In addition, they had to be comfortable with the public relations dynamics around using children's books as collateral in case of a loan default.

Impact Investor | Cynthia Livingston, Vice President, Not for Profit Banking Division, SunTrust

How did you evaluate First Book's funding opportunity? A representative from the SunTrust Mortgage Division had served on First Book's Board, so we were familiar with it before we began an operating relationship in 2005. The institutional side of the bank, the Not-for-Profit Banking Division, developed a relationship with First Book to provide day-to-day accounts and services. In 2011, First Book approached SunTrust about a loan in which the proceeds would support the growth of their infrastructure. The bank evaluated the organization's credit metrics and felt comfortable extending the credit. We determined that First Book's historical business results, management strength, and the sustainability of its mission and organization were strong and sound. First Book falls into SunTrust's nonprofit group domain, but the capital was deployed as it would be to any bank client—in an economically viable way.

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Impact Investor | Cassandra Archbold, Director, Investment Underwriting, Nonprofit Finance Fund

How did you evaluate First Book's funding opportunity? We learned about First Book via PCG Loan Fund. Nonprofit Finance Fund (NFF) is a CDFI that provides loans to organizations that have significant social impact in the communities they serve.

Since First Book met this qualification and was a fit from a mission perspective, NFF then evaluated its business model. We reviewed financial audits and First Book's business plan with market analysis. We evaluated the management and board, and challenged their financial projection assumptions. We looked at qualitative and quantitative aspects of the project to carefully consider how sensitive the organization would be to all factors that impacted financial outcomes, and finally we asked about alternatives if things didn't go according to plan.

Some banks were hesitant to use their book inventory as collateral for a loan, due to the potential for public relations risk.

Grant Maker | Martha Molina Bernadett, MD, MBA, Executive Vice President, Molina Healthcare; Founder, The Molina Foundation

How did you evaluate First Book's funding opportunity? The Molina Foundation is a nonprofit public charity that promotes access to education in order to reduce disparities in education and health status experienced by underserved populations. We typically find our own opportunities, though sometimes we are solicited. In any case, the evaluation process is the same.

First we look at the organization's business and operating model and assess the following:

- Is it sustainable?
- Is it scalable?
- Is it unique or a market leader?
- What are the industry trends?
- Has the organization proven astute enough to identify market changes and nimble enough to adjust and execute necessary changes?
- Is it serving a population that is consistent with our core values?
- Does it have a reputation for ethical business practices?
- Is there enough transparency for us to know that the funding is being used wisely?
- Is the business operating efficiently to assure that our investment will go as far as it can?

First Book satisfies all of these criteria. It has a history of sound business practices, from market surveillance to innovation; the team applies strategic thinking and executes on their decisions rather than endlessly analyzing; they are nimble and adjust quickly and ably to market changes and opportunities. Importantly, they learn from their mistakes and build on their successes. They minimize waste through rapid-cycle implementation and analysis. They do not perform endless pilots, but they conduct mini-demonstrations with rapid analytics to determine whether to replicate and expand or discontinue a process or program.

From a values standpoint, First Book is well aligned with our own mission and complements it. I have not seen a systemic social sector model like theirs before, and am hopeful of the power of this solution.

Perspectives: Negotiating

Enterprise | Kyle Zimmer, President and CEO, First Book

What challenges and opportunities do you face when working with investors and grantors, and how do you decide to seek one kind of capital over another? Overall, getting funding from both grantors and investors had unique challenges. Some impact investors were interested, but were too small to offer more than one loan in 2008. Venture capitalists were interested, but their fees were too high to be attractive.

We found that some U.S. foundations were unwilling to make program-related investments in a hybrid revenue-generating organization if we had not already been one of their grantees in prior years.[2]

The CDFI sector sometimes faces its own challenges, given that they must be responsive to stakeholders like their boards, which makes refinancing difficult in situations where private sector lenders would be willing to do so.

Corporate Supporter | Brian Jones, Director, KPMG Corporate Finance LLC

What role did you play in negotiations, and what value can corporate supporters add to the conversation? We introduced the First Book opportunity to both local and national banks, conducting a typical capital sourcing process utilizing language that institutional bankers could understand. The biggest hurdle First Book faced was that some banks were hesitant to use their book inventory as collateral for a loan, due to the potential for public relations risk.

We then helped First Book analyze and prioritize the term sheets submitted by interested lenders. First Book received strong interest from several banks and ultimately selected SunTrust Bank, which provided creative financing in the form of a revolving line of credit. The line of credit converts to a term loan after a designated time period and supports the organization's expansion initiative by giving it enough time to reach an adequate cash flow position prior to conversion.

Impact Investor | Cynthia Livingston, Vice President, Not for Profit Banking Division, SunTrust

What funding structure and terms did you agree on? Were they affected by the presence of the other type of capital? Our division focuses on larger tax-exempt organizations and only lends to financially sound organizations that we feel have the ability to repay. Not all nonprofits that we work with qualify for Community Reinvestment Act (CRA) credit; SunTrust learned that this loan could qualify after it was executed in 2011.[3] The ultimate facility we agreed upon was a term loan with an initial revolving feature where principal and interest would be termed out and repaid at the conclusion of the interest only/revolving period. This provides the flexibility to First Book to only borrow what they need.

Impact Investor | Cassandra Archbold, Director, Investment Underwriting, Nonprofit Finance Fund

What funding structure and terms did you agree on? Were they affected by the presence of the other type of capital? We agreed on a fixed-term rate loan paid in monthly increments over three years, beginning in 2008. The capital disbursement and repayment schedules

[2] Program-related investments (PRIs) are a tool U.S. foundations can use to generate outcomes that are in line with their programmatic agendas. Like grants, PRIs make inexpensive capital available to for- or nonprofit enterprises addressing social and environmental challenges. Unlike grants, PRIs are expected to be repaid, with a modest, risk-adjusted rate of return.
For more: http://bit.ly/grantspacepri

[3] The Community Reinvestment Act of 1977 (CRA) provides a framework for U.S. financial institutions, state and local governments, and community organizations to jointly promote banking services to all members of a community. CRA prohibits denying or increasing the cost of banking to residents of racially defined neighborhoods and encourages efforts to meet the credit needs of all community members, including residents of low- and moderate-income neighborhoods.
For more: http://1.usa.gov/1hP6Xy5

were influenced by our co-investors. We resolved to disperse capital in increments based on growth plan needs. The reimbursement schedule is accelerated from our standard agreements, a function of the loan terms that needed to be provided by a co-lender. We try to be aware of our co-investors' constraints—being flexible is important in nonprofit financing because different lenders have differing credit policies and lending restrictions. For example, in some cases we use credit enhancement to improve the loan-to-value ratio and make a transaction financeable. Ultimately, no one will move forward unless everyone can move forward. So NFF tries to help bring good deals across the finish line.

Grant Maker | Martha Molina Bernadett, MD, MBA, Executive Vice President, Molina Healthcare; Founder, The Molina Foundation

What funding structure and terms did you agree on? Were they affected by the presence of the other type of capital? We have donated various amounts based upon their need and our competing priorities each year. Our donations have ranged from USD 10,000 to hundreds of thousands of dollars in a given year. We have provided direct and matching funds on different occasions.

In general, we evaluate programs and support for infrastructure enhancement on a year-to-year basis. First Book reports metrics that matter to us based on the specific purpose of the grant and goals to be achieved. We discuss how things are going throughout the year and offer our expertise along with our financial support. They are great business partners in that regard. We know our funding goes far.

First Book invited us as a builder, not as a passive donor. We are active donors. We want to participate in the solution rather than just writing a check and hoping that it helps. We look to contribute our expertise and experience along with our funds.

First Book invited us as a builder, not as a passive donor.

Perspectives: Blending Capital

Enterprise | Kyle Zimmer, President and CEO, First Book

How do you use capital from traditional investors, impact investors, and grant funders across your organization? First Book has diversified revenue generation across the organization and across funding sources. Internally, we challenge all of our departments with revenue goals. External revenue sources include the private and social sectors, our two revenue-generating distribution models, and public outreach to support the educators we serve.

We are constantly evaluating trends, projecting growth, and developing budgets for capacity building. We speak to funders and investors about our plans and goals, address the areas that will create the most improvement, and demonstrate how that improvement will impact our mission. Funding supports ongoing operations, as well as capacity-building projects on both a small and large scale.

Impact Investor | Cynthia Livingston, Vice President, Not for Profit Banking Division, SunTrust

How do you view collaborating with the other type of capital? We saw grants as a source of financial strength for First Book. The ability to raise donations that would then be available to help repay loans represented a strong aspect of any nonprofit client's business profile.

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Impact Investor | Cassandra Archbold, Director, Investment Underwriting, Nonprofit Finance Fund

How do you view collaborating with the other type of capital? Organizations with scheduled payments of debt add to project risk, so they need "soft dollars," or patient capital, to make it more likely for the project to succeed. Flexible, philanthropic funding is an ideal option for new social enterprises, but is not always easy to come by.

We also frequently collaborate with other lenders, from mainstream financial institutions and large banks to other like-minded CDFIs. CDFI loan limits tend to be lower than those of community banks, so we collaborate on deals that may be too large for one CDFI to originate alone.

When organizations are first undertaking a project, it is challenging to obtain financing from commercial banks until the model is proven. Early-stage CDFI collaborations can prepare organizations to secure future financing from traditional sources.

Grant Maker | Martha Molina Bernadett, MD, MBA, Executive Vice President, Molina Healthcare; Founder, The Molina Foundation

How do you view collaborating with the other type of capital? Collaboration with other investments is part of effective funding. We evaluate financial management of organizations in the nonprofit and for-profit spaces similarly. Are they mindful of opportunities to leverage resources, engage appropriate debt, and balance cash flows? Are they fiscally prudent?

Our funding does not overlap with or directly impact the other fiscal tools that we would expect organizations to have in place. First Book is diligent and transparent about how they use funds. We see investment as part of the equation and look at the responsible management of the organization's entire fiscal picture.

First Book has never fallen in love with our model more than our mission.

Last Words: Advice

Enterprise | Kyle Zimmer, President and CEO, First Book

For social entrepreneurs: There is no substitute for doing your homework. Successful entrepreneurs are not born—they succeed because their thinking is great. Create a good business plan.

Stay innovative and keep inspecting your business model. First Book has never fallen in love with our model more than our mission. We keep evaluating what we could do better, which forces us to innovate and results in getting more books to more children more efficiently.

Regarding funders, don't think donors or investors owe you just because you have a good social cause. It has to be a fit.

Invite others into the building process. As you refine your models and build new ones, you should constantly reach out to people from every category of talent to make certain that you have the best thinking incorporated into your work. Invite criticism so that you can launch the strongest solutions.

As in all organizations or corporations, individuals are the key. Recruiting the brightest innovators is a challenge for all institutions, and possibly an even bigger challenge in the social sector.

Similarly, managing risk is always a challenge. Meeting the mission goals we have set sometimes requires us to take leaps that ordinary businesses might not take, so we focus relentlessly on business planning to see around as many corners as possible.

Impact Investor | Cynthia Livingston, Vice President, Not for Profit Banking Division, SunTrust

For social entrepreneurs: Leverage any relationships to financial institutions that you may have through a board member, volunteer, donor, or other stakeholders to create lasting ties.

Develop a relationship with a financial institution or banking provider that understands your business and operations. Strong communication and a deeper understanding of the work leads to continued dialogue and the ability to best work together to meet the organization's financial and social goals. When your financial institution knows and trusts your business management, an ideal situation is created to work with you on financing.

For lenders: There are well over a million U.S. nonprofit organizations in operation that are providing their services both domestically and internationally. Doing business with and focusing on these types of entities is a significant opportunity for any financial institution. There is considerable inherent goodwill in serving this sector and helping these organizations achieve their goals, as they are doing good work in our communities, our country, and around the world. This industry can be very satisfying and lucrative.

Impact Investor | Cassandra Archbold, Director, Investment Underwriting, Nonprofit Finance Fund

For lenders: An organization's business plan is key to a lending decision, particularly if the organization is taking on debt to finance growth, as these kinds of ventures tend to be the riskiest. A well-thought-out business plan should have concrete growth benchmarks that are informed by marketing and feasibility studies around market need, size of opportunity, and competitive landscape.

Management expertise and resources like access to capital, partnerships, and organization infrastructure are another large factor. Has the team thought through the ways the organization will change and how they will adjust as the change is taking place? Do team members have relevant skills, contacts, and experience, or does the organization have a plan for training staff or acquiring this expertise?

Are the organization's leaders persuasive in communicating their idea and its potential? The team must be confident in its plan, but also able to react to changing circumstances and think through ways to meet new demands. Management must understand the context in which they are operating the social enterprise venture, in terms of regulation, tax, and the political environment.

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For social entrepreneurs: When I think about social entrepreneurs who are trying to build a relationship with a grant maker, they can learn a great deal from First Book. We did not grant at our current level from the outset. We have been learning about and working with First Book for about ten years. The first few years were spent learning about what they did, who they reached and served, and how they did it. We learned about their strategy, and they involved us by asking us to share our expertise and experience in reaching their population of interest long before they asked for any funding. They had clearly defined priorities all along the way. Their consistent focus was impressive. I would advise social entrepreneurs not to approach funders during their early learning and experimenting phase. Ask for funding after your focus is clear and you know you can stick to it.

Understanding the funders' interests is another important element in successful relationships. If your focus is not aligned, don't ask; this will save both organizations a lot of time and resources. However, do ask funders you know to point you in the right direction. Funders often know each other and might recommend you to a colleague in your field if they believe in your underlying strengths and focus.

There is much talk about impact these days, as more grant makers are looking at their grants as a social investment portfolio. Organizations that can delineate specific uses of a grant, benchmarks that will be impacted, and timelines to make specific changes in those benchmarks, will be ahead of the game. Yet there is one very important factor that should never be overlooked: you. You as individuals and as an organization are the most important factors in grant making. Grant makers and philanthropists do not just fund business plans; they fund individuals who they believe can execute those plans successfully.

Successful relationships with funders include understanding the funders' interests. If your focus is not aligned, don't ask; this will save both organizations a lot of time and resources.