

Venture Philanthropy in Europe: Landscape and Driving Principles

Book Chapter

Dr. Maximilian Martin and Dr. Rob John

15 December 2006

1. INTRODUCTION

Since the mid-nineties, the rise of venture philanthropy has mirrored the rise of social entrepreneurship in civil society in interesting ways.¹ Social entrepreneurs and venture philanthropists alike have often laid claim to being among the most innovative players in the civil society and social change space. Their rise to prominence has mainly been driven by five developments: the general growth of more entrepreneurial approaches to social change; the increasing professionalization of civil society; increasing levels of wealth; the changing demographic composition of donors; and their greater desire for involvement in philanthropic ventures.²

Given its early stage and the capital available, the European venture philanthropy landscape is likely to evolve significantly in coming years. The degree of path dependency is limited and driven by mindsets and mental models: most venture philanthropy organizations (VPs) are currently small and experiment with various intervention models. This chapter gives a brief overview of the main characteristics of the European venture philanthropy landscape and looks into the "DNA" of venture philanthropy as a core driver of future VP strategy. We also ask what this means for social entrepreneurs who look to VPs for funding.

2. THE EUROPEAN VENTURE PHILANTHROPY LANDSCAPE

The emerging venture philanthropy landscape in Europe is at an early stage. In many European countries, there are only at most a few venture philanthropy organizations and they are small compared to the more traditional charitable foundations.³ Rob John's recent overview paper lists 36 venture philanthropy organizations in Europe.⁴ The European Venture Philanthropy Association (EVPA), currently Europe's sole network of VP organizations was only created in 2004. It had 39 members in December 2006.⁵

Analogous to social entrepreneurship, a host of competing definitions of what venture philanthropy is or should be, and how it relates to venture capital, are vying for hegemony. Economy of argument does not allow us to review the main definitions.⁶ In terms of actual practice, a survey of 35 VPs provides the following picture⁷ (for an illustration of a specific VP, see also **box 1** on Impetus Trust, UK).

- *Focus on startup philanthropy.* VPs focus overwhelmingly on supporting early or expansion-stage civil society organizations. In the sample, 86% of the respondent organizations focus on growth, 63% on early stage, 46% on established organizations, and 14% on mergers (multiple priorities possible).

¹ The term "venture philanthropy" dates back to John D. Rockefeller III, who used it in 1969 in a hearing on tax reform before the Committee on Ways and Means at the U.S. House of Representatives. However, the takeoff of venture philanthropy as a discernible approach dates back to the mid-1990s, the rise of the new economy, and the influential Harvard Business Review article "Virtuous Capital" (Letts et al. 1997). For sake of simplicity, we do not broaden the discussion to include private equity.

² For a detailed analysis of the concept and its drivers, cf. Martin, M. (2004a, 2004b).

³ Broadly speaking, the distribution of VPs follows venture capital hubs. Among the 14 full EVPA members listed in the website, 5 are from the UK, 2 from Italy, 1 from Estonia, 1 from France, 1 from Germany, 1 from Hungary, 1 from Ireland, 1 from the Netherlands, and 1 from Spain.

⁴ Cf. John, R. (2006a).

⁵ In December 2006, EVPA had 15 full members, 21 associate members, and 3 honorary members (cf. <http://www.evpa.eu.com/directory.html>).

⁶ For a discussion, cf. e.g. Letts, C., et al. (1997), Council on Foundations (2001), Carrington, D. (2003), Scott, J. (2002), John, R. (2006a).

⁷ Data from John, R. (2006b).

- *Micro-size.* The bulk of the organizations is very small. 54% have 1-5 staff.
- *Some involvement in governance.* VPs take a less interventionist approach to involvement than venture capitalists, but they tend to be more involved than "traditional" foundations. In the sample, 15% of respondents report a board seat as a requirement for funding, whereas 24% state to never get involved at the board level. 61% reserve the right to take board places depending on the individual investment case.
- *Still mainly traditional financing instruments.* Grantmaking remains the preferred means of financing target organizations, but there are some interesting innovations. 83% of the respondents make grants, 63% make loans, 43% take equity, and 26% engage in mezzanine financing. Given the strong interest in financial innovation, new tools are likely to become significant in the medium term.
- *Involvement beyond financial instruments.* Value-added, non-financial services are considered key to the VP social change value proposition. Many funds position themselves as contributing services related to strategy, governance, financial management, fundraising, and access to networks. Such services are delivered either through in-house capabilities or by third parties, who may or may not be in a strategic relationship with the VP.

Box 1: VP Example: Impetus Trust, UK⁸

Impetus Trust was set up in 2002 (<http://www.impetus.org.uk/>). The organization describes itself explicitly as a general purpose venture philanthropy organization. The founders, a venture capitalist and an entrepreneur, wanted to bring their business skills into the social sector by working with small to medium size charities in the UK ready for a step change in their lifecycle, described as likely to be 'growth, turnaround or merger.'

For charities with a proven appetite for high-engagement funding, Impetus offers a package of long-term core funding over three to five years, hands-on management support through regular senior staff meetings with Impetus executives and targeted capacity building against a plan for strengthening key aspects of the charity, and delivered by volunteer associates.

Impetus raised an initial fund of £2m, a large proportion of which was seed capital from its founding board and grant making foundations. A second funding round aims to raise a further £3m. During its launch phase Impetus screened more than four hundred potential investments before making its first commitment. By mid 2007, Impetus expects to build up to a portfolio of twelve charities by adding up to four each year. Impetus targets registered charities in the a size range £400k to £10m which have been operational for at least three years, and working to provide sustainable improvements to the lives of 'disadvantaged people.'

Like a venture capital investment decision, Impetus is seeking out potentially 'best in class' organizations which can deliver innovative and sustainable responses to social problems, led by highly capable management teams (without explicitly using the term 'social entrepreneur'). Impetus Trust's current portfolio of five charities is diverse by sector: adults with learning difficulties; homelessness; eating disorders; conflict resolution and ethnic minority sexual health.

The charities have annual turnovers in the range £350k to £1.8m and Impetus' grants range £175k to £400k over the lifetime of each investment. Impetus is experimenting with a 'surplus share scheme' whereby the portfolio charity will return to Impetus a portion of its grant when the charity generates a surplus, most usually from earned revenue or property. In this way Impetus plans to recycle some of its investment capital.

Impetus' more recent investment, in NAZ Project London (<http://www.naz.org.uk/>) provides sexual health and HIV prevention and support services to targeted Black and Minority Ethnic (BME) communities in London. It is notable for being the first in a co-investment partnership with the

⁸ Based on John, R. (2006a), pp. 28-29.

Charities Aid Foundation's (CAF, <http://www.cafonline.org/>) grantmaking program. CAF will contribute a further £100k and free consultancy time to NAZ. This partnership with a grant maker signals an important trend in European venture philanthropy. Venture philanthropy funds are relatively small and to be effective must leverage additional, external funding.

Among the strategies being explored by VP funds are offers of co-financing on a project by project basis. In this example with CAF, the grantmaker brings consulting resource in addition to funding. In determining what capacity building interventions are required for the particular charity in its portfolio, Impetus has adapted the McKinsey Capacity Assessment Grid, originally developed by McKinsey and Company for Venture Philanthropy Partners in the US.⁹

Impetus is recruiting a pool of associates drawn from business and social sectors to provide the value-added services to each charity as determined through the capacity assessment. The associates are both individuals and corporate partners prepared to donate consulting time to the Impetus portfolio. The Impetus approach could be termed as classical "grant-based" venture philanthropy, and breaks new ground in the UK. Just as U.S.-based VP groups provided role models for the UK, so these innovations in the UK are likely to be closely watched by continental Europeans interested in developing high engagement models.

Impetus builds on its founders' connection with the private equity community and aspires to encourage the industry to develop its social responsibility through the medium of venture philanthropy.

3. FROM VENTURE CAPITALIST TO VENTURE PHILANTHROPIST

For social entrepreneurs who consider seeking support from VPs, it is important to develop an understanding of the "DNA" of venture philanthropy. This requires grasping its relationship with venture capital which provides the underlying source of wealth and professional socialization of most venture philanthropists.

Venture capitalists are in the business of identifying promising startups and investing in them. They typically take a systemic perspective: combining multiple companies into a portfolio is critical to reduce individual investment risk. Venture capitalists then take the portfolio companies through a clearly defined growth process with the objective of cashing out within a certain period of time, usually between four and seven years after the initial investment, depending on the type of venture. As the portfolio companies grow, need for financing the expansion arises, and venture capitalists draw in new investors.

In addition to being a source of interesting returns on investment, venture capital is also regarded as a disproportionate source of innovation in business relative to the volumes invested. Examining the relationship between venture capital activity and rates of patenting in a sample of 530 venture-backed firms in the U.S., Kortum and Lerner find that while the ratio of venture capital to R&D has averaged less than 3% from 1965-1992, venture capital accounted for 15% of industrial innovations in the sample.¹⁰ The twin observation of venture capital's disproportionately high contribution to innovation and the low contribution level to overall R&D expenditure is consistent with the underlying logic that a closer look at the venture capital mechanism reveals.

Since venture philanthropists typically have a background in venture capital, their philanthropic activities builds on key concepts and experiences from their profession, seeking to adapt them to the realities of civil society. To some extent, this is an exercise in translation. In the language of VPs, "donor" becomes "social investor," "grantee" becomes "investee," and "nonprofit leader" becomes "social entrepreneur."¹¹

⁹ Cf. Guthrie, K. / Preston, A. (2005).

¹⁰ Cf. Kortum, S. / Lerner, J. (1998).

¹¹ Cf. Council on Foundations (2001).

However, venture philanthropy goes beyond an exercise in semantics. Concepts such as the generative grammar (Noam Chomsky)¹² or the *habitus* (Pierre Bourdieu) help to understand the main patterns in venture philanthropists' practice.¹³ Based on their experience, mental models predispose venture philanthropists to structure reality in a certain way, and to prefer specific arenas and approaches in their philanthropic interventions. Four defining experiences in the world of venture capital tend to drive venture philanthropists' practice.

- *A keen sense of timing.* Venture capitalists use systems of discrete funds to implement their investments. The typical fund life span is in the order of 6-7 years, and funds are organized into general and limited partners. General partners contribute expertise, and limited partners the money. The general partner makes all investment decisions and is compensated by the limited partners for managing the fund, typically at a base fee of 2% of the fund volume, plus 20% of the performance ("carried interest"). The investments of the limited partners are subject to lock-up periods, but they get 80% of the fund's performance. As general partners, venture capitalists need to develop a keen sense of timing as one of their core competences. They are used to looking for investments that are likely to be able to pay off within the fund's life span. In most cases, this means that they need to identify investments that are likely to pay off within a range of 2-4 years. As a result, they will look for investments that do not require very long lead times in terms of research, and they must not be confused with "business angels" who fund the earliest stage of an innovation.
- *Cyclical as a fact of life.* Venture capital is a cyclical business. Since the ultimate objective of venture capital is cashing out a multiple of the initial amount invested, the absorption capacity of the IPO market is critical. Funds come and go with the business cycle. This leads to cyclical funding patterns. Analogously, the first wave of venture philanthropy followed the dot.com boom in the nineties, and venture philanthropy then became much less visible again when tech stocks took a nose dive. Recently, venture philanthropy has made a comeback on the back of rising securities markets.
- *Schematized investment process.* Venture capitalists take portfolio companies through a three-stage sequential investment process. *Series A* investments back a team with an idea to develop a prototype. *Series B* investments help bring this working prototype to market and build the initial pipeline of orders. Once a product shelf is in place, *series C* investments grow the pipeline of orders and the client base. To avoid liability and conflict of interest, venture capitalists are unlikely to invest in different funds that have overlapping portfolio companies.
- *Focus on measurable innovation.* Venture capitalists create economic value by mainly investing in, developing and selling companies that have a technology component. However, given the funds' short life spans, they are more likely to recognize and fund innovations that represent improvements within an established frame of reference, rather than fundamental breakthrough innovations. Empirical evidence supports this – of the 1303 high-tech IPOs from 1993-2002 on NASDAQ and NYSE, only 25 were classified as "highly innovative."¹⁴

¹² Cf. Chomsky, N. (1965). Chomsky's generative grammar is commonly defined as a set of rules that recursively specify and thereby "generate" the expressions of a natural language that are considered to be well-formed.

¹³ Pierre Bourdieu defines the *habitus* as the "system of durable, transposable dispositions, structured structures predisposed to function as structuring structures, that is, as principles which generate and organize practices and representations that can be objectively adapted to their outcomes without presupposing a conscious aiming at ends or an express mastery of the operations necessary in order to attain them." Cf. Bourdieu, P. (1980, p.53).

¹⁴ Cf. Stuck, B., / Weingarten, M. (2005); Gompers, P.A. (1994).

4. LOOKING TO VENTURE PHILANTHROPISTS FOR FUNDING

When venture capitalists migrate to the field of venture philanthropy, they build institutions that embody some of the core organizing principles of the venture capital industry. For a social entrepreneur looking to VPs for funding, it is important to analyze compatibility of his or her work with the following five action principles that are likely to drive VP strategy and funding decisions.¹⁵

- *Exit and self-sufficiency.* Profitable exit is critical in venture capital. A core stated principle of venture philanthropy is the desire to be able to exit funding at some point because investees have achieved financial self-sufficiency. This sounds quite logical – philanthropic resources are scarce, so there is no point in locking them up longer than necessary. In practice though, this approach has implications for the set of organizations that are likely to be funded. In cases where social entrepreneurs or NGOs seek to provide public goods, there may be no earned-income models available to cover all costs. Venture philanthropists are more likely to fund social service organizations or local businesses in underprivileged communities than advocacy organizations with no underlying earned-income business.
- *Theory of success.* Venture philanthropists seek to define what constitutes success in terms of social impact and then try to establish metrics and milestones to measure the achievement. They will then seek to reward success, as well as requiring accountability for failure to meet objectives. This approach favors measurable innovation that can be reached within a medium-term timeframe, rather than long-term funding of fundamental research. Moreover, for many venture philanthropists, success is correlated with scale. This tends to favor interventions that are scaleable. This approach reaches its limits where a cause requires long-term involvement, e.g. in the case of disaster preparedness initiatives, and where success is contingent on factors outside the control of the organization.
- *Financial engineering.* While many venture philanthropists do in fact make grants rather than for-profit investments, there is great interest in going beyond grantmaking and developing innovative financing mechanisms for non-profits. Moreover, venture philanthropists are aware of changing risk-reward profiles at the different stages of a venture. This makes venture philanthropy a very attractive source of funding for for-profit social entrepreneurs with strong underlying sustainable businesses that create social impact and benefit from a combination of capital injection, strategy advisory, and financial engineering.
- *Involvement.* Just as venture capitalists often seek board seats to make sure their portfolio companies stay on track, venture philanthropists often seek a formal form of involvement with the organizations they fund. This tends to be a mixed bag. Often, adding value to the operations of civil society organizations requires sector-specific skills that venture philanthropists do not have. On balance however, many civil society organizations have margin to further professionalize their management. Social entrepreneurs who welcome explicit board roles that render donor influence visible are naturally compatible with VP governance preferences.
- *Core funding.* Venture philanthropists express greater willingness to fund core operations, rather than just specific programs. This helps to build institutional capacity and is perhaps the most significant departure from established funding approaches where foundations put up money for programs without footing the bill for the accompanying institution-building of the grantee. Social entrepreneurs with a strong underlying intervention model looking for core funding will be a natural match for VPs.

¹⁵ Cf. Letts, C., et al. (1997).

5. CONCLUSION: THE PROMISE OF VENTURE PHILANTHROPY FOR SOCIAL ENTREPRENEURS

While venture philanthropy is unlikely to displace more established patterns of philanthropic giving, the approach has comparative advantage with respect to a specific set of social challenges. When targeting VPs as a potential source of funding, social entrepreneurs are well advised to note the following core components of the "DNA" of venture philanthropy:

- Preference for funding social service organizations with measurable and scaleable outputs
- Ability and ambition to build organizational effectiveness
- Predisposition to lend credibility to a social entrepreneur, similar to lead venture capitalists who lend credibility to a startup

In our experience, social entrepreneurs who enter the VP screening process with good answers to the following questions should consider targeting VP funding:

- *Latent demand.* Does my intervention fill a relevant need?
- *Relative advantage.* Is my intervention really better? How is it different from "mainstream" approaches?
- *Trialability.* Can my intervention be piloted at a comparatively small scale?
- *Scalability.* Once the prototype works, is it apt for expansion and scaleable?
- *Measurability.* Can the impact be measured?
- *Management team.* How strong is our team?

These are exciting times for social entrepreneurs and venture philanthropists alike. In Europe, venture philanthropy is a more recent development than in the U.S. The European venture philanthropy scene is currently in a take-off phase. Institutionalization is just beginning, as the activities of the EVPA indicate.

Given the cultural heterogeneity of Europe, the success of the emerging venture philanthropy movement will be contingent to some degree on its ability to recognize and work productively with the cultural, legal and economic specificities that characterize the different European countries. The "swarm of locusts" debate in 2005 in Germany indicates that skeptics remain regarding the ability of venture capital and private equity to contribute to healthy economic growth. Similarly, venture philanthropy is not without critics.

In coming years, it will be interesting to note to which extent the growth pattern of the venture philanthropy "industry" will follow the business cycle. But the overall outlook is good and should create interesting opportunities for social entrepreneurs to garner support for building their social change initiatives.

6. REFERENCES

- Bourdieu, P. (1990 [1980]): *The Logic of Practice*. Stanford: Stanford University Press.
- Carrington, D. (2003): *Venture Philanthropy: A New Concept or an Old Idea Re-Wrapped?* Transcript, Association of Charitable Foundation Conference. <http://www.evpa.eu.com/news.html>
- Chomsky, N. (1965): *Aspects of the Theory of Syntax*. Cambridge, Mass.: MIT Press.
- Council on Foundations (2001): *Board Briefing Venture Philanthropy*. Washington, DC: Council on Foundations. www.evpa.eu.com/downloads/BB2VenturePhilanthropy.pdf
- Gompers, P.A. (1994): *The Rise and Fall of Venture Capital*. *Business and Economic History* 23 (4). pp. 1-26.

-
- Guthrie, K. / Preston, A. (2005). Building Capacity While Assessing It: Three Foundations' Experiences Using the McKinsey Capacity Assessment Grid. Blueprint Research & Design, Inc. www.blueprintrd.com/text/capacityassess.pdf
- John, R. (2006a): Venture Philanthropy: The Evolution of High Engagement Philanthropy in Europe. Working Paper. Oxford: Skoll Centre for Social Entrepreneurship, Said Business School, Oxford University. www.sbs.ox.ac.uk/skoll/research/Short+papers/Venture+Philanthropy+in+Europe.htm
- John R. (2006b): Venture Philanthropy: Evolution and Opportunities. Presentation at the WINGS Forum 2006 on Emerging Patters in New Philanthropy, Bangkok. www.wingsweb.org/forum06/documents/Track2_emerging_John.pdf and personal data from the author.
- Kortum, S. / Lerner, J. (1998): Does Venture Capital Spur Innovation? NBER Working Paper 6846. Cambridge, Mass.: National Bureau of Economic Research. <http://papers.nber.org/papers/W6846>
- Letts, C. / Grossman, A. (1997): Virtuous Capital: What Foundations Can Learn from Venture Capitalists. Harvard Business Review.
- Martin, M. (2004a): Surveying Social Entrepreneurship. Arbeitspapiere, Band 2. St. Gallen: Zentrum für Führung in Gesellschaft und Öffentlichkeit, Universität St. Gallen. www.cse.unisg.ch/download.php?file_id=230
- Martin, M. (2004b): Strategic Legacy Creation: Toward a Novel Private Banking Value Proposition. Arbeitspapiere, Band 3. St. Gallen: Zentrum für Führung in Gesellschaft und Öffentlichkeit, Universität St. Gallen. [www.cpl.unisg.ch/org/cpl/web.nsf/SysWebRessources/CPL-Arbeitspapiere+Band+3/\\$FILE/CPL_Bd3_online.pdf](http://www.cpl.unisg.ch/org/cpl/web.nsf/SysWebRessources/CPL-Arbeitspapiere+Band+3/$FILE/CPL_Bd3_online.pdf)
- Scott, J.A. (2002): New Economy, New Philanthropy. Washington, DC. National Committee for Responsive Philanthropy. www.philanthropyuk.org/documents/JasonScott.doc
- Stuck, B. / Weingarten, M. (2005): How Venture Capital Thwarts Innovation. IEEE Spectrum. www.ieeeexplore.ieee.org/iel5/6/30636/01413731.pdf