When is it Time to Say Goodbye?

Exit Strategies and Venture Philanthropy Funds

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The purpose of this piece is to stimulate discussion and encourage many viewpoints. We describe the variety of exit strategies we believe VP funders can work toward in their relationships with investees. While this paper does present a definitive perspective on "exit strategy," it is not intended to be the final word. The authors acknowledge this topic needs further discussion and a broader range of insight. Additional commentary and further conversation are welcome.

Introduction

In the emerging practice of "venture philanthropy" (VP) (or engaged grant making), one of the most interesting and least understood pillars of the approach is the "exit strategy." As presented in the article "Virtuous Capital: What Foundations Can Learn from Venture Capitalists"[1], the articulated exit strategy is one of the critical areas where foundations can learn from the practice of venture capital. Many commentators flatly rejected the notion of exit and therefore VP altogether. Why has this idea of exit strategy generated a fair amount of debate and rancor within the philanthropic sector?[2]

As with many things in life, part of the answer may lie in different interpretations of the same term. If 10 different people were asked what an exit strategy means in the context of the nonprofit sector, there would no doubt be 10 different definitions. Before we can discuss what constitutes a "successful" exit strategy, and how such a concept might add value to the nonprofit sector, we need to start with a shared definition and common view of why an exit strategy makes sense in the first place.

We acknowledge from the start that the foundation community has always exercised a pseudo "exit strategy" with nonprofits they fund. Funders typically only make grants to nonprofits over a specific time period. These time periods are usually not determined in collaboration with the nonprofit and have little to do with the nonprofits' ability or capacity to achieve desired results, but are instead driven by the funders' guidelines. While some foundations and governmental organizations make longer-term grants, many grants are provided for simply a one or two-year period. Regardless, there is usually a stated end point to the grant, beyond which the grantmaking entity has no further commitment to provide support to the nonprofit. The implicit "exit strategy" in these cases is that the nonprofit must find additional funding from other sources in the future. This type of exit strategy occasionally results in closing good programs and often prevents nonprofits from building the capacity to achieve a long-term vision. We posit that responsible VP should not practice this type of arbitrary, solely short-term, time-based exit strategy.

The Exit Strategy in Venture Capital

In the context of a traditional, for-profit venture capital (VC) model the exit strategy, crafted at the initiation of the investment, is the plan by which investors hope to receive financial returns on their

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[1] Letts, Christine W., W. Ryan & A. Grossman. *Virtuous Capital: What Foundations Can Learn From Venture Capitalists.* Harvard Business Review. March/April 1997.

[2] Sievers, Bruce. *If Pigs Had Wings.* (Published in) Foundation News and Commentary, November/December 1997 and Kramer, Mark. *Venture Capital and Philanthropy: A Bad Fit.* Opinions page in The Chronicle of Philanthropy, April 22, 1999.

investment and managers of the company hope to secure long-term capitalization of their enterprise. While there are variations on how these stages are executed in practice, VCs often achieve their exit through the following:

1. Raising additional funds needed for the company through secondary offerings to subsequent or "B" round investors (often other VC firms)
2. Selling the company to a third party (often a larger player in the same or a related market)
3. Completing an initial public offering (IPO) whereby shares of the company are sold on the stock market in order to both "take out" the original investors as well as raise additional capital

In contrast to venture capital, philanthropy's goal is not to benefit financially from charitable investments and therefore the term "exit strategy" must have a very different meaning and application. Contrary to the for-profit capital market, the U.S. Nonprofit Capital Market[3] as a whole is not organized to provide different stages of funding to nonprofits, although select grant makers do target their giving at certain stages of a nonprofit's development (seed, start-up, operating support, replication). And, at this time, there is no nonprofit stock market willing to "take out" seed funders who gave early grants to an organization developing a new program. Restrictions on nonprofit private ownership prohibit the IPO form of "exit" and therefore the IPO has little relevance to nonprofits in the U.S.

These examples of how the VC model cannot apply to nonprofits are where much philanthropic furor and confusion has taken place. Indeed, many of those who criticize VP do so in part because of the fact that a nonprofit cannot go "public"—and they therefore conclude the notion of an "exit strategy" is an irrelevant concept. Such conclusions would be similar to stating that since debt plays a different role in the for-profit as opposed to nonprofit sector, debt is of no use to nonprofit managers—a statement we know to be false. We must be clear therefore, when we use the term "exit strategy" in relation to philanthropy and nonprofits, that it is a useful analogy but not a literal translation.

What is A Nonprofit Exit Strategy?

A true nonprofit "exit strategy" in venture philanthropy is a shared commitment between funders and those funded to:

1. Determine a strategy for accessing different types of funding over the organization's lifecycle to ensure its long-term viability
2. Provide assistance through the VP to the nonprofit to build the organization's capacity to access these different types of funding
3. Specify capacity building milestones, time periods, and roles for the VP funding relationship given the overall funding strategy

Ideally, this exit strategy, like its for-profit counterpart, is crafted at the time of the investment or at least long before the end of a funding relationship. It should create a mutual working relationship and shared mindset focused toward jointly (not unilaterally) creating a positive exit scenario.

[3] For a more detailed description of the structure and functioning of this nonprofit "capital market," please see "The US Nonprofit Capital Market", *Social Purpose Enterprises and Venture Philanthropy in the New Millennium*, Volume 2, Chapter 10, available from the REDF Web site www.redf.org.

Pre-Conditions to Exit in VC and VP: Organizational Capacity Building

Whether the organization in question is a for-profit or a nonprofit entity, a critical issue is whether an organization is "ready" to exit to another stage of funding. For a nonprofit, how does one know whether the organization is effectively meeting its mission and should pursue a long-term future? When is it ready to "exit" the relationship with its current investor/funder and access different, broader, "scale-up" types of funding? The answer is, when the organization has the capacity to move to the next stage of development and when it has demonstrated the ability to make appropriate use of additional capital.

Both The Roberts Enterprise Development Fund (REDF)[4] and Social Venture Partners Seattle (SVP)[5] have designed their venture philanthropy work around investing in and building organizational capacity in the nonprofit organizations they fund. REDF and SVP (as well as other VP funders around the U.S.)[6] make long-term funding commitments to their investees to build organizational infrastructure in areas such as management and staff, operations, financial accounting systems, technology, and management information systems. REDF and SVP also provide additional funding and hands-on assistance in areas such as strategic planning, business planning, and social outcome assessment. These organizational capacity-building activities are pursued over years of intense involvement between REDF and SVP as funders and the funded nonprofits. As certain organizational development milestones are reached, new ones are established and progress made toward organizational stability continues to be measured over time.

REDF and SVP have both extensively documented their approaches to this challenge of building organizational capacity through venture philanthropy.[7] For the purposes of this paper, however, the following is a summary of the qualities of a nonprofit with strong organizational capacity – which will hopefully be the result of many years of dedicated, collaborative work by both the nonprofit and the VP funder:

1. Good leadership and management, including the ability to plan strategically and respond to its market
2. Solid organizational infrastructure
3. A track record of meeting short-term objectives on a consistent basis
4. Positive social outcomes and evidence of progress toward meeting the mission
5. A clear vision for the future

This list is by no means exhaustive. But if these five things are present, an organization will be in a strong position to access new funding sources and have good chances of long-term success. These are the pre-conditions of a nonprofit's ability to achieve a "successful exit strategy." A clear implication here is that the VP's original due diligence in selecting its investments is critical, as well as the VP's ability and commitment to building the nonprofit's organizational capacity on the road to its exit strategy.

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[4] Please visit www.redf.org for more information about The Roberts Enterprise Development Fund.
[5] Please visit www.svpseattle.org for more information about Social Venture Partners Seattle.
[6] For a list of other VP funders, please read "2001 Venture Philanthropy: The Changing Landscape" by the Morino Institute, 2001.
[7] Please see Tuan, Melinda T., and J. Emerson. "The Roberts Enterprise Development Fund: A Case Study on Venture Philanthropy." *Social Purpose Enterprises and Venture Philanthropy in the New Millenium*, Volume 2. San Francisco: The Roberts Foundation, 2000. Found on http://www.redf.org/pub_boxset.htm. and Social Venture Partners Seattle's document describing their capacity-building approach at www.svpseattle.org/about_svp/model.htm.

Another critical issue to consider in nonprofit exit strategy is the availability of next stage funding. Once a nonprofit demonstrates the capacity to absorb and productively manage additional financing, a market must exist to serve those secondary funding needs. Ideally, this entails segmentation of the nonprofit capital market and diversification of financial products (grants, loans, etc.) thus aligning donor funding with organizational development and financial need. The hope and expectation is that VPs will facilitate exits by linking grantees that have achieved capacity building targets with some of their next level funding sources.

Stages of Funding and Exit Strategies

In practice, the strategy for accessing different types of funding and determining the appropriate exit strategy is based on multiple factors. The stages of funding and exits available to domestic nonprofits, social purpose enterprises, and international non-governmental organizations (NGOs) can be represented along a spectrum in which not every exit is available to every type of nonprofit organization. At the same time, a single nonprofit may access multiple types of funding and the VP may explore multiple types of exits at different stages of the nonprofit organization's evolution.[8] At REDF for example, early stage funding for a portfolio member may include an unrestricted grant for management and staff salaries and capital grants for the enterprise in the start-up stage. Over time, as the nonprofit organization/enterprise matures, REDF's funding may "graduate" to provide performance bonuses for managers, recoverable grants to finance enterprise needs, and access to a revolving loan fund to build credit history and provide short-term financing.[9]

For our discussion of exit strategies, we will primarily focus on exit strategies currently available to U.S.-based nonprofit organizations. Later in the paper we will profile examples of how international NGOs employ exit strategies that are not currently available to U.S. based nonprofits – these may point to future improvements within the U.S. Nonprofit Capital Market.

The following charts summarize the variety of exit strategies we believe VP funders can work toward in their relationships with investees. We have provided examples of each type of exit for illustrative purposes, and drawn as much as possible from our own experience to date.

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[8] For a brief summary of the stages of funding, funding instruments, and funding agents that comprise this nonprofit "capital market", please see Emerson, Jed, J.G. Dees, C.W. Letts, and E. Skloot. "The U.S. Nonprofit Capital Market: An Introductory Overview of Developmental Stages, Investors, and Funding Instruments." *Social Purpose Enterprises and Venture Philanthropy in the New Millennium*, Volume 2. Chapter 10, p. 193. San Francisco: The Roberts Foundation, 2000. Found on http://www.redf.org/pub_boxset.htm.

[9] For more detail, please see Tuan, Melinda T., and J. Emerson. "The Roberts Enterprise Development Fund: A Case Study on Venture Philanthropy." *Social Purpose Enterprises and Venture Philanthropy in the New Millenium*, Volume 2. San Francisco: The Roberts Foundation, 2000. Found on http://www.redf.org/pub_boxset.htm.

Exit Option	Description	Pros	Cons
Access New Funders (Individual donors, foundations, government) Good option for organizations at any stage of development that have achieved predetermined targets and level of capacity, and no longer meet investor funding priorities, yet require additional or diverse funding to realize full extent of mission.	Not a definitive exit, but progress toward this end. VP helps nonprofit develop relationship with new investors corresponding to evolutionary stage and capital needs. Managerial capacity building and performance results defined to further develop organization along evolutionary continuum.	Fund diversification. Corresponds with organizational development and changing needs for capacity building and funding requirements. Allows for continuity; enables organization to have a far-reaching vision.	Organization may suffer growing pains (resistance or periods of ambiguity, mission shifts), requiring new staff; some existing staff may lose jobs. Tensions arise between players in process (i.e. parent organization, board members, VP). Can be slow and arduous process; final divestment of external support difficult once organization is deemed "sustainable." Requires cohesion and coordination in funding community.
Build Earned Income Opportunities A fund diversification strategy used by many nonprofits to varying degrees. Sophistication of income generating mechanisms range from simple fee-for-service payments, which supplement grants to social purpose enterprises (see below).	Not a definitive exit, but progress toward this end. VP helps nonprofit create opportunities to charge fees for services it already provides or helps nonprofit develop products or services to sell for profit. A further step toward fund diversification.	Reduces donor dependence by generating revenue independent of grants. Exits are enabled by replacing grants with income, accumulating assets to access more complex financing—i.e. equity financing and loans available in commercial and quasi-commercial markets. See below for additional "Pros"	Many nonprofit programs do not lend themselves to integrating income-generating mechanisms. Income generation, particularly sophisticated ventures, which yield higher financial returns, require strong business competency and for-profit mentality that are not often found in traditional nonprofits and threaten existing leadership. Not a quick fix, income generation requires significant up front investments in scarce resources and must be incorporated in strategic planning.
Strengthen Social Purpose Enterprise Activity A savvy fund diversification strategy used by a limited number of nonprofits. Enterprise activities may be mission or non-mission related, for-profit or market-based nonprofit ventures that generate income for the nonprofit.	May be definitive exit, depending on profitability of enterprise chosen. VP helps nonprofit create and run market-based businesses.	Generates sustainable new resources to support nonprofit activities. Engages market forces to work for the nonprofit sector. Allows greater flexibility by bringing in unrestricted revenue. Decreases dependence on external funding. Devises new ways to leverage assets. Increases nonprofit accountability and management rigor. See above for additional "Pros"	Many mission-related social purpose enterprises, especially related to employing target populations, are not able to generate excess income beyond covering social costs of operating the enterprise. Significant risk of spectacular failure, high financial losses, or mission-drift associated with operating market-based businesses. See above for additional "Cons"

Exit Option	Description	Pros	Cons
Access Debt Financing (Below Market-Rate PRIs, Loans, Market-Based Bonds, Commercial Loans) Practical for certain types of projects (e.g. capital campaigns), select social purpose enterprises.	May be definitive exit. VP assists nonprofit with accessing forms of debt through building relationships with lending institutions. VP can build nonprofit's credit worthiness through loan guarantees, extending credit lines, other.	Enables nonprofit to take on larger, capital-intensive projects. Allows greater flexibility by bringing in unrestricted source of funds. Decreases dependence on external funding. Devises new ways to leverage assets and allows for creation of new assets. Increases nonprofit accountability and management rigor.	Debt service. Risk of nonprofit not being able to handle level of accountability and responsibility of debt.
Merge with A For-Profit or Nonprofit Organization Practical when two similar programs are competing on the same turf for clients and resources with a threat of one failing.	Definitive exit. VP assists nonprofit merger with existing like organization or company. Assumes similar mission, organizational priorities and target population. Presumes VP knows players and industry well enough to assist.	Combined resources (human, financial and asset); potential synergies and cost savings in back office; may increase likelihood of organizational success; continuity for target population and on larger scale; merging may eliminate a former competitor; and increase possibilities for funding.	Tension around leadership, decision-making power, and sacred cows; post merger fallout due to cultural adjustment, shifting staff structure - some personnel may lose jobs. Instantly larger enterprise program may tax managers and systems. Threat of compromised mission.
Transfer Programs to Another Nonprofit Organization Pragmatic when one organization does not have the resources or interest (not seen as a priority) to continue and another organization does.	Definitive exit. VP facilitates transfer of nonprofit's assets, client portfolio and responsibility to achieve mission to another organization conducting similar or related program.	Clean exit with assurance that mission will wholly or partially be pursued. Continuity for target population. Retain some jobs by transferring staff. Possibility for VP to continue involvement—i.e. board seat. Larger scale, better capitalized, increases funding opportunities, reduces competition. Avoids slow death by nonperformance.	Lose all control over future of organizational management; mission may change/evolve. Assets associated with organization or program are transferred. Some staff may lose jobs. Internal wars may arise if some stakeholders want to stay vested in organization.
Spin Off Program into New Nonprofit Organization Common for programs seeded by parent organizations that evolve into organizations themselves. Examples include international organizations that emphasize localization or social purpose enterprises born out of other sector organizations.	Definitive exit. VP assists nonprofit/program to formally separate as independent legal entity from parent organization. New nonprofit has distinct mission, governing board, objectives and funding base.	Organization actualizes own identity, culture, priorities, and growth. Mission pursuit continues, although may change to align with other strategic allies/partners. Separate governance and funding, although parent organization and/or VP may retain board seat. Considered a success in terms of local institution.	Difficult to cut ties with parent organization. Can be a protracted and tenuous process, as newly independent entity requires continued support from parent. Separation may ignite wars if parent perceives new organization as having potential for attracting large scale funding. Possible failure or collapse due to weak management/fragile systems. Requires seeking own funding and/or generating own income streams and major capacity building.

Exit Option	Description	Pros	Cons
Sell Nonprofit to For-Profit Entity Uncommon among nonprofit organizations, although cases exist. Possible only for profitable social purpose enterprises, which demonstrate attractive financial returns and/or have significant assets.	Definitive exit. VP facilitates purchase of nonprofit by a company or individual based on valuation.	Total divestment; nonprofit receives cash or get relief from debt burden or subsidizing costs. Sustainability highly probable. Slight possibility for VP or nonprofit to retain board seat. Introduces rigor, professionalism and high expectations for performance and success.	Must find ready buyer or company. Lose all control over future of organization. High likelihood that staff and management will lose jobs, replaced by owner. Threat that mission will be completely compromised. High potential for negative impact on target population.
Close Program or Nonprofit "Old style" approach that dictates termination of program upon completion of funding, or complete failure of program/nonprofit.	Definitive exit. Nonprofit terminates operations; returns, keeps or transfers existing assets, VP severs relationship with organization.	Easy, good for non-performing organizations; those that will never achieve sustainability or wide scale impact; also organizations that are in definite decline. Clean finish. Ironically, closing a program is usually not considered a failure by donors.	Target population losses; no continuity, no assurance of services by another organization. Staff lose jobs. Learning ceases. Cop out for organizations with culture clashes over capacity building and performance objectives.

Access New Funders

SVP Seattle began its funding/grantmaking cycles in early 1998. Two of its earliest investees were Project LOOK[10] and Powerful Schools.[11] Over the first 2½ years of SVP's relationship with these two organizations, SVP partnered with the nonprofits on a wide range of capacity-building strategies and activities. Examples include real estate negotiation, strategic planning, social enterprise exploration, technology assessment and implementation, branding and marketing, PR and video production, etc.

Only after 2½ years of working together, developing mutual trust, and assessing the leadership and potential capacity of each investee did SVP explore the idea of actively promoting these two investees to other funders with deeper pockets. SVP had become acquainted with, and worked to build relationships with 4-5 major funders beginning in 1998. Over several years, SVP and these funders became familiar with each other's work, motives, and approaches. In the third and fourth years of SVP's relationship with Project LOOK and Powerful Schools, SVP introduced the nonprofits to these major funders and helped support and initiate their potential funding relationships (the ultimate funding success was in the hands of the investee Executive Directors).

As of 2001, Project LOOK and Powerful Schools have each secured over $200,000 of annual funding with multiple year potential from two of the funders and they are still in serious discussions with one or two of the other funders. SVP thus succeeded in playing a positive role in significantly broadening and deepening the funding capacity of two investees via accessing new funding agents.

Build Earned Income Opportunities

SVP Seattle is in its third year of a funding relationship with the Institute for Family Development (IFD).[12] Similar to the examples above, SVP engaged in a number of capacity-building endeavors over the first two years, strongly focused in the marketing and technology areas. In the third year, IFD and SVP jointly began exploring a revenue generation idea that had been "on the shelf" for some time at IFD.

IFD has extensive expertise and knowledge in working with and helping families in severe crisis – representing significant intellectual capital. IFD had generated revenue through service and government contracts in the past, but had not looked specifically into the idea of their knowledge as an intellectual asset with real "market value" to therapists and other professionals working with families in crisis.

At IFD's initiative, SVP began working with IFD to explore the idea of creating products that could be sold to the therapist market. SVP is currently in the final stages of helping IFD bring to market "Your Deal" cards. Over the course of this product exploration, SVP and its networks provided strategic and marketing planning, branding and graphics services, publishing expertise, and discounted pricing. The yet unrealized potential is for this set of products to generate significant, self-controlled, sustaining revenue streams for IFD. Rollout plans are being pursued within the next 6-12 months.

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[10] Please visit www.projectlook.org for more information about Project LOOK.
[11] Please visit www.powerfulschools.org for more information about Powerful Schools.
[12] Please visit www.bsihomebuilders.org for more information about the Institute for Family Development.

Strengthen Social Purpose Enterprise Activity/Earned Income

REDF began funding and working with Rubicon Programs[13] in 1990 under its predecessor, the Homeless Economic Development Fund (HEDF). The partnership focused on expanding Rubicon's fledgling social purpose enterprise, Rubicon Buildings & Grounds (B&G), to employ disabled and formerly homeless individuals. In 1989, Rubicon B&G generated revenues of $88,000 and projected to reach $280,000 in 1990. In 1995, after several years of HEDF-funded capacity building efforts, including developing a business plan and hiring a salesperson for the enterprise, Rubicon Building & Grounds generated revenues of $3 million, contributing nearly $250,000 in excess revenue to the agency and to support administrative overhead.[14] In 2000, the financial strength of what is now called Rubicon Landscape Services has enabled the enterprise to contribute over $700,000 toward Rubicon Programs' administrative and social service costs, as well as fund portions of Rubicon's new enterprise development, including Rubicon Bakery and Rubicon HomeCare Consortium.

In 1991, REDF made its first investment in Ashbury Images (AI)[15], a silkscreen printing shop run by Golden Gate Community, Inc.[16] At the time, AI was generating less than $24,000 in sales, employing individuals in recovery from homelessness and drug/alcohol addiction. Operating out of a tiny storefront on Ashbury Street in San Francisco, this low margin business was managed by an individual with no background in silkscreen printing and was looking at a breakeven point of $250,000 in sales. This breakeven point eventually proved to be about $850,000. For ten long years, REDF invested in AI's capacity through capital grants, assisting with hiring professional staff, pricing analyses, accounting overhauls, sales plans, business plans, 3 summer MBA interns, and monthly management team meetings to review the enterprise progress. In 2000, AI earned close to $1 million in revenues and is on track to generate over $20,000 in net income after social costs and subsidies in 2001.

Access Debt Financing

When Juma Ventures[17] spun off from its former parent organization in 1996, the organization needed to establish its own infrastructure and also its own credit history. As a fledgling social purpose enterprise organization running several Ben & Jerry's ice cream franchises to employ at-risk youth, gaining access to commercial lines of credit was essential for Juma's success and future. REDF, in addition to working with Juma on other capacity-building issues, provided cash guarantees for Juma to establish a credit line with CitiBank. As Juma proved itself to be a credit-worthy organization through accessing and paying off the credit line, REDF's cash guarantee was no longer necessary.

In 2000, REDF formed its own $300,000 Revolving Loan Fund (RLF) in partnership with the Northern California Community Loan Fund (NCCLF) in order to provide its Portfolio enterprises with short-term, low-interest loans collateralized on future receivables. The RLF has not only enabled REDF to "graduate" or "exit" several Portfolio enterprises from requiring

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13 Please visit www.rubiconpgms.org to learn more about Rubicon Programs.
14 Emerson, Jed and Fay Twersky, *New Social Entrepreneurs: The Success, Challenge and Lessons of Non-Profit Enterprise Creation*, September 1996, p. 25.
15 Please visit www.ashburyimages.org for more information about Ashbury Images.
16 Please visit www.ggci.org for more information about Golden Gate Community, Inc.
17 Please visit www.jumaventures.org for more information about Juma Ventures.

grants for working capital, but also helped build the enterprise/organization's foundation for accessing debt financing in the future.

Merge with a For Profit or Nonprofit Organization

Mennonite Economic Development Associates (MEDA) created Chispa in the early 1990s as Nicaragua emerged from a centrally planned to a freer market economy. Chispa became one of the first programs in Nicaragua designed to provide loan capital to micro-entrepreneurs. It was hoped that, over time, this program would become a privately held, full-service bank serving Nicaragua's micro and small business community.[18]

By 1998, Chispa, which was still wholly owned by MEDA, had become profitable in a sector that now numbered over 30 NGO-led micro-finance programs. In order to achieve its goal of becoming a privately held bank, Chispa needed two things: a banking license and private investor capital. The objective was achieved through a complicated transaction completed in 2000. What emerged was Financiera Confia, the only Micro/Small Business Bank in the country. Confia brought together four groups of investors, each of which delivered something of value to the new institution:

- MEDA delivered its Chispa operations into Confia;
- The shareholders of Financiera International (Interfin) brought their banking license and their operations into Confia;
- IMI and Profund, two international investment funds with a focus on Micro/Small Business Banking, each brought cash into Confia.

The merger itself proved to be quite difficult as the partners discovered that the Interfin Balance Sheet was significantly over-valued. As a result, the former Interfin shareholders lost the equity they had hoped to receive in Confia. While many business investments are fraught with difficulties, mergers present a special case due to the difficulty of merging product lines, employees, management, and culture. Fortunately, Confia overcame these difficulties and remains today as the country's only bank serving the micro/small business sector.

After the merger, MEDA[19] sold its investment interest to Sarona Global Investment Fund Inc..[20]a for-profit investment fund that it had itself started. But all three of the owners, Sarona, IMI, and Profund[21] remain concerned about the liquidity of their investment. Eventually, they too need to find an exit strategy through a sale of shares into the international capital markets.

Many excellent examples of U.S. based nonprofit mergers have been documented on the La Piana Associates[22] website as part of the Strategic Solutions Initiative – a five-year, foundation-funded initiative dedicated to assisting the nonprofit sector with strategic restructurings,

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[18] MEDA focuses on nonprofit development organizations starting enterprises and then mainstreaming them into the private sector marketplace. As such, their intervention is catalytic and is never expected to carry on work in any not-for-profit form. This practice is currently more applicable to the international setting than in the U.S. due to the limitations of the U.S. Nonprofit Capital Market.

[19] Please visit www.meda.org for more information about MEDA.

[20] Please visit www.saronafund.com for more information about Sarona Global Investment Fund.

[21] Please visit www.profundinternacional.com for more information about Profund.

[22] Please visit www.lapiana.org to learn more about La Piana Associates.

including mergers. Additionally, Thomas A. McLaughlin's book *Nonprofit Mergers and Alliances*[23] is a valuable resource to any nonprofits considering the merger option.

Transfer Programs to Another Nonprofit Organization

REDF began funding Youth Industry in 1993, when the organization first became incorporated as an independent 501(c)3 nonprofit. Over a seven-year partnership with Youth Industry's leadership, REDF invested extensively in the organization's capacity to operate social purpose enterprises to employ homeless youth. Activities included helping Youth Industry purchase the building in which one of their enterprises was housed (right before the boom in the San Francisco real estate market), working on accounting issues, sales, marketing, operations, and a variety of other issues related to the enterprises.

By the end of 2000, Youth Industry was successfully running five social purpose enterprises, including two thrift stores, a recycled merchandise business, a bike repair shop and a restaurant generating over $3 million in sales and over $200,000 in net income. However, the unique leadership team of Youth Industry decided they could not personally sustain running the organization and neither they nor REDF had been able to identify appropriate successors. REDF and Youth Industry explored multiple options for ensuring the future of YI's enterprises through a course of many intense and emotional strategy sessions, and ultimately the decision was made to transfer the enterprises to two other REDF Portfolio organizations.

In late 2000, REDF facilitated numerous sessions between the leadership of Youth Industry and CVE, Inc.[24] and Golden Gate Community, Inc., to preserve the social mission and ensure the continuity of the enterprises/services. Due to REDF's long-term partnerships with each of the organizations involved in the transfer, REDF was able to provide the historical context for each organization, culture, management team, mission and help translate when communication issues arose. As of early 2001, CVE, Inc. is now running Nu2U, Nu2U2, and Recycled Merchandise, and Golden Gate Community, Inc. is operating Pedal Revolution and Einstein's Café.[25]

Spin Off Program into New Nonprofit Organization

For years Save the Children Federation (SCF) has incubated and spun off its domestic and international programs into local nonprofit organizations. In the past the process has been arduous, ill defined and rife with emotion as new fledgling organizations struggled for independence and the parent organization (SCF) struggled to relinquish its control. SCF is developing a methodology to systematize spin off, positioning programs from the outset to change into independent organizations, thus bypassing (or minimizing) a painful period of identity ambiguity.

In May 1998 when SCF launched a pilot micro credit program in Armenia, it housed the new program in a separate downtown office about 20 minutes from SCF's headquarters. This physical distance facilitated the program's autonomy while enabling SCF to maintain oversight and provide technical support. Branding was initiated early on, dubbing the program "Microfund" and creating its own logo and tagline. Bank accounts and accounting systems were

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[23] McLaughlin, Thomas A. *Nonprofit Mergers and Alliances*. New York: John Wiley and Sons, Inc. 1998.
[24] Please visit www.cve.org for more information about CVE, Inc.
[25] For a more detailed description and analysis of this transfer of Youth Industry's enterprise, please refer to REDF's upcoming case study on Youth Industry.

also separated from the outset; SCF treated Microfund as a sub-grantee responsible for managing its fund allocations and reporting back. The purpose was to build Microfund's accounting and financial management capacity and prepare it to diversify funding. SCF hired a qualified Program Manager to lead the initiative to independence and transition to the position of Executive Director. Development of Microfund's local advisory board during the pilot stage paved the way for its Board of Directors. Infrastructure and systems were also strengthened at this time. Microfund developed operations and personnel manuals, management information systems, and procedures and policies. Throughout the incubation period Microfund's relationship with SCF was contractual based on achieving capacity building performance targets.

Microfund was incubated by SCF and then it was spun off in April 2000 and registered as a nonprofit organization. (Prior to establishing a spin-off methodology, SCF supported its programs indefinitely with spins off occurring after five to seven years on average). In an official ceremony program staff resigned from SCF and signed a new employment contract with Microfund Inc. All program assets were transferred by SCF into Microfund's name. Legal authority and documentation were also transferred. The pilot, seeded by SCF with $100,000, received funds from two other sources the following year, then a grant major from USAID, which required Microfund to separate from SCF. As part of the spin off plan, Microfund negotiated a paid contractual agreement for technical assistance from SCF's Economic Opportunities Office and external consultants for the duration of the grant. SCF is a minority shareholder in Microfund and holds two board seats, where it will remain for the next three years, at which time Microfund should be fully institutionalized and self-sustaining organization.

Sell Nonprofit to For-Profit Entity

Benetech, a nonprofit organization located in Northern California, built a self-supporting social enterprise developing and distributing reading machines to people with visual and reading disabilities. Over ten years of operations, sales were four to five million dollars per year, with an average net margin of 1%. The business operations of the Arkenstone reading machine project were sold for $5 million in June 2000 to Freedom Scientific, a for-profit roll-up formed to buy companies in the adaptive technology industry. These proceeds are being used to create a handful of new social enterprises patterned after this model.

Close Program or Nonprofit

REDF exited its funding relationship with Building Opportunities for Self-Sufficiency (BOSS) in 1999 when the enterprise they had built together, BOSS Enterprises, shut down. From 1996 to 1999, REDF and BOSS worked hard to make the light construction business succeed on a financial basis. However, by mid-1999, it became clear that the social mission of employing homeless individuals was not being sufficiently met and a mutual decision was made to close the business and give the remaining assets of the business to other nonprofit organizations with a similar social mission.[26]

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[26] For a more detailed description and analysis of the REDF/BOSS/BOSS Enterprises closure, please see Twersky, Fay, and L. Lanzerotti. "Enterprises Gone But Not Forgotten: Lessons Learned from Three Organizations and REDF." *Social Purpose Enterprises and Venture Philanthropy in the New Millennium*, Volume 2, Chapter 3. San Francisco: The Roberts Foundation, 2000. Found on http://www.redf.org/pub_boxset.htm.

Venture philanthropists should be exploring possible exit strategies with their investees during the early to mid stages of their relationship with funded organizations. As discussed earlier in the exit descriptions, each exit strategy assumes a certain level of organizational capacity and infrastructure has been built within the nonprofit organization. The essential role of the VP is to assist the nonprofit with organizational capacity building over a sustained, multiple-year relationship, in order to achieve mission goals and access different exits.

Performance goals tracking organizational capacity building and greater self-sufficiency should be built into an exit plan and when ultimate targets are met, the VP relationship may be terminated and the nonprofit may move on to the next level of capacity building and funding with a new investor. *The exit therefore is based on managerial capacity and performance goals rather than a fixed time period or solely programmatic goals. Exit is a process that affects all aspects of the organization, and capacity building investments and funding approaches must be aligned with organizational needs at each stage of its evolution.*

Exit Strategies Employed in the International NGO Community

In the U.S., a key difference between exits for nonprofit and for-profits are the legal restrictions of ownership – and regulations prohibiting private enurement to principals involved with the nonprofit. Due to these regulations, the current U.S. Nonprofit Capital Market is not structured to allow investors to take a true equity position. International NGOs have tried to remedy this situation in the field of microfinance by 1) creating investor-owned for-profit subsidiaries to mediate nonprofit capital access, 2) using advocacy to address legal obstacles facing nonprofits, and 3) strengthening nonprofit capital markets.

Creating Investor-Owned For-Profit Subsidiaries. A commonly practiced microfinance exit strategy entails spinning programs off from their parent organizations into separate legal entities. Newly independent microfinance institutions are registered as nonprofit organizations. Once substantial capacity is built, the nonprofit may be transformed into a for-profit entity such as a bank, private limited company, or credit union, contingent upon the legal and regulatory restrictions in the country where it operates. The parent organizations hold a minority equity position in the microfinance institution along with other shareholders, including local nonprofits, donors, and individuals. As the organization matures or changes it legal structure, the parent divests its interest by selling its equity or donating it back to the organization.

Using Advocacy to Address Legal Obstacles Facing Nonprofits. Implementing exits such as those described above requires an enabling legal environment – which currently does not exist in the U.S. – including provisions for nonprofit ownership and allowances for malleable legal structures. In Armenia, an advocacy group of practitioner organizations was organized to influence policy-making and reform banking laws governing nonprofit microfinance institutions. The advocacy group sought to exempt microfinance institutions from paying taxes on income generating activities (i.e. collecting interest on loans); reduce paid-in capital requirements and loan loss provisions; allow nonprofits to hold and mobilize deposits; and permit individuals, nonprofits, and donor agencies to take equity positions. The United Nations Development Programme (UNDP) funds the initiative, and if successful, new laws will foster nonprofit sector and microfinance development in Armenia.

Strengthening Nonprofit Capital Markets. Although traditional international donors do not mirror the behavior of VPs in the U.S., they have been instrumental in advancing the thinking on and facilitating microfinance exits. Institutional donors have made a concerted effort to change their grantmaking according to the maturity, capacity building, and financing needs of the organizations they fund. Major agencies have carved out funding niches: UNDP through its Microstart program funds early stage, United States Agency for International Development (USAID) Office of Microenterprise Development funds intermediate stage, and World Bank's Consultative Group Against Poverty (C-GAP) funds senior stage. The funders work in concert to ensure their successful grantees receive next stage funding through facilitating linkages to these other funding sources.

While the circumstances in which exit strategies take place in the international microfinance field are vastly different than those in the domestic nonprofit sector, some valuable lessons apply. In the U.S., there is clearly the need for dealing with the equity issue, a more enabling legal environment, and better funder coordination and participation to develop the nonprofit capital market.

Why is the Exit Strategy Essential in Venture Philanthropy?

An explicit exit strategy is a vital part of the value proposition a nonprofit should expect from a VP funder. An articulated exit strategy is not just an add-on, but an essential, value-added strategy in five specific ways.

First, an exit strategy means *the funder starts explicitly discussing the "end" with an investee early in the relationship,* well before the ending actually occurs. A focused discussion of mutual priorities, conducted early in the funder-investee relationship can be instrumental in clarifying how the VP can best invest in the funded nonprofit's sustainability.

Second, including an exit-strategy may *encourage nonprofit investors to be more disciplined about their organizational capacity building efforts:* to diversify their financial products to better serve their investees; and to move them more quickly along the organizational development continuum. The foundation or donor will be forced to have a conscious, thoughtful approach to doing everything possible to ensure that investees have developed substantially along all of the dimensions explained above.

Third, the exit strategy may be an honest, open representation of both parties' intentions, and thus can be a *continuation and deepening of the close, working relationship* between a VP funder and investee. Such a relationship is probably the most truly unique aspect of the VP model in the first place. Ideally, an exit strategy allows sufficient time, resources, and support for an investment to mature to the agreed upon level. Depending on evolutionary stage, duration, level of investor engagement, and exit options available, implementation of successful exits can take up to a year or more, and the organizational capacity building required to bring about the exit may span many years in advance of the actual exit. A shared vision of progress and a common view of the exit strategy means optimal alignment of effort and resources by both the VP and the nonprofit.

Fourth, wider and more consistent application of exits could help to *effectively segment and organize the nonprofit capital market by requiring greater coordination and cohesion between funders*. This would lead to greater efficiency and value creation for our limited philanthropic dollars. Nonprofit investors may also develop niche markets choosing to invest only in start up, mezzanine, or phase funding, etc., thus better linking organizations to appropriate next-stage investors once capacity levels have been successfully achieved and funding requirements change.

And fifth, as VPs partner with their investees to pursue exit strategies, the inherent frustrations and limitations of the current options may encourage VPs to *advocate for a more enabling legal environment for nonprofit organizations*. As evidenced by this paper, our pursuit of appropriate exits with our investees has resulted in engaging you, our colleagues, around this topic in the hopes of improving current practice!

Are Exit Strategies Only Essential to Those Practicing Venture Philanthropy?

We believe all funders should carefully consider what process they use in transitioning out of their funding relationship. While there is certainly a place for “one time” funding, if foundations seek to engage in strategic philanthropy that promises to maximize the impact of their resources they must think about what will take place following the end of their own grant. Certainly, a number of foundations already take this approach in some of their grant making. Successful philanthropy is not simply a function of the grant transaction, but rather the creation of real social value through the use of charitable resources. Whether or not one opts to pursue a long-term approach to working with grantees, all foundations should give thought to how future resources will be provided and how the future capacity of the organization to execute the funded strategy will be supported.

Conclusion

In sum, the exit strategy is not simply a *single event* (a la IPO), but rather *a path, a series of steps, a mindset* directed toward a positive, long-term relationship with an investee. If one is going to move beyond simply allocating grants and engage in efforts to truly invest in the creation of social value, it is critical there be an articulated exit strategy. The exit strategy must clearly indicate how funds will be provided, what form those funds will take, how organizational capacity will be built, and how future funding and sustainability will be pursued. The exit strategy provides the opportunity to frame an unambiguous vision for the future of the nonprofit organization that is not tied to funding cycles or the latest fad in philanthropy. Indeed, the exit strategy is essential to the realization and sustainability of the nonprofit organization’s mission.

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