EVPA
EUROPEAN VENTURE PHILANTHROPY ASSOCIATION

LEARNING FROM FAILURES IN VENTURE PHILANTHROPY AND SOCIAL INVESTMENT

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Email: info@evpa.eu.com
Website: www.evpa.eu.com

Author: Lisa Hehenberger and Priscilla Boiardi
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LEARNING FROM FAILURES IN VENTURE PHILANTHROPY AND SOCIAL INVESTMENT

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PREFACE

EVPA's first report on Failures is a little piece of history.

It marks the maturing of the venture philanthropy / social investment industry, as EVPA itself reaches ten years old. Like all early stage industries, we have been slow to admit our mistakes to the outside world. This is partly human nature, and partly reflects the inevitable behaviour of an early stage industry that had yet to prove itself – to its donors / investors, to its investees, and to the wider world.

Failure accompanies Risk. Venture capital has always assumed (and priced) risk into its portfolio approach to risk and return. This has been harder in venture philanthropy / social investment for a number of reasons – measuring social return on investment is hard, which makes pricing hard, and it is harder (and arguably unwise) to be brutal about which investees are successful or failing, when we are so often investing in people's life outcomes. Both of these reasons have meant that admitting failure is difficult.

Shell Foundation and ONE Foundation have bucked the trend and published reports outlining their learnings from Failure. It is perhaps notable that neither had to fundraise. As Declan Ryan, repeatedly reminded his team at ONE, "If we are not failing, we are not taking enough risk. What failures have we had so far?"

Within the EVPA community, we have encouraged openness about mistakes to learn from each other. This report moves the debate on, by documenting and organising the learnings from failures from 12 venture philanthropy and social investment organisations, and sharing the learnings widely. It is a valuable read for both experienced practitioners and newcomers to venture philanthropy and social investment.

We wish we could have read it ten years ago.

As Samuel Beckett wrote, "*Try again. Fail again. Fail better*"[1].

Deirdre Mortell
CEO, Social Innovation Fund Ireland
Former CEO, ONE Foundation

Pieter Oostlander
Chairman, EVPA

1. **Beckett, S.,** 1983, "*Worstward Ho*". London: John Calder.

PREFACE

Expert Group Composition

EVPA would like to thank the following Expert Group for their contribution to the development of this manual.

Name	Organisation
Erwin Stahl	BonVenture
Antony Ross	Bridges Ventures
Nat Sloane	Impetus PEF
Andrew Muirhead	Formerly with Inspiring Scotland
Celia Tennant	Inspiring Scotland
Benoit Fontaine	King Baudouin Foundation
Wolfgang Hafenmeyer	LGT VP
Nicole Etchart	NESsT
Matthijs Blokhuis	Noaber Foundation
Luciano Balbo	Oltre Venture
Olivier de Guerre	PhiTrust Partenaires
Richard Gomes and Chris West	Shell Foundation
Deirdre Mortell	Formerly with The One Foundation

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With both the venture philanthropy and social investment sector (VP/SI) and EVPA reaching ten years of experience, it is time to look back at what happened to understand what worked and what did not and to distil the lessons learned for the sector and for all those organisations that want to practise VP/SI.

This report entitled "*Learning from failures in venture philanthropy and social investment*" aims at collecting the lessons learned from the first ten years of VP/SI, to learn from strategies and investments that failed and mistakes made in organisational set-up and help VP/SI organisations avoid repeating the same mistakes. For a VPO, failure happens when the social objectives, and sometimes the financial objectives, are not reached, or are only partially reached.

The generation of *intelligent* failures is natural in environments where experimentation and creativity are core values, such as VP/SI, so the generation of social innovation is fostered in environments where there is the 'permission to fail'. To that end, we hope that this report will encourage the VP/SI sector to promote a culture of transparency and open dialogue around failures.

This report is the result of several years of research and knowledge gathering through the annual EVPA industry survey, EVPA workshops, in-depth interviews with CEOs from 12 VP/SI organisations and a consultation on earlier drafts with the same experienced practitioners. Where possible, we corroborated stories and individual cases with data from our industry survey or other research. Therefore we feel confident that the results presented in the report are backed with evidence - while representing the diversity of the sector.

We have grouped the causes of failure into three main categories: issues related to the internal organisation of the VPO that are identified as ***organisational risk***, misalignments in the development of the investment strategy of the VPO, ***strategic risk***, and failures in the execution of the investment strategy, ***execution risk.***

The VP/SI approach is used to finance social entrepreneurs who try to solve pressing social problems by means of disruptive social innovations. As VP/SI deals with innovation it also has to deal with the risks that come from investing in what Nicole Etchart's from **NESsT** defines as 'the most difficult issues in the most difficult countries in the most difficult times and in the most risky stage of development': organisational risk, strategic risk and execution risk. Awareness about these risks can help VPOs mitigate them. Such awareness can especially reduce the level of organisational risks – which is connected to the way the VPOs organise their internal operations – and execution risk.

Our recommendation is to accept the level of risk needed to support social innovation, while continuously learning from failures to identify possible risk mitigation strategies so that the failure rate decreases. Taking it a step further, organisations that encourage intelligent failures though deliberate experimentation can achieve the greatest results.

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Figure 1 gives an overview of the main causes of failures in VP/SI grouped into three categories:

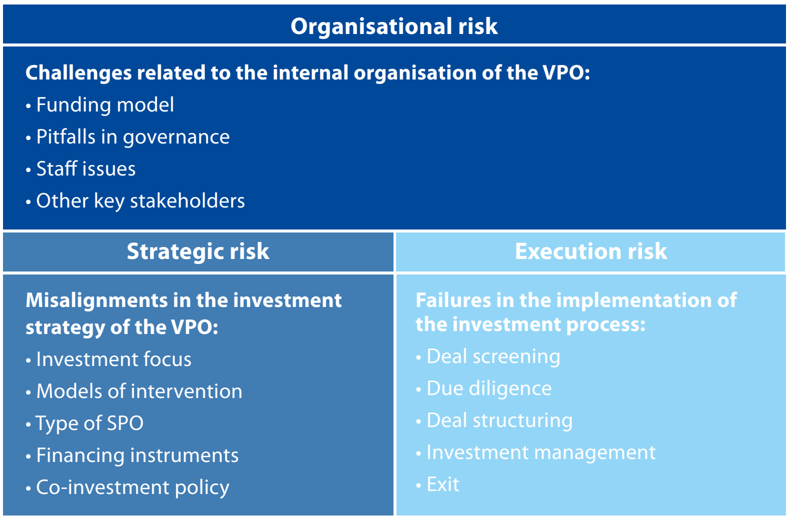

Figure 1: Causes of failure in VP/SI

For what concerns the **organisational risks**, we have identified, four main challenge areas: the funding model, the governance structure, issues with the staff and issues with other key stakeholders.

First, the **funding model** can pose challenges, especially when it comes to the *financial sustainability* of those VPOs that do not have an endowment and thus have to count on fundraising to find enough and sustainable funding. VP/SI needs '*patient capital*' that is flexible enough to accommodate for unforeseen circumstances. VPOs have tried to find **solutions to financial sustainability issues**, such as adding consultancy work, finding ways to recycle capital and increasing the size of funding to generate economies of scale in the management fees.

Another challenge to the funding model comes from the **difficulty of operating in the 'hybrid' space**. Having to balance social and financial return can be challenging, and some VPOs have found it difficult to manage investors' expectations. **Increasing awareness about what VP/SI is and how it works** can reduce the fundraising challenges faced by VPOs. As investor sophistication and awareness of VP/SI increases, this challenge will become less acute, but the sector still has a long way to go.

Second, the CEOs interviewed identified two main challenges related to **governance**. First, past failures have taught VPOs that there is the need for *governance structures* that include a *balanced mix of experiences*, from both the private and the social sector. Although diversity can bring challenges, having a rich mix of perspectives prevents VPOs from making mistakes. Members of the Board must be chosen based on their collaborative mind-set and capability to respect people with different backgrounds, but most of all for their *entrepreneurial approach*.

In terms of **staff** composition and motivation, the interviewees agreed on two main challenges.

First, VPOs find it difficult to compose *teams with the right mix of financial and social skills*. As with the Board, the team of the VPO must be composed of people with different and complementary backgrounds, coming from the business, the financial and the social sectors. As VP/SI evolves, the pool of human resources will specialise, ending the existing dichotomy between financial and social backgrounds and allowing VPOs to 'divide people by stage', i.e. develop teams with specific skillsets that can be useful at different stages of development of the SPOs.

Second, the lack of specific competences of the VPOs' teams in the start-up stage of the VP/SI approach gave rise to issues in assessing *the power and the role of the board versus the management team*. This challenge was faced by most VPOs when they were founded, as it was difficult in the past to separate roles and responsibilities. As the sector evolves, management teams gain experience and become more professional, which entitles them to have more decision-making power compared to the board of directors.

Lastly, three challenges were identified as sources of failure when dealing with **other key stakeholder** groups in VP/SI, more specifically the government, the final beneficiaries of the investees' intervention, pro-bono contributors and volunteers. VPOs need to accept that it is necessary to engage with the government, as it possesses the resources (in terms of money, expertise and access to policy makers) necessary to drive systemic change. *Final beneficiaries* are also difficult to engage, but hearing their voice is necessary to make sure that impact is created. Similarly, *pro-bono contributors* and *volunteers* have expectations that the VPO needs to manage.

VPOs are vehicles that channel funding from donors and investors to selected social purpose organisations (SPOs). The investments are made according to an **investment strategy** developed by the VPO. Broadly speaking, the investment strategy of the VPO is composed of six main elements: investment focus, models of intervention, type of SPO, financing instruments, co-investment policy and non-financial support and misalignments can occur in each of the six elements. The investment strategy of the VPO is the part where most experimentation happens, thus the VPO must accept a certain degree of uncertainty and some failures.

The VPO choses the **investment focus** in terms of sectors and geographies it serves. Challenges arise if the investment focus becomes a limitation. This happens when there is not enough deal flow, either in the geographical area of intervention chosen or in the sector targeted. It is important to stay flexible and adapt or change the investment model when needed.

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Many VPOs have developed a *stronger social sector focus* as they have grown and matured. Stronger focus on a specific social sector or thematic areas can generate and demonstrate more impact. This logic is based on lessons learned from past mistakes and from experimentation using the VP/SI approach.

The learnings from the pioneer VPOs interviewed provide some useful lessons for the sector in terms of **models of intervention**. There is still quite a diverse range of models in the VP/SI space and also some divergence in what works best. Some of the CEOs interviewed proposed that VPOs should not invest in small SPOs, but rather focus on a few, large investees that can achieve disrupting impact. As the risk in VP/SI is high, you need to invest in *organisations that have potential to scale*, and in entrepreneurs that are willing to do so.

VPOs that have invested in *early stage* SPOs have faced difficulties in attracting patient capital. The ecosystem is slow in recognising the importance of early stage and this increases the risk of failure. The model of intervention of VPOs so far may be threatened by a move of the sector towards low-risk and high-return investment driven by the increasingly important role played by institutional investors to the detriment of investment in social innovation. Clearly, the VP/SI sector will need actors at different positions on the investment spectrum, but if too many choose financial return over social innovation, there is a risk of systemic failure. The best advice here is to look for the right investors instead of trying to adapt the investment strategy to the investors.

As part of their investment strategy, VPOs choose the **type of SPO** they want to finance in terms of organisational structure and stage of development. Although the EVPA Annual Survey[2] shows that VPOs invest largely in SPOs with non-profit structures, some VPOs believe that for-profit structures have a different mind-set which is more in line with the SPO sustainability principles of VP/SI.

The choice of the type of SPO to fund and the set-up and financial return expectation of the VPO will determine the **financing instruments** used. More specifically, experienced VPOs expressed some frustration with the use of *grants* and explained some of the issues encountered when using *debt* instruments.

For *grants*, issues arise because it is sometimes difficult to control what grant money is used for and in some cases the lack of high-quality projects that can be financed through grants. Suggestions on how to overcome these challenges include disbursing the grant according to milestones and requesting a matching grant. However, the VPOs also emphasise the continued need for grants to act as risk capital supporting social innovation.

When starting to experiment with VP, using *debt* is a good funding solution: convertible loans can be used instead of equity to avoid costly valuations. Good advice when it comes to convertible loans is to avoid compulsory convertibles, as they can force the VPO to convert at a too-high valuation.

2. **Hehenberger, L., Boiardi, P., Gianoncelli, A.,** 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.

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Often VPOs decide to **co-invest** with other funders to provide the SPO with additional funding, promote VP activities among a wider audience and spread the risk. However, the relationship with co-investors is not always optimal, especially if co-investors do not *share the same objectives*. VPOs should always perform a thorough analysis of potential co-investors before co-investing not only to check for alignment in the objectives, but also to avoid co-investors' 'free-riding'.

Non-financial support is generally seen as a key component and value-added of the VP approach. Despite the massive need for non-financial support it is generally difficult to quantify impact or benefit, and despite the efforts VPOs are contributing, the sector is still failing to show the full potential impact of non-financial support.

Another issue with non-financial support is how to provide it effectively when the operations of the VPO have a wide geographical spread. To avoid failure the VPO has to be *close to the investee*, for example by co-investing with someone with local presence. Building strong and close partnerships with investees is a key risk mitigation strategy as it allows the VPO to monitor how the investee is progressing and identify early on where further support is needed.

Lastly, VPOs can incur failures when **implementing the investment strategy**. The so-called execution risk is embedded in each investment made by the VPO and in each of the steps of the **investment process**: deal screening, due diligence, deal structuring, investment management and exit.

In the experience of the VPOs interviewed, **deal screening and selection** failed for five main reasons: the SPO had a high product/service risk, the VPO did not understand the sector, the VPO invested too quickly or invested to fill quotas, it could not add strategic value, or finally because the SPO was not ready for the VP approach. Recommendations to avoid failures during the deal screening phase include avoid taking too much risk on too many dimensions, avoid investing in sectors that the VPO does not know or where the risk of not creating impact is too high. A risk mitigation strategy is to make pilot investments before putting more capital in. When financial drivers are related to social drivers, the mission drift is less of a risk, so aligning the two reduces the risk of failure on one driver.

Investments can fail if the VPO does not conduct sufficient **due diligence** on the investee's governance (and in particular on the board), on the management team and on the market. Dysfunctional SPO's boards are time-consuming and constitute a major problem. The management team can cause issues, as it is easy to overestimate the capabilities and the entrepreneurial spirit of the management team of the SPO. The appeal of a specific SPO can also make the VPO overestimate the future development of a market. Performing thorough due diligence on the board and the management teams, performing thorough reference checks on the management team, investing in strengthening the governance of

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the SPO and trying to be prudent when making valuations are the main recommendations that our expert group gave with respect to how to conduct a good due diligence.

Investment can fail because of issues in **deal structuring** for a number of reasons. First, the VPO might not have been realistic about risks and did not protect itself from such risks. Good practice is to always make a provision for enough legal support and consider the worst case scenarios. Second, the VPO could overemphasise the appeal of a project and invest at too high valuation. VPOs admit that they have been too optimistic about some geographies and sectors that then turned out to be difficult, so they stressed that trying to be always realistic is the key to success. A third reason is a misalignment in the goals of the VPO versus the co-investors (who can be either too financial or too social).

VPOs have failed at **investment management** because they did not monitor the investee's work and consequently the SPO strayed from objectives. Additionally the VPO can fail when it puts too much emphasis on the financial return at the detriment of the social impact. One last important remark to make for what concerns investment management relates to the SPO having the 'permission to fail'. Social innovation only happens where risks are taken, and risks generate higher probabilities of failure. Only acknowledging and accepting this, the VPO can act to support the SPO and help it not to fail.

The last step in the investment process is the exit. As EVPA's research team has recently analysed in its *Practical Guide to Planning and Executing an Impactful Exit*[3], a big challenge is defining the right timing of an exit. VPOs have failed at exiting either because they did not have an exit plan from beginning – and were therefore 'surprised' by the exit – or because they struggled to find the right balance between financial sustainability and social return – and thus exited too early or too late. Best practices concerning how to plan and execute an impactful exit can be found in EVPA's recent manual[4].

At EVPA, we have aimed to provide important lessons learned from failures, and have supported the information provided by our interviewees with other sources of data where possible. However, our future objective is to build on these learnings to enable an even more solid understanding of the difficulties and challenges faced by VP/SI practitioners and potential solutions. We would be delighted to hear from readers as to their views on the failures identified in this report, the lessons learned and/or on any additional thoughts or comments. Any comments or suggestions can be sent to lhehenberger@evpa.eu.com.

3. **Boiardi, P.** and **Hehenberger, L.,** 2014, "*A Practical Guide to Planning and Executing an Impactful Exit*". EVPA.
4. Ibid.

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Introduction and Background

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Introduction

This year, EVPA celebrates its 10th anniversary as an association, and the venture philanthropy (VP) and social investment (SI) sector has been around more or less the same time in Europe. We believe that time is ripe to draw some first lessons from the VP journey: What can we learn from strategies and investments that have failed? What governance and staffing have worked best for VP organisations and what hasn't worked? EVPA has collected the experience of 12 CEOs and founders of VP and SI organisations willing to share their stories of failure and have complemented this qualitative research with quantitative backing from our VP/SI survey data. This report is meant to help VP/SI organisations avoid repeating the same mistakes in the future by making them aware of possible failures and providing strategies of risk mitigation, but also to stimulate a culture of transparency and an open dialogue around failures in VP/SI. The key final message is that taking risk is necessary and the generation of *intelligent* failures is natural in environments where experimentation and creativity are core values.

What is VP/SI?

Venture philanthropy (VP) and social investment (SI) work to build stronger investee organisations with a social purpose (SPOs) by providing them with both financial and non-financial support in order to increase their social impact.[5]

The term SPO captures the entire spectrum of organisations whose primary purpose is to create social value (rather than shareholder value). The terminology for these different kinds of organisations varies enormously across countries and jurisdictions, and is therefore far from precise. The following types of organisations will fall under the banner of SPOs:

- Charity, non-profit, foundation, association, company limited by guarantee (having no trading activities, or where trading is of marginal importance)
- Social enterprise, Community Interest Company (having trading as a significant or exclusive part of their operations). Some do not make any financial returns to investors (or cap returns) but reinvest surpluses into the organisation. Even within social enterprise there are several different models.
- Socially driven business – profit distributing businesses but with clear and stated social objectives.

Often the SPOs are referred to as the 'investees', as VPOs invest in SPOs using the venture philanthropy approach.

Venture philanthropy is an approach that includes both the use of social investment (debt and equity instruments) and grants and is characterised by high-engagement, tailored financing, multi-year support, non-financial support (such as capacity building and

5. http://www.evpa.eu.com/knowledge-centre/what-is-vp/

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managerial skills), involvement of networks, organisational capacity-building and impact measurement.[6]

Figure 2: Definition of Venture Philanthropy
Source: EVPA

Organisations that practise venture philanthropy following the principles outlined above are defined as 'venture philanthropy organisations' (VPOs), social investors (SI) or more simply 'investors' in this document.

6. See also: http://www.evpa.eu.com/knowledge-centre/how-to-practice-vp/

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Why a research on failures?

> *'The gift of failure is a riddle. Like the number zero it can be both the void and the start of infinite possibilities. So how do we multiply something by zero and increase its value? How exactly does a setback become an aid?'*
>
> Sarah Elizabeth Lewis
> – Engineers without borders Canada Failure Report[7]

Social innovations are new strategies, concepts, ideas and organisations to meet pressing societal needs. Social innovation is intrinsically risky: only by experimenting with new structures and ideas can concepts be tested and eventually proven. As a consequence, the model proposed by the social purpose organisation that is trying to solve the societal need is only one of the tools for solving the particular social problem; it is new and as such needs to be tested and can eventually fail. 'Intelligent' failure is thus good for social innovation because it proves that society is experimenting with new concepts and models to prove what works and what does not work: it is necessary to take risk in VP/SI to reach real social innovation. However, society as a whole learns about what works and what doesn't only if failure is *identified*, *analysed* and *shared* so that the lessons learned feed the decision-making process. This is precisely why an increasing number of organisations and thought leaders are advocating for increasing openness and transparency in sharing failure stories.[8]

A recent report by **Giving Evidence** claims that not all grants have to succeed and that a certain percentage can fail in light of the fact that they constitute learnings.[9] According to a quote of Franklin Thomas, former president of the Ford Foundation, in the Giving Evidence report, charitable money can be 'the research and development arm of society'. However, when asked, most managers and executives from the most disparate sectors would say that failure is negative. At the same time most managers know very well that the best way to improve is to learn from past failures. Failure is not spoken about, to the point that talking about it is considered a pioneering innovation.[10]

The dichotomy between the recognition of the importance of the topic and the reluctance to tackle it needs to be reconciled. VPOs can only distil key learnings to avoid the repetition of mistakes by sharing experiences. As nicely summarised by David Pritchard: 'if only success is reported and poor results are hidden, charities are left to repeat each other's failures'.[11]

7. **Engineers Without Borders (EWB)**, 2011, "*Failure Report*".
8. http://www.theguardian.com/social-enterprise-network/2013/mar/18/discuss-failure-social-enterprise-sector
9. **Fiennes C.** and **Wulf, L.**, 2014, "*How funders can better understand their performance: Five easy tools – A White Paper by Giving Evidence*". Advice on Giving Based On Evidence.
10. http://www.pioneerspost.com/news-views/20141017/the-worlds-top-10-innovations-philanthropy
11. http://www.theguardian.com/voluntary-sector-network/2012/dec/03/honesty-failure-improving-impact-measurement

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Benefits of transparency:[12]

- Less time spent explaining goals and strategies to potential grantees
- Better, more on-target grant proposals
- More effective and informed grant-making based on feedback from grantees and other stakeholders
- Stronger and more open relationships with grantees and other non-profit organisations
- Closer relationships with other foundations, leading to more collaborative grant-making
- Increased public trust

Being transparent and admitting failure is the first step to avoid repeating the same mistake over and over again. Failures are readily being 'promoted' and shared on '**AdmittingFailure.com**'[13] and **Antiheroes**, websites that collect and share stories of organisations that have failed, stating that 'failure is inevitable', and provide a platform and space for people (entrepreneurs, practitioners, consultants, investors, etc.) to share their failure stories and learn from each other. Organisations can use the websites to (i) understand why failure is important, (ii) read failure stories, (iii) share their own failure stories, (iv) learn about how to create a failure report. For example, on the **AdmittingFailure.com** website, it is stated that learning from failures can help offset a recurring problem: 'A mistake is made somewhere in rural Tanzania. It is not publicized—a donor might be upset. Two years later, the same mistake is repeated in Ghana. Six months later in Mali. And so the story continues as it has for over 60 years'.[14] The **Spark Foundation** has joined the 'Institute of Brilliant Failures'. As stated by the organisation itself, 'SPARK recognises that error is inevitable. SPARK shares its Brilliant Failures in order to inspire people and organisations to see failure and success as two sides of the same coin'.[15] The **Failure Conference**[16], which takes place each year since 2009 in a different location in the world, is 'a one-day conference for technology entrepreneurs, investors, developers, and designers to study their own and others' failures and prepare for success'. The idea for this conference came from the need felt in the technology industry to have an event that differentiated itself from the others and provided learnings instead of a mere showcasing of few success stories.

Admitting and sharing failures is a moment of reflection that does not involve only individuals, but entire teams, as failures teach a great deal more than successes.[17] For this reason an increasing number of organisations have started reporting on failures and collecting failure stories.

Engineers Without Borders (EWB), a Canadian NGO, publishes an annual Failure Report in which engineers share their failure stories, and the lessons they learned. As EWB puts it: 'Engineers are open about failure: it's pretty clear if your bridge fell down.' EWB pushes its employees to dare and share what went wrong so that the organisation 'learns how to learn', and is increasingly transparent. **FailForward** has developed useful guidelines on

12. **Parker, S.,** 2014, "*Opening Up: Demystifying Funder Transparency*". GrantCraft.
13. http://www.admittingfailure.com/
14. **Engineers Without Borders (EWB)**, 2011, "*Failure Report*".
15. http://www.spark-online.org/results/brilliant-failures/ and http://www.briljantemislukkingen.nl/en/
16. http://thefailcon.com/about.html
17. **Fiennes C.** and **Wulf, L.,** 2014, "*How funders can better understand their performance: Five easy tools – A White Paper by Giving Evidence*". Advice on Giving Based On Evidence.

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how to be more open about failures ("*Failure Reports: A How-To Guide*") and supports organisations in creating their own failure reports, as a way of becoming more transparent and accountable both internally and externally, towards funders and beneficiaries alike.

A recent activity to increase transparency in the world of foundations also when it comes to admitting failures is represented by the **Glasspockets**[18] initiative of the Foundation Center. Glasspockets supports foundations in becoming more transparent by collecting information on how funds are used, and includes reporting transparently on the occurrence of failures so that actions can be taken to avoid repeated mistakes and/or activities can be restructured to increase efficiency and effectiveness. The **HP Foundation**, reported mistakes made in the "Community leadership project"[19], as a way of promoting transparency and avoiding mistake repetition.

As stated in the 2013 Annual Report[20] of the **C&A Foundation,** results-based learning is critical to the effectiveness and success of VPOs' activities. To this end, in 2014 C&A Foundation prepared a report with Giving Evidence[21] on the lessons learned from C&A's Sustainable Supplier Programme (SSP), a programme designed to improve the productivity and working conditions of C&A's suppliers and – more in general – of workers in the apparel industry. The goal of the C&A report is to present what worked (i.e. the '*highlights*' of the programme), what didn't (i.e. the '*lowlights*') and to distil the *learnings* that will help improving the programme in the future. All findings, both positive and less positive, are supported by data, such as the level of achievement of the KPIs. For example, the report highlights that factory recruitment was problematic, as not as many factories as expected joined the programme, making it more expensive than expected for C&A. The report concludes by outlining some options to tackle the issues and the next steps in the programme, such as – to tackle the factory recruitment problem – to try and have multi-brand collaboration, in order to be more cost-effective and achieve scale.

The **King Baudouin Foundation** (KBF) in Brussels, Belgium, has embraced the idea of internal learning by putting in place systems to share performance assessments, and proactively encouraging its employees to discuss failures internally. Among other activities, KBF has launched the "Best failure" award and encouraged staff to submit a project in order for the entire organisation to learn from each other's mistakes.[22] Similarly, the **Hewlett Foundation** has an annual award for the staff member who made its 'worst grant'.

The **King Baudouin Foundation's** VP fund engaged an external evaluator to assess the success of its strategy, looking at failures and successes of different groups of investees, categories according to their stage of development (start-up, growing, declining). The analysis of the achievement of the KPIs showed that in 80% of cases the expected impact had been reached and that 95% of the investees perceived the intervention of KBF to have had a key impact. This triggered further analysis showing that 20% of cases in which the impact had not been achieved as expected.

18. www.glasspockets.org
19. http://www.communityleadershipproject.org/
20. **C&A Foundation**, 2014, "*Annual Report 2013*". P. 10, "*Learning from Success and Failure*".
21. **Buckland, L.** and **Fiennes, C.**, 2014, "*Frankly Speaking: C&A Foundation's Sustainable Supplier Programme*". C&A Foundation and Giving Evidence.
22. **Parker, S.**, 2014, "*Opening Up: Demystifying Funder Transparency*". GrantCraft.

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Furthermore, **Shell Foundation** created its own performance evaluation methodologies to assess the actual and projected impact and sustainability of its grantees across time. By analysing the success rate of its grants, the foundation found that providing a smaller number of larger-sized grants would enable the organization to have greater impact and proceeded to change its operations accordingly. This enabled them to move from an 80% failure rate to a point where 75–80% of their partners are now demonstrating potential for large-scale impact and financial-viability. As they state in their 2005 report, *Enterprise Solutions to Poverty*: 'Most of our early projects were competently completed by our grantees. But we now judge many of these to have 'failed' because they did not leave behind initiatives capable of surviving or going to scale without our ongoing support or that of other donors'.[23]

The need to open up and be more transparent is increasingly felt also in the social enterprise side. However, few social entrepreneurs openly talk about their past failures, though many advocate for increased openness on the topic.[24]

In a recent interview with The Guardian, a social entrepreneur stated that: 'Social entrepreneurs who have failed are likely to be more innovative, can be better at managing cash flow and even more attractive to certain investors. And, I think if you're not failing, you're not innovating. Really successful social entrepreneurs fail multiple times. But one of my bugbears is that these discussions only happen in the bars at conferences, not on stage'.[25] Initiatives like **The Secret Social Entrepreneur blog** provide an opportunity for social entrepreneurs and – more in general – for people working in social enterprises to share their thoughts anonymously, including failures experiences.

23. **Shell Foundation**, 2005, "*Enterprise solutions to poverty – Opportunities and Challenges for the International Development Community and Big Business. A Report by Shell Foundation*", p. 20, "*Energy access as market failure*".
24. http://www.theguardian.com/social-enterprise-network/2013/feb/11/failure-social-enterprise
25. Ibid.

Learning to fail intelligently

> *'Looking back at 2014 as venture philanthropists, we have seen brilliant entrepreneurial initiatives fail, apparently sound projects collapse – and courageous ventures unlikely ever to survive surprisingly flourish. I firmly believe that these often unexpected ups and downs are an essential part of our mission, taking the risk to reach out to yet unexplored territory in the world of societal change.'*
>
> Peter W. Heller
> – Canopus Foundation

This report provides an overview of the main areas in which failures can happen in VP/SI. The framework presented in this report is supported by practical examples and cases collected among VP/SI practitioners. The reason behind this research project is the belief that often it is not possible to avoid failures, and *admitting that failure is possible* and learning to fail intelligently can be a deliberate strategy to promote social innovation through the promotion of experimentation and creativity. Sharing failures and openly discussing them is the first step of a wider process by means of which VPOs can learn to fail intelligently.

The issue is then to understand the root causes and discover the wisdom contained in the failure. To make the most out of mistakes from failures an organisation must go through a process of *identification, analysis* and *learning*. Organisations that make failures visible, analyse them systematically to distil valuable lessons are better at supporting impactful social innovations. The key is to accept a certain level of risk, but to continuously learn from failures to identify possible risk mitigation strategies so that the failure rate decreases. Taking it a step further, organisations that encourage intelligent failures though *deliberate experimentation* can achieve the greatest results.[26]

26. **Cannon, M.D.** and **Edmonson, A.C.**, 2005, "*Failing to Learn and Learning to Fail (Intelligently): How Great Organisations Put Failure to Work to Innovate and Improve*". Long Range Planning 38: 299–319.

1. **Admit failures are possible**
2. **Detect failures**
3. **Analyse failures**
4. **Learn from failures**

Figure 3: Learning to fail intelligently

INTRODUCTION AND BACKGROUND

Once the VPO *admits failure is possible*, the next step is *detecting the failure*, i.e. identifying the deviation from the expected and desired result. Each VPO will have its own definition of failure depending on what its objectives are. A failure can be either the consequence of an avoidable error or the unavoidable negative outcomes from experimenting and risk-taking.

Then the VPO must *analyse the failure*. Uncovering the root(s) of the issue allows everyone to see the points with the most leverage for avoiding that failure in the future. In this step it is important to consider the context in which the failure happened (i.e. the geographical location, the project objectives, the assumptions, the hypothesis and the timeline), the specific actions and activities undertaken and the assumptions that drove the actions taken.[27] It is at this stage that the failure is assessed against the desirable outcome and the VPO asks itself why the failure happened, which were the events that lead to the failure and what will be the long-term impacts. Analysing organisational failures requires inquiry and openness, patience, and a tolerance for causal ambiguity: complex and more risky systems make it more difficult to understand the cause-effect relationships.[28] Motivating people to go beyond first-order reasons (procedures weren't followed) to understanding the second – and third-order reasons (i.e., the reasons behind the simple assessment that procedures weren't followed) can be a major challenge. Ways to do this are, for example, use interdisciplinary teams with diverse skills and perspectives or asking for the support of external parties.

Once the analysis of the failure is performed, the VPO can distil the *lessons learned* that will inform the future decision-making process. The VPO asks itself what are the implications for the future given the changes in some of the assumptions and hypothesis. This step is not complete until the VPO has institutionalised the learnings and drawn recommendations for other projects in similar situations. These learnings include risk mitigation strategies to lower future failure rates while allowing for the level of risk needed to support social innovation.

Technical and social barriers can prevent the process of learning from failures to work. Technical barriers consist in the difficulty to determine the causal linkages while social barriers refer to the psychological reactions that people have against failures. The issue therefore becomes how to create an environment that is conducive of openly discussing and learning from past failures.

27. https://failforward.org/
28. **Edmondson A. C.,** 2011, "*Strategies For Learning From Failure*". Harvard Business Review.

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Talking failures

'There is a deep-rooted fear of finding out (or 'being found out') that one has not had the impact that was intended. Organisations are incredibly reluctant to admit that programmes have not gone according to plan. Some simply do not tell funders the truth; others are very opaque when reporting back to funders; yet others cherry-pick clients to ensure low success rates are minimised. Lessons of 'failure' are rarely shared. When funders become aware that the desired results have not been achieved for whatever reason, they are seemingly equally reluctant to take constructive action, for fear of damaging the organisations' (and possibly their own) reputations.'

Sandra Velthuis – "Demonstrating Impact: Current Practice Amongst Social Purpose Organisations in the Republic of Ireland". The Wheel.[29]

Though everyone agrees that to achieve social innovation sometimes it is *not* necessary to *avoid* failures, getting over the fear of admitting failure is a big challenge. It is very difficult to put learning from failure into practice as discussing failures publicly makes VPOs vulnerable and could damage the SPO involved.

Part of the reason for not talking about failures in public is that many funders of SPOs and VPOs are only interested in successful organisations. The more successful examples are shown to the outside world, the more money is attracted to the sector. However, experimentation is necessary to achieve social innovation and there is no experimentation without failure.

Additionally, often organisational structures and cultures can discourage people from identifying and reporting failures as they have little tolerance for (and punish) failures. According to an Harvard Business Review's article[30], 'failure and fault are virtually inseparable in most households, organizations, and cultures'. This is what HBR calls 'the blame game'. A natural consequence of punishing failures is that employees learn not to identify them, let alone analyse them, or to experiment if the outcome might be uncertain.[31]

As acknowledging failure can be painful and demotivating, it is agreed that it is crucial for senior management to make it 'safe' for staff to admit mistakes, by setting up suitable data-collection systems and rewarding honesty.[32] One way of overcoming these issues is to create an environment in which sharing failures is 'safe' as the negative emotions

29. **Velthuis, S.**, 2011, "*Demonstrating Impact: Current Practice Amongst Social Purpose Organisations in the Republic of Ireland*", The Wheel,
30. **Edmondson A. C.**, 2011, "*Strategies For Learning From Failure*". Harvard Business Review.
31. **Cannon, M.D.** and **Edmonson, A.C.**, 2005, "*Failing to Learn and Learning to Fail (Intelligently): How Great Organisations Put Failure to Work to Innovate and Improve*". Long Range Planning 38: 299–319.
32. **Fiennes C.** and **Wulf, L.**, 2014, "*How funders can better understand their performance: Five easy tools – A White Paper by Giving Evidence*". Advice on Giving Based On Evidence.

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experienced by people when sharing failure stories inhibit learning, can be triggered in contexts where failures are punished.[33] According to Deirdre Mortell, co-founder and former CEO of the One Foundation, one of the expert practitioners interviewed for this study, it is important to give people the 'permission to fail'. This permission should not just apply to the internal staff of the VPO, but also to the SPOs financed. Giving people a safe environment where they can discuss failure is necessary to make sure they feel they can share their experiences. It is very rare that a meaningful failure was caused by just one person or one reason. Discussing failures openly in teams and showing people that responsibilities are shared helps create an open learning environment.

Methodology

This report is the result of several years of knowledge gathering, through the annual EVPA industry survey, EVPA workshops, including one on failures at EVPA's annual conference, in-depth interviews with practitioners and a year of in-depth research. We started by scanning the literature on failures from all available sources, to discover that although experiences exist in accounting for failures and reporting on past mistakes at an organisational level, the topic had not been extensively studied in VP/SI as a sector. We then reached out to the EVPA network to engage VP/SI practitioners and composed an expert group of 14 experts from 12 VP/SI organisations. We carried out in-depth interviews with each of the CEOs, asking them to share failure stories and past mistakes, and insights on how they overcame them and the lessons learned.

We then organised a high-level roundtable to test our findings with experts from 9 out of the 12 organisations that were part of the original expert group and shared a draft version of this report for feedback. During this second round of consultation we also asked the CEOs to identify open challenges for the VP/SI sector, ten years after the inception of VP operations and looking into the ten years ahead. The roundtable allowed us to fine-tune our recommendations that are highlighted throughout the report.

The manual is structured as follows. In the next section we outline the different ways in which failures can generate and then dig deeper into each of them by means of practical examples provided by the VPOs that joined this research project. For each source of failure we provide recommendations of how to decrease the failure rate in VP/SI rather than to eliminate the inherent risk. The aim is twofold. By assessing how failures are generated in VP/SI we can derive lessons learned that can help other VPOs avoid making the same mistakes. Second, we want to share with organisations using the VP/SI approach how leaders create an environment where it is possible to learn about failures and to overcome them.

33. Ibid.

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Learning from failures in VP/SI

LEARNING FROM FAILURES IN VP/SI

What is failure in VP/SI?

Failure has been defined as the deviation from expected and desired results.[34] For a VPO, **failure happens when the social and, in some cases, the financial return objectives are not reached, or are only partially reached**. Other important factors used to assess failure include the **time** it took to achieve the results and the **costs** incurred: an investment may have reached its social impact objectives but at a cost that greatly surpassed initial projections, or taking much longer than expected.

Failure in VP/SI is a complex issue that depends very much on the strategic objectives of each VPO. Sometimes, a VPO may consider an investment as a failure because it only partially reached its original expectations, although the investee organisation is doing well and has increased its social impact. For example, for Shell Foundation failure is an investment that has not made progress towards financial sustainability. For PhiTrust, failure is when the social impact is not higher at the end than at the beginning of the investment.

Causes of failure in VP/SI

From the experience of the CEOs and founders of VPOs that joined EVPA's research on failures, we have grouped the causes of failure into three main categories: issues related to the internal organisation of the VPO that are identified as *organisational risk*, misalignments in the development of the investment strategy of the VPO, *strategic risk*, and failures in the execution of the investment strategy, *execution risk* (see Figure 4).

Organisational risk

Challenges related to the internal organisation of the VPO:
- Funding model
- Pitfalls in governance
- Staff issues
- Other key stakeholders

Strategic risk	Execution risk
Misalignments in the investment strategy of the VPO:	**Failures in the implementation of the investment process:**
• Investment focus	• Deal screening
• Models of intervention	• Due diligence
• Type of SPO	• Deal structuring
• Financing instruments	• Investment management
• Co-investment policy	• Exit

Figure 4: Causes of failure in VP/SI

34. **Cannon, M.D.** and **Edmonson, A.C.**, 2005, "*Failing to Learn and Learning to Fail (Intelligently): How Great Organisations Put Failure to Work to Innovate and Improve*". Long Range Planning 38: 299–319.

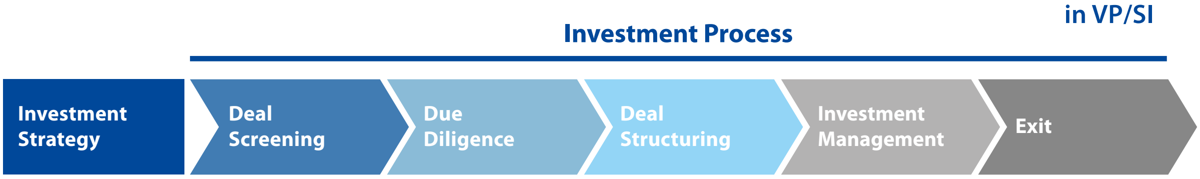
LEARNING FROM FAILURES IN VP/SI

When the VPO is set up and the internal organisation is decided, founders make decisions about the funding model, governance, staff composition and identify the stakeholders to build relationships with. Those decisions are re-evaluated over the life-time of a VPO by the CEO, the management team and sometimes the board as they realise that the structure it has chosen may not be optimal or mistakes were made in allocating tasks and responsibilities of the staff or among stakeholders. Such mistakes may generate failure or simply hinder the growth and positive evolution of the VPO, constituting *organisational risk*.

In order to choose which SPOs to invest in, the VPO decides on its investment strategy. The starting point for developing an investment strategy lies in a clear articulation of the VPO's objectives. The investment strategy will encompass issues like sector and geographic focus, preferred models of intervention, preferred types of SPOs to support, social impact targets and financial targets (if any). It can also include the development stage of the SPO (i.e. start-up /early stage/more established organisations).[35] Misalignments and issues in the investment focus, the social and financial return targets set, the financing instruments used and the co-investing policy constitute *strategic risk* and may cause failures.

The third category of failures comes from *executing the investment strategy* by implementing the investment process. For each investment, the VPO goes through an investment process as outlined below.

Figure 5: The investment process in VP/SI



Mistakes can be made at any point in the investment process: when screening new deals, when conducting due diligence, when structuring the deal, when managing the investment and when exiting. Identifying execution risk means that the VPO can learn to safeguard its activities so that mistakes can be prevented. Such mistakes may result in failed investments or sub-optimal outcomes of the investments.

In the next sections we will analyse each of these potential failure situations by means of practical examples provided by experienced VP/SI organisations that have shared their failure stories.

35. **Balbo, L., Hehenberger, L., Mortell, D.** and **Oostlander, P.**, 2010, "*Establishing a venture philanthropy organisation in Europe*". EVPA.

Sources of organisational challenges of the VPO

Mistakes that arise when setting up a VPO and in the daily management of the VPO

With the term 'organisational challenges' we refer to general issues that arise from how the VPO is set up and in the organisational processes over the life time of the VPO. When organising its operations, a VPO can make mistakes that will make it difficult for the organisation to work properly. More importantly, we see the organisational challenges as crucial to address in order to create the type of structure that takes risks and allows 'intelligent' failures to happen. From the interviews, we have identified that internal challenges arise due to issues in the funding model of the VPO, the governance model, the selection and retention of the staff and the relationship with other key stakeholders. Where possible, we have proposed potential solutions to the challenges.

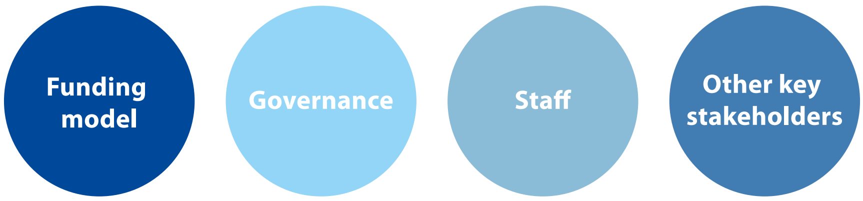


Figure 6: Sources of organisational challenges

In the following sections we will outline different examples of the challenges faced by VPOs related to their organisational set-up and to the definition of their internal operations and the lessons learned by VPOs.

Funding model

The CEOs we interviewed identified two main issues pertaining to the funding model:

- Challenge of financial sustainability of VPOs – finding complementary revenue streams and raising larger social investment funds
- Difficulty of operating in the hybrid space – need to educate and raise awareness and deliver clear messages

Financial sustainability of VPO

As in any new sector, finding enough and the right type of funding is one of the major challenges in venture philanthropy and social investment. This challenge is not as relevant for endowed foundations with a relatively steady budget. The latest EVPA survey[36] showed that a majority of European VPOs had annual budgets of less than €2.5m including overhead costs and investments. Some of the interviewees explained their struggle in fundraising and identified mistakes and learnings.

36. **Hehenberger, L., Boiardi, P., Gianoncelli, A.**, 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.

LEARNING FROM FAILURES IN VP/SI

Finding enough and sustainable funding

NESsT is a VPO that develops and invests in sustainable enterprises that solve critical social problems in emerging market economies, primarily in Latin America and Central and Eastern Europe. A major problem for NESsT has been – and still is – to generating untied and sustainable funding to support its portfolio of social enterprises. Attracting funders in the first place can be difficult; for NESsT an issue is that the countries where NESsT is present are not on the 'radar screen of major donors, e.g. USAID', according to Nicole Etchart, co-founder of NESsT. Although NESsT tapped into international funding when entering a country, it thought that with time, it would be able to cultivate local philanthropy that would replace international donors and be willing to engage and support early stage enterprises. However, despite the fact that NESsT has been in Central and Eastern Europe and Latin America for over 17 years trying to raise awareness around the importance of funding venture philanthropy, it has not been able to leverage this support on a great scale. NESsT had assumed it would be possible to convert its network of over 300 business advisors around the world into donors, but this assumption proved to be wrong. In Latin America, local philanthropy is still very limited, and tends to focus on direct charity and short term projects. High-net-worth individuals (HNWIs) tend to mistrust intermediary organizations and prefer to create their own foundations. In Central and Eastern Europe, people are ready to invest their time, but once they have given it, they feel like they do not have to give any financial support.

Challenge of funding cost base and high engagement approach

Impetus-PEF, the VPO that resulted from the merger in 2013 of Impetus Trust and the Private Equity Foundation in the UK, has evolved a lot since the two organisations were set up individually in 2002 and 2006. Following the merger, the number of people on the investment management team has grown and evolved from volunteer executives to paid professionals, a trend in line with the findings from the EVPA survey of European Venture Philanthropy and Social Investment.[37] According to Nat Sloane, co-founder of Impetus Trust, 'it was a good move as you have people dedicated full-time but the challenge is the cost base you have to fund'. Luciano Balbo, founder of **Oltre Venture** in Italy, further stresses the 'challenge to fund the core costs of the VPO'. Andrew Muirhead from **Inspiring Scotland** relates this challenge to the inability of the VP/SI sector so far to sell the value of the engaged VP intervention vs. grant making ('simply writing cheques'). He admits that Inspiring Scotland 'has not sold the value added of the VP approach as well as they could have done'. An example is when the Scottish Government opened a tender, and Inspiring Scotland pitched to run a VP fund for 6% of total funding per annum as overhead costs. The winning pitch offered 3% p.a. Clearly, Inspiring Scotland failed to sell the value of its work well enough to justify the extra 3%. More recent independent publications have helped build understanding of this.

Finding high risk, flexible funding

Many of the pioneer VPOs face the additional challenge of having to build the market in geographies where there is little awareness of social entrepreneurship and even less of VP/SI. The market development work calls for additional resources from the VPOs, often unforeseen when the VPOs were initially set up.

37. **Hehenberger, L., Boiardi, P., Gianoncelli, A.**, 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.

LEARNING FROM FAILURES IN VP/SI

NESsT and many other VPOs have struggled with funding sources that have been often short-term and tied to donor interest. The problem with restricted funding is that it can compromise the quality of the investment when forced to have 'quotas' to make a certain number of investments in a specific geography or social sector. In a sector that is in its early stages (in certain geographies more than in others), it is important to be able to provide 'patient capital' to allow investees to achieve the desired social impact, and to have a fairly flexible investment strategy to accommodate unforeseen circumstances and react to changes.

Many of the interviewed CEOs expressed a need for more high-risk funding, stating that this type of funding is still largely coming from high-net-worth-individuals (HNWI). The latest EVPA survey[38] corroborates that the largest funding source of VP/SI is still HNWI (19% of funding), followed by corporations (17%) and external foundations (14%).

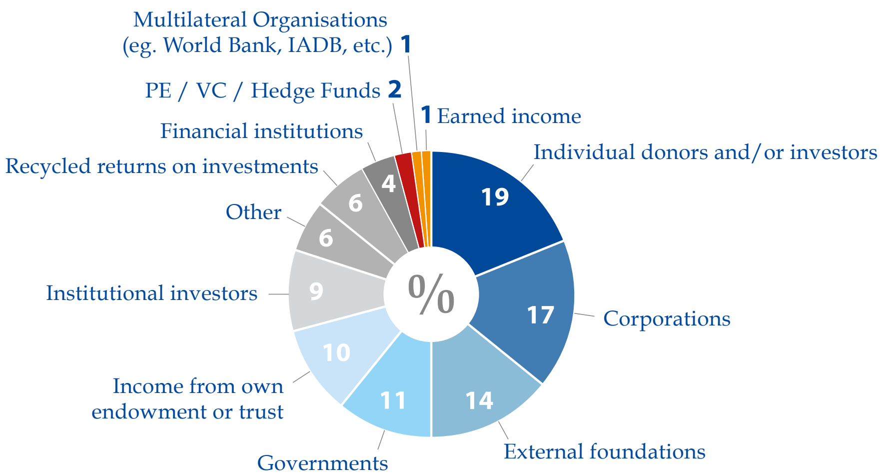


Figure 7: Distribution of total funding made available to VPOs by source

n=85

As Olivier de Guerre from **PhiTrust** in France explains: VP/SI is about venture-type investments. You need to take the risk – but investors are too afraid. 'He also explains that corporations understand the risk of doing business, but banks don't. They just care about the balance sheet.' Andrew Muirhead at **Inspiring Scotland** added that it is most difficult to deal with third party professional managers because the concept of VP is quite alien to them and they try to apply procedures and the mind-set of a traditional financial investor. Furthermore, for Inspiring Scotland, trusts and foundations can occasionally be challenging on fundraising as they occasionally feel threatened by the VP approach, and typically argue: 'What can VP do that is different from what we do already?'. This translates into difficulties in communication. IS's strong roots in the Trust and Foundation sector has helped address this, it has also contributed to various "Value Add" research initiatives, often funded by foundations to build understanding and mutual respects. Luciano Balbo at **Oltre Venture** believes that we need pioneer investors that are willing to take on a high level of risk – we need philanthropists to develop the new industry:

38. **Hehenberger, L., Boiardi, P., Gianoncelli, A.,** 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.

LEARNING FROM FAILURES IN VP/SI

'The industry is like a small baby – it is sensitive and vulnerable and needs to be nurtured with patient capital!'

Finding complementary revenue streams and raising larger social investment funds

To enable self-sustainability in terms of funding, **NESsT** has set up its own social enterprise that provides consulting services to organizations that need the tools that NESsT has developed. The profit goes back to NESsT and now constitutes 20% of the funding. It is building a business plan for an investment fund to enable funds to be recycled. It plans to use loans and equity – and diversifying its own income strategy. However, this new strategy will also be challenging given that NESsT's investees are mostly early stage enterprises that often need patient capital requiring a longer period of repayment and lower interest rates.

As evidenced by the EVPA survey data, other VPOs are also moving in the direction of requesting their money back or even requiring a positive financial return.[39]

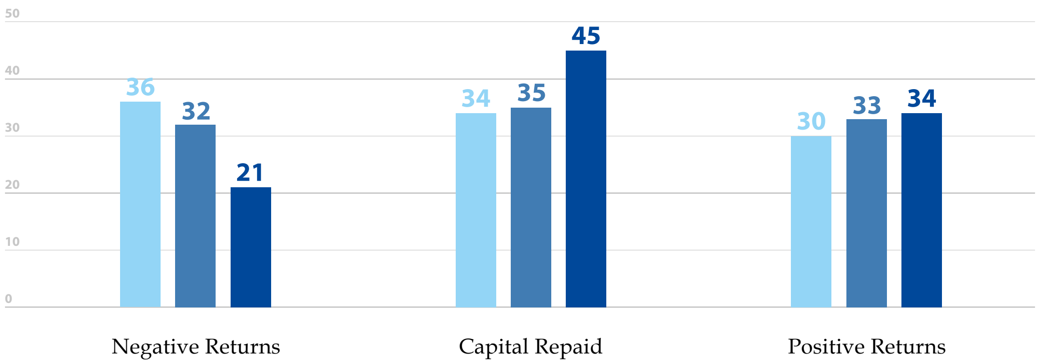


Figure 8: Return expectations of VPO respondents

Clearly it is attractive to raise a larger social investment fund so that more investments can be made and it is possible to pay appropriate salaries to the management. According to Erwin Stahl at **BonVenture**, bigger funds are more efficient because there are economies of scale linked to the management fee. As he explains: 'For example, with a €4m fund, you need a 4% management fee to pay fixed costs of €200,000/year. With a €20m fund and a 2.5% management fee, you have a budget of €500,000/year which allows you to pay people a decent salary. You do not need proportionally more people to run a €20m than a €4m fund. Therefore, with a bigger fund, you can also make a lower financial return, and still return the same to investors as the management fee is proportionally lower'. With its third fund, BonVenture will invest in later stage social enterprises, which implies less risk, same return, but lower management fee (in %), thus being able to attract institutional investors such as the European Investment Fund. To reach the returns targeted by the EIF, BonVenture needs higher volumes and to target investments in the growth phase.

Similarly, Luciano Balbo at **Oltre Venture** believes that to attract the institutional investors needed to raise a larger fund the target financial return has to be higher than for smaller funds, and the risk lower. To lower the risk, VPOs need to move towards more business-like

39. Ibid.

investments. However, if the key discussion focuses on the financial return, there is a risk that social impact ends up being a secondary consideration. Luciano believes that the pressure for financial returns is causing a deep change in the sector where VPOs will have more conservative strategies driven by institutional investors who expect higher returns. Wolfgang Hafenmayer from **LGT VP** agrees with Luciano that institutional investors are increasingly interested in financial return whereas high net-worth individuals and foundations still focus on social return.

Since institutional investors put much more money on the table, they push the sector towards higher returns. This move towards higher financial return may be a threat to the sector as 'high risk' investment opportunities that promote social innovation may be overlooked because the social investment fund managers need to produce the promised financial returns. Such a tendency goes against Nicole Etchart's from **NESsT** statement that 'it is sometimes necessary to address the most difficult issues in the most difficult countries in the most difficult times and in the most risky stage of development'. Clearly, the VP/SI sector will need actors at different positions on the investment spectrum, but if too many choose financial return over social innovation, there is a risk of systemic failure.

Olivier de Guerre explains that **PhiTrust** has just registered its PhiTrust Partenaires investment company as a European Social Entrepreneurship Fund (EuSEF[40]), the second in Europe after BonVenture. When asked whether this new label will mean that the fund will seek higher financial return than previously, Olivier gives a solid no! His experience to date has shown that there are a number of private and institutional investors who are ready to embrace a social impact fund because they understand that there is higher risk and high uncertainty, but that the social return compensates for a lower financial return. Therefore, Olivier does not think it is necessary to adjust the investment strategy to raise additional share capital, but rather ensure that 'you are targeting the right investors. If you are in a social investment fund, you know you have to look for a specific investor, not alter your investment strategy'.

Difficulty of operating in the hybrid space – need to educate and raise awareness and deliver clear messages

Managing finance first and impact first funds within same organisation.

The **Noaber Foundation** is a VPO based in the Netherlands aiming to support breakthrough social innovations, mostly in the healthcare sector. Its Managing Director Matthijs Blokhuis explained how the Noaber Foundation first structured its activities in three funds: the foundation, an impact first fund and a finance first fund. The idea behind this structure was that Noaber would divide the support in two parts. On one side the foundation would give grants and donations to organizations with no potential to become financially viable. On the other hand organisations that showed the potential to become financially sustainable were financed through the impact first with the idea that – once reached financial sustainability – they could move to the finance first fund. In practice, such a transfer did not happen for two reasons:[41]

40. http://www.esma.europa.eu/page/Venture-Capital-and-Social-Entrepreneurship-Funds

41. **Metz Cumming, A. and Hehenberger, L.,** 2011, "*A guide to Venture Philanthropy for Venture Capital and Private Equity Investors*", EVPA.

LEARNING FROM FAILURES IN VP/SI

1. Noaber Foundation realised the need to ensure that the social ventures in the portfolio kept focussing on the social mission. This involved building in remuneration schemes that would link any financial return to the VP's investors to the social impact achieved by a portfolio social ventures. Thus if the SPO doesn't meet its impact targets it is not allowed to pay dividends to its shareholders. This also applies to other incentive schemes, e.g. for the management fee. Because of this stricter rule, organisations that started as impact-first were designed to stay that way, lest they incur mission drift. To change, they would have to alter their shareholder agreements.

2. As Noaber Foundation had decided the main focus was on social venturing, they were committed to using greater amounts of capital for social investments rather than financial ones.

Ultimately the main issue with that was that Noaber's proposition just wasn't clear enough for potential investees. Right now, there is more of an impact investing market, but at the 2005–2007 time, social venturing really was an unknown way of working that people did not fully understand. It was important for Noaber to send just one clear message (we strive for impact and the methodology is supportive of that) to the market. Working with a separate impact first and finance first vehicle just did not support that message.

The failure of the separate-funds system was an important learning moment for Noaber. At the time when Noaber set up this separated-fund scheme (2005–2007) social venturing was a very immature market. With VP being the practice of applying VC principles in the social space, Noaber's idea was to remain active in VC for learning and experience reasons. Therefore this separated-fund scheme was for Noaber a way to try to help mature the social investment market.

Noaber Foundation's finance first fund experienced several issues. It was difficult to generate new deal flow, Noaber Foundation did not have the right capacities to manage a finance first fund and the fund was too small to actively look for high quality deal flow. From this experience Noaber Foundation concluded that when applying VP, the VPO needs to stay in the impact first space. Therefore, it merged the participations from Hoechst (finance first fund) with George Avenue (impact first fund) into Noaber Ventures and exited the finance first strategy.

Difficult to manage investor expectations in new, 'hybrid' space.
Another challenge of operating in the hybrid space is how to manage investor expectations. **NESsT** receives funding from foundations, the private sector, individuals, and governments. Each type of donor has different expectations and it is difficult to keep everyone happy. Part of the difficulty comes back to the lack of knowledge and awareness of VP/SI and how it works. In **Inspiring Scotland's** experience there were even early donors who became very excited about Andrew's ambition and vision but in all likelihood decided to invest too quickly, without sufficient due diligence and without being completely clear on what they

were 'buying'. In the early stages of IS there was a considerable level of investor discussion required, as to exact levels of participation etc.

According to Luciano Balbo from **Oltre Venture**, for the social impact investing area the aim is a combination of social impact and financial sustainability – sometimes with contrasting goals. Luciano struggles with the fact that some investors think that Oltre Venture is not social enough while others think the opposite. Evidence from **Noaber Foundation** when operating multiple funds corroborates the challenge of managing investor expectations: 'From a marketing perspective, it became confusing. The social sector distrusted the profitable motives from the VC arm and financial investors were wary of the social side, which could be perceived to compromise financial return although hosted in a separate entity'.[42]

Educating and raising awareness and delivering clear messages

As investor sophistication and awareness of VP/SI increases, the challenge of operating in a hybrid space will become less acute, but according to our interviewees, the sector still has a long way to go. Nicole Etchart from **NESsT** thinks it is necessary to continue building awareness. NESsT has identified small changes happening. NESsT now focuses more on the markets where there is some critical mass already and has developed a regional approach with hubs, leveraging existing investors to open doors locally and be more cost effective when building markets. Clearly explaining what VP/SI means and delineating different types of investment strategies into separate entities, as illustrated by **Noaber Foundation**, are other important parts of the solution. Luciano Balbo from Oltre Venture would like to launch campaigns aimed at high-net worth individuals explaining VP/SI and asking them to take higher risk while promoting a 'Social Responsibility of Wealth'.

Governance

The CEOs we interviewed identified two main challenges related to governance:

- Need for governance structure that includes mixed range of experience (private and social sector).
- Difficult to convince board to embrace VP approach and be patient.

Establishing a functioning governance structure that includes 'balancing voices' (private and social sector)

The Board of Directors of the VPO has a crucial role when it comes to taking the investment decisions and answering strategic questions. Therefore it is important that the Board is diversified and brings in a balanced mix of experiences and backgrounds to avoid making crucial mistakes.

At **BonVenture**, a German VPO, for the first VP fund investment decisions were prepared by the management company and the board made the final decision whether or not to invest. BonVenture soon realised that to make the right decisions, it was necessary to set

42. ibid.

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up an investment committee consisting of board members but also including people with expertise on social and ecological issues and with a network in specific fields. Although the focus of BonVenture is broad, the experts were needed.

Nat Sloane, co-founder of **Impetus Trust**, highlighted the need for a board from both the private and the social sector with a mixed range of sector experience. Diversity sometimes brings conflict, but as Nat explained 'a bit of diversity is very important to be able to tease out some of the issues. A lot of the input from fractious members early on was very helpful, for example making sure the geographic diversification around the United Kingdom was taken into consideration and that Impetus would not just finance organisations that Stephen (the other co-founder, ed.) and I knew in the beginning'. The discussion were not always easy, but looking back Impetus would have made more significant mistakes without having that rich mix of perspectives.

At the **One Foundation** the issue of the board was, as is often the case, a learning process. It is difficult to know what you need when there is so little precedent and you need to be flexible and adapt when working in such a 'fluid and high learning environment'. After the first few years, Deirdre Mortell – the co-founder and CEO of the One Foundation – was much clearer about the kind of profile of Board members needed in order to add value to the work of the One Foundation. In particular, there was a need for a mix of experiences – *balancing voices* – from dealing with investment processes and from dealing with the realities of the social sector, especially related to the particular social sectors that One Foundation focused on. Additionally, the board members needed to have a collaborative mind-set and be respectful of people with diverse professional backgrounds. In the end it was a matter of finding the right alignment between governance, organisation structure and staff to enable the smooth functioning of the VPO.

Difficult to find board/convince board to embrace VP approach – results needed and a 'leap of faith'

Other reports have accounted for the difficulty especially to convince the board of established foundations to start using the VP approach. For example, Chris West, Director of **Shell Foundation**, had to convince his board that VP was a more effective way to deliver large-scale development impact than standard project-based funding to a large number of non-profits. To do this, Shell Foundation had to show that its early grants weren't working, adapt its strategy, develop new skillsets to identify and better support breakthrough social innovators, and professionalise its approach to risk mitigation and cost-efficiency. Chris and his Board worked hard to evaluate the implications of these changes but it still required a leap of faith. Only after several partners were delivering impact at a global level, a period of around ten years, was Shell Foundation able to prove the benefits of a VP approach to grant funding. When new VPOs are set up from scratch, the challenge lies in building the right board that allows for an entrepreneurial approach. Andrew Muirhead, founder and former CEO of **Inspiring Scotland**, explained how difficult it was to build a Board that was sufficiently aligned and with sufficient knowledge on what the VPO was trying to achieve, indeed this is a global challenge for a new industry. Directors have been drawn from a variety of professions (corporate, public sector etc.) with excellent experience of the traditional philanthropic world where most things come with a prescribed instruction book. The fact that VP is still evolving and is in an entrepreneurial phase can be difficult for a Board. Inspiring Scotland is a societal impact first (and only) organisation but has been looking at different forms of investments such as payment by results and financial along with societal return in the form of debt or equity. These types of models can receive push back from the Board.

Furthermore, some VPOs express a frustration because of the lack of patience of board members regarding the time it takes to show results. For Chris West at the **Shell Foundation**, it was difficult to convince the board of the need for 'patience' as they were expecting more immediate results. As an organisation Shell Foundation was putting in considerable financial and non-financial support without seeing a material difference in social return, so it was a reasonable question to ask. By setting in place KPIs, milestones and projections against which to evaluate promising and failing partnerships, Chris was able to convince his Board that creating early-stage social enterprises would deliver exponentially more impact over time.

Staff / Management

In terms of staff composition and motivation, the interviewees agreed on two main challenges:

- Finding the right mix of financial and social skills.
- Allowing management to take risks while ensuring proper governance.

Difficult to find right mix of financial and social skills – diversity needed with a preference for financial and business backgrounds

As in the case of the board, interviewees emphasise the risk involved in running a VPO without a mix of skills from the private (including both the financial and the general business sectors) and the social sectors. When impossible to find someone with dual experience, the preference seems to be to hire from the financial and/or corporate sector. Evidence from the latest EVPA survey report shows that the professionals in the VP/SI organisations surveyed have a financial and private sector background (58%) and/or a social mission driven backgrounds (34%).[43]

43. **Hehenberger, L., Boiardi, P., Gianoncelli, A.**, 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.

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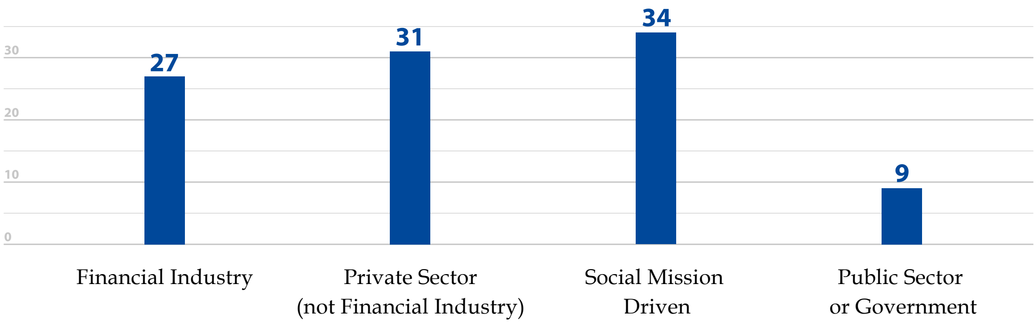

Figure 9: Professional background of VP/SI Team

n=95
numbers in %

Erwin Stahl from **BonVenture** stresses both the difficulty of finding people with a dual social and financial background and the importance for employees to have at least basic financial skills. Similarly, Wolfgang Hafenmeyer at **LGT VP** and Luciano Balbo at **Oltre Venture** prefer hiring staff with a strong business or financial background who can then learn about how to apply their skills to the social sector. At **Shell Foundation**, most team members have a business background, with broad business planning and financial skills and experience working in emerging markets, and are entrepreneurial as individuals. According to Chris West: 'those people, just like partners, are not so easy to find.' Chris wouldn't generally hire anyone who did not have commercial experience in addition to development knowledge.

At **Inspiring Scotland**, Andrew Muirhead's ethos has been to build a team with people from all backgrounds, including the private and public sector and the voluntary and non-profit worlds. The idea behind this choice is that each background brings something that contributes to the overall 'roundness' of the team. The organisation and teams are very outcome-focused, so despite the differences in backgrounds and views they have avoided conflicts so far. Andrew sees the calibre of the people in the Inspiring Scotland's team as very high: they are young and dynamic individuals who have left successful corporate and public sector positions to join Inspiring Scotland. Although this proves that VP can attract talents, the selection and recruitment of staff is still challenging. According to Andrew, for every potential candidate from the corporate or public sector, you need to 'work through ten to get one who really wants to do it'. Two pending staff issues are the discrepancy between the warm glow that surrounds the sector vs. the reality of the challenges of the work and the fact that a significant percentage of people who apply to join a VPO do not really want to do what is needed to be successful in the role.

According to Nicole Etchart from **NESsT**, aligning the VPO team with the investees is critical. NESsT has gone from investing only in non-profits to investing also in for-profits, which implied moving from being a pure grant-maker to being an organisation using also commercial instruments. These developments have required changes in staff – from capacity builders to also investors – through both training and hiring of new people.

According to the CEOs interviewed as VP/SI evolves VP/SI professionals will develop skills that are specific to working in the hybrid space, ending the dichotomy between financial and social profiles. For example, **Impetus-PEF** is evolving towards organising the team by type of investee supported (individual charities vs. SEs) or by sector verticals, to organising the team by stage of development of the investee (early-stage planning vs. later-stage scale up). Nat Sloane thinks the next phase of evolution could be to divide people by stage i.e. some people will spend more time with charities on planning while some others will focus on taking the organization to scale. The new division reflects the different skillset required for supporting investees in different stages of development, and is no longer connected to the dichotomy social vs. business/financial sector backgrounds.

Allowing management to take risk while ensuring a proper governance

Many VPOs started with limited resources and without a clear model for how the governance should work. There were few professionals with the 'right' experience and often the boards were heavily involved in anything from fundraising to making investment decisions, and in some cases with board members acting as the mentors of specific investees.

Governance has been an issue that has created some problems in the case of the **One Foundation** in Ireland, as explained by Deirdre Mortell. The role of the 'Advisory Board' was not very clear at the beginning. In many other aspects, the One Foundation implemented the same approach and processes as New Profit Inc., one of the first VPOs established in the United States, but in the case of governance, the New Profit Inc. model could not be replicated as a major function of New Profit's board was fundraising (which was not needed in the case of ONE). The initial ONE board was composed of people who had shown an interest in the new initiative, mainly Declan Ryan's contacts, and they became heavily involved in particular investments, working closely with the staff of the One Foundation. As is typical in start-ups, 'active' Board members were needed. The problem with working so closely with the staff was that they did not always have enough distance to advise on more strategic decisions requiring a helicopter view. It was also unclear to both staff and to Deirdre what the role of the board should be which created confusion at times. Investment decisions could become muddled because the board made decisions that were not aligned with management recommendations. So what happened was that over time, as ONE matured and moved out of the start-up stage, some people left the board, and some new people joined who were less actively involved with the investees, and operated more at a distance. The time required of them was also less than had previously been expected, with less frequent meetings and more structure.

As the sector evolves, the management teams gain experience and become more professional. Thus Wolfgang Hafenmayer, founder and managing partner at **LGT VP,** believes that the management team should have increasing decision-making power as opposed to the board of director. Too much power in the board may prevent the VPO from making investments that the board perceives as too risky because it does not know all the details

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that the management team does. There is a risk in doing too little in VP/SI, thus passing on opportunities that could have had tremendous societal impact.

Deirdre Mortell from the **One Foundation** stressed the importance of building the culture of a VPO centred on the 'permission to make mistakes'. At the One Foundation, peer reviewing and peer learning were core elements, as evidenced in the fact that all new investments had to be approved by the entire team in a private review process. There was also a problem solving slot available each month in which staff were encouraged to share a problem that they needed advice on how to solve. These various practices contributed to building an atmosphere of trust and collaboration. A highly competitive environment can be a risk in VP and who carries the risk is the investee.

According to Erwin Stahl, founder and managing director of **BonVenture**, from the experience of the first two funds the VPO learned that it is important not only to have a diversified team of people, but also to give the management team more decision-making power. Erwin believes that team members will have better vision and motivation if they can decide what the company is doing. Also, there is more experience and knowledge about the sector in the team than among shareholders as team members are in the field and in touch every day with the social enterprises. For BonVenture's third fund, the board will no longer act as investment committee. The investment committee of the third fund will be composed of a maximum of five people, including two-three people who are investors, one or two external people and one or two people from the management team. The fund will be run using a partner model where team members will have shares of the management company and will be able to provide guidance on the strategy followed. Erwin also stresses that BonVenture will remain a social business and that any profit will go to BonVenture's foundation structure.

Other Key Stakeholder

The following challenges were identified when dealing with other key stakeholder groups in VP/SI:

- Reticence to engage with government needs to be overcome to achieve systems change.
- Difficult but necessary to engage stakeholder groups in governance of investees.
- Need to manage expectations of pro-bono and volunteer contributor.

Reticence to engage with government needs to be overcome to achieve systems change

Many VPOs have started engaging with the government only in recent years, as evidenced by the surge of social impact bonds and the increased policy debates involving VP/SI practitioners. Nat Sloane at **Impetus Trust** explained that there was a deep reticence to engage with the public sector in the early years (2003–2010). In two occasions Impetus had to back away from interesting projects due to uncertainties regarding the duration of government funding (1–2 years), if the funding itself would be sufficient and how involved or intrusive the government would be. As the approach and strategy at Impetus shifted from proving VP could work to how to use VP to drive change, Impetus became more cognisant and comfortable with the fact that it would have to engage with government to drive social impact and change in the long-term. Impetus found that to generate impact to a certain scale – e.g. reducing reoffending – it was not enough to work with a SPO working with one-quarter of the English prisons: the whole prison sector was to be involved if what was sought was systemic change. However, the level of resources (money, expertise, access to policy makers) required implied the government had be involved as a party. For Impetus, this was a shift in the level of ambition. They needed a few years to prove the concept so as to be a credible partner to government as well as to increase their self-confidence, but when they manage impact was generated.

Difficult but necessary to engage stakeholder groups in governance of investees

Beneficiaries are a stakeholder group difficult to involve. However, in order to make sure beneficiaries' needs are met so that impact is truly created, it is necessary to engage with this stakeholder group. Stakeholder analysis is an important component of impact measurement as well. **Noaber Foundation** has found that it is difficult to engage beneficiaries, for example parents of children with ADHD, in the governance of investees. It is difficult to find a person to really represent the group of beneficiaries and it is hard to get them engaged. It is important to keep the best interest of this stakeholder group in mind and involve them, but they do not have a financial incentive, there is information asymmetry, and it is difficult to engage them. A solution is to try to include stakeholders groups by providing them with incentives, e.g. by making them shareholders.

Need to manage expectations of pro bono and volunteer contributors

The VP/SI sector counts on a number of pro bono and volunteer contributors to provide non-financial support to investees. **Inspiring Scotland** works with a large number of pro bono and volunteer contributors; their current pool is 200 volunteers and the challenge is to keep the pool as active as the volunteers would like. The assumption of the volunteers is that their skills (law, accounting, etc.) will be needed right away whereas the reality is that they are working with around 80 ventures and only look to fill the gaps in their professional needs. As Andrew Muirhead at Inspiring Scotland explained: 'People can sit in the pool for months without active engagement, we need to be more effective in managing expectations as they don't have an immediate gratification for providing their time'. To deal with this issue, Inspiring Scotland has hired a full time pro bono manager to build communication and education and to manage the relationships with the pool of contributors.

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Misalignments in the investment strategy of the VPO

The investment strategy of the VPO

VPOs are vehicles that channel funding from donors and investors to selected social purpose organisations (SPOs). The investments are made according to an investment strategy developed by the VPO. Broadly speaking, the investment strategy of the VPO is composed of six main elements, as illustrated in Figure 10.

Elements of the investment strategy:
1. Investment focus
2. Models of intervention
3. Type of SPO
4. Financing instruments
5. Co-investment policy
6. Non-financial support

Figure 10: Elements of the investment strategy

The investment strategy of the VPO flows from a set of choices that determine its focus (1) and its objectives (2). The investment focus and the preferred models of intervention of the VPO will influence the type of SPO that will be supported (3), in terms of type and stage of development of the SPO. VPOs have small portfolios – the sector average is 24 and the median is 14 per VPO[44] – and maintain active relationships with each of them. The choice of the type of SPO to fund and financial return expectation of the VPO will determine the financing instruments used (4). VP funding instruments are similar to the ones used by venture capital, with the addition of grant and grant related funding. Often VPOs decide to co-invest with other funders in order to raise more funds for VP activities, promote VP activities among a wider audience and spread the risk (5). The last important element of the investment strategy is non-financial support. In addition to financial support, VPOs provide value-added services, such as strategic planning, marketing and communications, executive coaching, human resources advice and access to other networks and potential funders (6).[45]

In the next paragraphs we will go through each element of the investment strategy and analyse where mistakes can be made, using examples from cases shared by EVPA members.

Investment focus (sector, geography, etc.)
The first element of the investment strategy is the investment focus. The VPO determines the sector and the geographical areas it wants to invest in. A general comment in terms of developing the investment focus is to be prepared to experiment and evolve and to accept a certain degree of uncertainty and some failures. In what follows we outline some general observations about the evolution of VP/SI in terms of geographic and social sector focus, and then highlight the main considerations in terms of risks and examples of mistakes and failures.

44. **Hehenberger, L., Boiardi, P., Gianoncelli, A.,** 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.
45. **Balbo, L., Hehenberger, L., Mortell, D.** and **Oostlander, P.,** 2010, "*Establishing a venture philanthropy organisation in Europe*". EVPA.

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Geographical choices

VPOs need to define the geographical scope of their activities. According to the EVPA industry survey, European VPOs tend to invest in their home country or in developing countries. The VPOs surveyed mainly invest in Western Europe (65% of funding) and in Africa (11% of funding).[46]

VPOs that adopt an international focus face additional costs and management complexities in comparison with those operating within a single national jurisdiction. **LGT VP** points out how the specificity and technicality of legal requirements vary across different geographies; the legal peculiarities of an investment are not pertinent to another, which means the VPO will have to summon external legal support for any step further it takes when performing the investment process. This means that in each deal there is a lot of negotiation on terms and a high requirement for legal support. Engaged portfolio management is obviously more complicated if the investee organisations are dispersed across several countries, while the development of an overseas network is necessary to maintain deal flow.

A market study is normally required to understand the relevant demographics and the quantity, quality and size of potential investment targets. To ensure that the VPO can invest selectively in high-quality organisations, the number of potential investments should significantly exceed the total number of investments required to fill the portfolio.

Social sector choices

Most pioneer VPOs focused on demonstrating the VP model rather than on targeting a particular social sector. Having a broad-based portfolio allows a start-up VPO to appeal to a wide variety of stakeholders. As the VP industry becomes more established, many VPOs have started to focus on one or several social sectors, recognising the importance of sector-specific knowledge to better assist their investees and to leverage the VPO's resources.[47]

Economic and social development, education, research, health and culture and recreation are the sectors that have received most attention by European VPOs in the past year.[48]

Investment focus can be a limitation when not enough deal flow – be ready to bend or change the investment model

The investment focus can be a limitation both on the geographical side and on the sector side. **LGT VP**'s philosophy has always been to target a wide array of sectors and geographies. Wolfgang Hafenmayer, Managing Partner of the organisation, thinks the market is still too small to be overly focused. For VPOs operating in a small market where the social sector is still undeveloped, focussing on one specific sector may be detrimental as the deal flow would be too limited. In such markets, it is important to be flexible in terms of the investment focus to find the right deal flow. **The One Foundation**, for example, highlighted the limitations of operating in a small country such as Ireland. Although the foundation had decided to focus on providing growth capital to established organisations,

46. **Hehenberger, L., Boiardi, P., Gianoncelli, A.,** 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.
47. **Balbo, L., Hehenberger, L., Mortell, D.** and **Oostlander, P.,** 2010, "*Establishing a venture philanthropy organisation in Europe*". EVPA.
48. **Hehenberger, L., Boiardi, P., Gianoncelli, A.,** 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.

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Deirdre Mortell, co-founder and former CEO of the One Foundation, explained that ONE was forced to 'bend the investment model' on occasions when it realised that there was not enough pipeline available. In some cases, the One Foundation had to invest at the start-up phase because there was no mature organisation dealing with the social issue at hand. As Deirdre Mortell mentioned, when you start as a VPO 'you don't know your market', and it is a constant learning process. Another situation that a couple of VPOs mentioned as being difficult was when they were obliged to work with a 'difficult organisation' because they were the only option to deal with a particular social issue in a small geography.

Keeping the strategy flexible can also mean not covering the entire geographical scope set out in the investment strategy: investing for the sake of complying with the chosen investment focus may reduce the quality of the work. **BonVenture**, for example has Germany, Austria and Switzerland as a geographic focus. However, in the first years, it was very hard to find good investment opportunities in Austria and Switzerland. As a result, most of BonVenture's investments have been undertaken in Germany and only recently has Austria provided some interesting opportunities.[49] Thus, BonVenture has preferred not to invest exactly according to its initial strategy because it does not want to make sub-optimal choices.

For **NESsT** the pressure to comply with its investment focus derived from the fact that the funding was restricted and obliged NESsT to make a certain number of investments in the geographies where it was present. Between 2006 and 2007, NESsT went through a considerable extension of its geographic investment focus, going from 5 to 10 covered countries and committing on building solid portfolios in each one of them – a commitment which proved to be hard. As Nicole Etchart, co-founder and co-CEO of NESsT explained, 'You can work in 10 countries, but not always at the same level of success. If you raise expectations and funding, you may need to accept organisations that don't cut it. The problem is accentuated when the funding is restricted in terms of geography – it does not allow flexibility'. A recent strategic shift for NESsT based on this experience was to reduce the number of countries and going deeper rather than wider.

More focus on specific social sector/thematic areas to generate and demonstrate impact

Many VPOs have developed a stronger social sector focus as they have grown and matured. **LGT VP**, although staying fairly broad in its investment focus, has still decided to push knowledge generation in a few sectors. **NESsT** recently started to focus on three impact areas that affect marginalised communities: labour inclusion, sustainable income, and affordable technology. The logic is that the solutions can be more scalable if focused. In terms of funding, Nicole Etchart believes that the impact areas are transversal enough to fit many donors' interests, so that the new strategy will open new rather than close doors. Similarly, the **Shell Foundation** has always focused on particular issues and geographies, but now they are much tighter and are increasingly restrictive to a few focus issues, although within those issues they look at a range of options. In fact they started with a focus on five issues, but now only focus on three. This increased focus enables them to build further

49. At the time when the interview was recorded BonVentrure had 15 investments in Germany and 2 in Austria.

and deeper networks and partnerships, to leverage parent company support as well as to develop more thorough knowledge and understanding of the sectors.

Oltre Venture selected its investment focus – microfinance, social housing and healthcare – based on the exploratory work of its foundation and has developed expertise in those areas. Thanks to this strategy investments in those areas have been successful.

Since **Impetus** initially wanted to see if VP could work, in the first years it did not focus its strategy on any specific sector, but looked more generally for SPOs that were at a critical step change – and therefore more willing to engage with venture philanthropy. As Nat Sloane explains, 'with that in mind, we took a broad, permissive view, so we could invest in any mid-size organisations not involved in art, animals and religion'. Using this approach, after a few years Impetus had a broad portfolio. As they started getting more confidence that the VP model worked, they then started asking themselves to what end they were using this model. The trade-off seemed to be between funding 100 mid-size organisations getting bigger and doing a bit more vs. focussing on a few key sectors where Impetus could drive more change. Impetus chose to pursue this second strategy and at first it decided to focus on economically disadvantaged people, which then developed into a focus on clear outcomes through education, employment or training. Impetus then picked a couple of sector verticals – e.g. early years and re-offending – based on knowledge and on the significance and size of the problem to solve. Currently following the merger with the Private Equity Foundation, Impetus-PEF has fine-tuned its investment strategy and now focuses on UK's 2m young people from low-income backgrounds who are specifically disadvantaged by their lack of educational attainment and employability skills.

Noaber Foundation has significantly narrowed its sector focus in the last few years. As Matthijs Blokhuis, its managing director, explained, Noaber started with a broad scope, adding areas where it had no expertise, for example financial inclusion. In 2011, Noaber Foundation changed its strategy to focus exclusively on healthcare. An important reason to focus on a specific sector is that part of the value is generated in the interaction among investees and the role of Noaber is to connect and enable synergies to create impact at aggregated scale. Therefore Noaber has started to develop its own Theory of Change for the foundation as a whole based on a mapping of new investees to assess how they add value to Noaber – and to think about collective impact. Noaber's sector focus is working for the moment, but it might change in the future: the purpose of the foundation is to start off new innovation, so if it turns out in a few years that healthcare is no longer relevant, Noaber does not exclude refocusing its investment strategy towards areas that could enable it to create collective impact in a similar way.

The importance of building knowledge between investees is a point also stressed by **Inspiring Scotland** that took a sector approach from the beginning as it feels that a broad focus doesn't provide the leverage benefit of bringing sector specific organisations together. Celia Tennant, CEO of Inspiring Scotland, explains that IS's sector focus has become even

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stronger over time. IS has built internal sector expertise over time and found that small portfolios work better than big ones. In the past, IS often had portfolios of around 25–30 that worked 'reasonably well'. However, IS realised the portfolios could work even better when for one of the funds, it needed to exit 19 investees through necessity, and kept only 8. This reduction in size turned out to be a positive move for the investees that stayed because Inspiring Scotland was able to convene the smaller group more regularly, provide more efficient training and better support. The learning from this development meant a shift in strategy for Inspiring Scotland. Currently Inspiring Scotland is fundraising for two new funds using this new 8–10 organisation portfolio model with a very focused sector approach and high level of added value for capacity building.

Models of intervention of the VPO

VP/SI generally targets organisations that are young and need start-up capital, or with a proven track record that need support and money to grow and scale up, or that are at an inflection point and could benefit from a restructuring or merger. The learnings from the pioneer VPOs interviewed provide some useful lessons for the sector in terms of models of intervention. They often question the idea of achieving impact by investing in many small organisations, but rather see the need to invest more heavily in a few organisations of a particular type that can achieve massive and potentially disruptive impact. Finally, a major issue is how to combine social return and financial sustainability and the need for patient capital with long time horizons to achieve change.

Invest more massively in the winners – that can scale up massively

The combined **Impetus-PEF** entity will have more resources, and will be able to stick longer with organisations that have demonstrated they can scale up – and then think they have the potential to scale up massively. Nat Sloane asks the question: 'Why wouldn't Impetus-PEF stick with them?'. Impetus wants to find the 'google' of the social sector in the UK rather than work with a wider range of smaller organisations that can do good things but probably not reach an impact to drive significant social change. The aim is to put more and more resources into scaling successful organisations. As an example, in 2007 Impetus invested in "IntoUniversity", which focuses on how to raise the aspirations of young people from disadvantaged backgrounds to think about university. The organisation started working with two church-based community centres in West London, then scaled up to nine centres by 2012 and now sends hundreds of kids to university. Now the organisation has the potential to scale to a national level, so it is looking at scaling further, and looking at a different delivery model, working with major universities across England. This way, a VPO can behave a little like a VC, knowing that not every organisation funded is a 'google', but when a potential google is identified, the best strategy is to stick with the organisation and drive it to scale.

At the same time, there is a need for players that are ready to invest in market development to reach scale. Chris West explains that **Shell Foundation** can fill a gap in the market and take early stage positions creating deal flow for impact investors but it needs to do more on tackling the wider market barriers faced by pioneer social enterprises. It's the case with all investees that as they grow they encounter market barriers such as issues on finance, social marketing, distribution channels etc. Investors are generally not in a position to tackle or assist with these issues but not doing it is a hindrance to the social enterprise's success. Chris believes that the Shell Foundation will fail to achieve its objective of scale unless it gets involved in market development or market reform. However successful the SE, it can only go so far and have so much impact unless social investors can work with governments, corporates and non-profits to fundamentally change the ecosystem.

Shell Foundation's investments in clean cook stoves is an example of this issue. From 2002 to 2007, Shell Foundation invested over $20m in nine pilots across Asia and Africa to test possible solutions to the issue of inefficient cooking in developing countries. All pilot projects delivered local benefits but they failed to demonstrate any potential for scale or viability – typically due to a lack of management capacity to develop a viable and appealing value proposition and execute business plans effectively. At the time there were no social enterprises focused on clean cook stoves and the only players were the state and non-profits. These entities were not natural manufacturers, distributors nor vendors of the product. In 2007, Shell Foundation used the learning from these pilots (related to consumer desires, fuel choices, cooking styles and available technology) to identify a global partner with the right skills and background (Envirofit[50]) to co-create a global clean cook stoves business that has now benefited over 4 million people. Shell Foundation also worked to tackle a range of barriers at a sector level: access to carbon finance, creation of routes to market, social marketing and the co-creation of the Global Alliance of Clean Cook Stoves to set international standards on what is 'clean' for a cookstove, help leverage finance into the market, codify best practice and support new entrants. In 2014, Envirofit converted to a for-profit business in order to access commercial funding, with Shell Foundation providing a guarantee to mobilise new investment capital. The investment in market development and in the entire eco-system around the issue was necessary to reach significant scale.

Restructuring as a model of intervention rather than through necessity

Sometimes, VPOs need to help their investees to go through a restructuring process due to necessity. However, restructuring can also be a conscious strategy. **King Baudouin Foundation**'s VP fund has worked with three cases of restructuring already. According to Benoit Fontaine, 'if you can help it is a complete revolution, and the organisations are very open for the change because they know there is no other way!'

Use patient capital to find the right balance between financial sustainability and social return

According to Luciano Balbo at **Oltre Venture**, a major issue is how to combine social return and financial sustainability. There is a temptation to take short-cuts to sustainability – with a trade-off on the social impact side and this is a big risk in the exit process. Patient capital is needed to manage the trade-off, not to fall into the trap of seeking short-term financial

50. www.envirofit.org

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goals to the detriment of the social return. Wolfgang Hafenmayer at **LGT VP** concurs that investors must be prepared to finance long-term and be patient, but pushy. Patient Capital is the term that Olivier de Guerre from **PhiTrust** uses to describe financing the abundance of small projects that still dominate the social investment landscape, as that it takes time for these organisations to grow and develop.

Matthijs Blokhuis at **Noaber Foundation** explains that the 'valley of death is deep and long. 10 years is not a short period (before commercial investors can be interested)'. Noaber's role is enabling the company to start and to build the organisation in such a way that it is strong, scalable and has impact. Once the company is running and it no longer needs Noaber, it can exit or – at least – to leave the lion share of any follow-on investments to other, more traditional, investors.

Chris West at **Shell Foundation** reiterates the need to be very patient! A key risk for social investors is in the very nature of a dual objective of financial sustainability and social impact – if they are not patient enough with the financial sustainability part they might create or support business models that are not generating social impact. The balance point in all this is how to maximise social impact and get the maximum financial impact without giving too much emphasis to one or other. You also have to be realistic as some of the early adopters who initially take advantage of services aren't necessarily the poorest of the poor. Once the early adopters become more entrenched then the reach of the product or service can deepen to other sectors of society. By way of example, Shell Foundation originally thought 3–5 years would be a suitable term of involvement – they now believe it can take 7 to 12 years of support to pioneers to create and scale a disruptive solution, achieve financial viability and catalyse inclusive market growth.

Types of SPOs

The EVPA survey[51] shows that VPOs invest in a range of investee organisations, and that a majority of the funding still goes to non-profit structures.

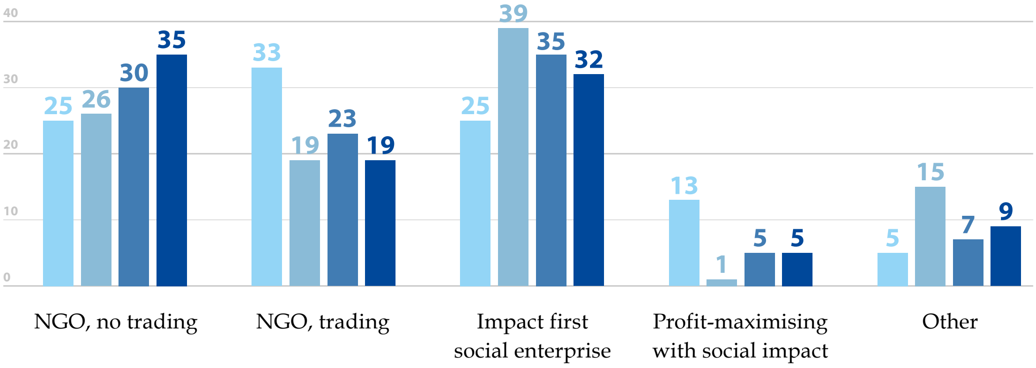

Figure 11: VP/SI Spend (€) by type of investee FYs 2011–2013

2013 n=82
2012 n=64
2011 n=51
2010 n=44

numbers in %

51. **Hehenberger, L., Boiardi, P., Gianoncelli, A.,** 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.

Non-profits are difficult to move to self-sustainability

Our interviews with pioneer VPOs indicate that non-profits are difficult to move to sustainability and the ability to generate earned income, regardless of legal set-up, is an indicator of the investee's potential to generate impact at scale. Nicole Etchart at **NESsT** explains how difficult it has been to move non-profits to self-sustainability, which was the original strategy of NESsT: 'Some don't have the necessary entrepreneurial capacity… we should have exited earlier in the process'. The difficulty of moving non-profits to sustainability is an experience shared by **Oltre Venture**. As Luciano Balbo explains: 'For non-profits, you need to provide a new grant every year, it is not sustainable, and in many cases never will be. The mentality of the non-profit sector is very difficult to change'. Oltre has invested in two types of organisations: for-profit companies and revenue-generating non-profit organisations. There has been no major issue with the for-profit companies, but there have been many problems with the non-profits. Non-profit orgnanisations are not prepared to develop entrepreneurial businesses (which is what Oltre is trying to do), and as a minority shareholder it is difficult to tackle problems, change management and change the skills. In healthcare, for example, Oltre has made some small investments in cooperatives, but soon realised that the structure of these organisations made it difficult to have any influence. Additionally, because of the nature of the organization – service is the objective, not financial sustainability – cooperatives overestimated the business plan because they wanted to be financed. Therefore, Oltre changed its strategy and decided to focus on for-profit governance structures.

Investee earning income as indicator of potential to deliver impact at scale

After many years testing different strategies, Chris West at **Shell Foundation** has concluded that 'having a for-profit structure completely changes your understanding of your target market: is it the customer or is it the funder? Within a for-profit structure you have a natural incentive framework to constantly understand whether you are giving the best quality service, this is a very different mind-set to non-profits'. Though Shell Foundation does support non-profit organisations, these tend to be early-stage entrepreneurs who have formerly established NGO structures to attract grant capital, or global institutions who are working to create a better enabling environment to support the growth of inclusive markets.

In either case his view is that earning income (by producing a product or service that customers are willing to pay for) is an indicator of potential to deliver sustainable impact at scale – by achieving financial independence and unlocking different forms of social investment and private capital to fund expansion.

Importance of investing in early stage SPOs – but incubators are not the answer!

Having to rely on short-term funding is an issue for any VPO, and becomes a real problem for VPOs funding organisations in the early stages of development, such as in the case of **NESsT**. The stage of development (early) calls for more patient capital and this reduces the amount of funding possibilities.

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The ecosystem is slow in recognising the importance of the early stage. On the agenda more than ever, NESsT has some publications (Social Enterprise in Emerging Market Countries: No Free Ride[52]) on what needs to happen in the ecosystem to allow for these early stages enterprises to really thrive. Positioning this topic on the policy agenda[53] is of vital importance, as it is still not on the agenda in many countries, and it's unlikely that without the support of the public sector, these businesses will be able to reach their fullest potential.

Several interviewees agree that incubators are not the solution to the gap in early stage investment. According to Luciano Balbo from **Oltre Venture**, the problem is *how* the money is invested: 'There are hundreds of incubators in Europe while the offer of good projects is so small! Spreading out the money to organisations that are average is not useful. It is better to focus on a few good projects and invest equity. In Italy all incubators are producing (and have produced in the past) very poor projects. Incubators do not have any vested interest in the later developments of a company. Investors need to take a risk and follow the company after the incubation. Incubators don't work this way in Europe!'

Wolfgang Hafenmayer adds that 'the ideas that come out of the incubators in Germany and Switzerland are not very good'. Wolfgang also discussed **LGT VP**'s own experience of setting up and running an accelerator in South East Asia. The idea was that the accelerator would generate deal flow for LGT VP. Now in its fourth year, it has generated 11 small investments whereas LGT VP first thought it would generate 50 to 100. According to Wolfgang, the incubator solution is often overrated and it is not solving the needs of early stage social enterprise. 'Everyone who did incubation work should be more honest about the rate of success of the incubation work. Most of them have huge marketing machineries, and they report only on how many people they push through their programmes, no one asking how many make it to a financially viable business model or are still alive after three years'.

Wolfgang further thinks that the best teams are not attracted by incubators. They have been successful before or they can attract capital differently. Additionally, often incubators are managed by people who do not have the experience themselves, are quite young and try to coach young entrepreneurs, which is one of the most difficult things to do! In the end if the team is good there is no need for an incubation period: the VPO can just go and invest in the SPO. Having a fund around it and more experienced people coaching the young entrepreneurs is fine, but a 'formal' incubator is not the answer.

Luciano Balbo believes that it would be better to use the same money used for incubators to start a fund that incubates only those projects that look promising for the future. A sort of seed and start-up fund, as there are many in the tech industry in the US, which accepts a different risk/reward ratio.

52. "*Social Enterprise in Emerging Market Countries: No Free Ride*", **Palgrave MacMillan**, New York, 2013, identifies eco-system opportunities that need to be supported in order to leverage the full potential of social enterprises.
53. NESsT´s most recent publication, "*Positioning Social Enterprise on the Policy Agenda: Road to Travel*" (2014, NESsT, Santiago, Chile), provides a framework for helping the public sector to recognize that social enterprise and impact investing are options to solve national social needs.

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Only disruptive (new) organisations – with the right attitude – can achieve scale and financial sustainability

Shell Foundation has conducted a thorough analysis of what worked and what did not work. Chris West explained that 'as a general point we have learnt that we need to look for 'disruptive' organisations if we want to fulfil our mission of achieving scale and financial sustainability. We have generally failed when we have supported existing solutions, and, as the entrepreneur risk is high (we invest in people not in business plans), we have sometimes failed because the entrepreneur was not fully aligned on the need to scale'. Shell Foundation stresses the need to co-found and co-develop new business and intermediary models that can achieve financial independence, be taken to scale and demonstrate the viability of new inclusive markets.

Olivier de Guerre from **PhiTrust** agrees that scaling can happen only if the SPO is *willing* to scale and *ready* to scale, and understands properly what scaling is and what it entails. **LGT VP** – which focuses on sustaining SPOs in the scaling stage – has quite some experience in this. For LGT VP what matters is the attitude of the whole investee management team – do they really want to reflect, change and scale?

Umbrella organisations complex to assess performance

King Baudouin Foundation had some negative experience of working with umbrella organisations with no direct link to the individuals working on the ground. Benoit Fontaine, who runs KBF's VP fund, explains that it is more complex to check the success with KPIs of such organisations and has placed a limit of maximum 20% of such organisations in its portfolio of investees.

Financing instruments

In line with the trend in the EVPA survey results pointing towards greater use of financing that can generate capital repayment and sometimes even a positive financial return, the interviewees expressed some frustration with the use of grants, although they reiterated the continued need for this financing instrument. They also explained some issues they have encountered when using equity and debt instruments.

Issues with grants

Difficult to control what grant money is used for

Erwin Stahl at **BonVenture** has had difficult experiences when working with grants in terms of the control the funder can exert on the investee: 'With grants, once a grant has been paid, there is no possibility of controlling what the investee does with the money, there is no penalty or sanction for misuse. You cannot have a contract for a grant'. Similarly, Olivier de Guerre from **PhiTrus**t points out that 'if a grant is provided to finance the investee, the social entrepreneur cannot expect to make money until the business model is self-sustainable'. By disbursing the grant according to milestones, or by requesting matching grants, more control can be gained over the process.

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Grants are not always suitable for investee's needs

When grants are not the most suitable way of funding an investee, other financial instruments should be used. Grants do not make sense for some types of needs – for example when funding working capital or buying a building for which a loan can be secured against the asset. **NESsT** has begun to introduce financing instruments other than grants, e.g. Infrastructure and growth loans, working capital loans and recoverable grants that are repaid once milestones are reach. Such funds will help the portfolio to begin the growing process and in some cases help them to become investment ready – while also recycling funds back to NESsT.

Grant model is not sustainable and you need a lot more money to make a difference

For Luciano Balbo at **Oltre Venture**, the main problem with grants is that they are needed forever, and are not sustainable. 'With grants you need a lot of money to develop something new. With an impact investing approach you can do more, leverage money more'. If the investment is successful, the leverage is much larger, and the new model can be developed.

…but grants are essential to fund early-stage, high-risk organisations

Despite all the issues, the fact remains that grants are still the number one financing instrument used by European VP/SI organisations by total spend, according to the EVPA survey[54]. According to Richard Gomes at **Shell Foundation**, 'there is a vast number of excellent innovators out there who can benefit from grant funding to test and validate new solutions. They need the right type of early-stage, high-risk grant (plus business support and market links) to enable them to become investable propositions'. According to Richard, 'the issue is not with the lack of interesting grant deals; it is rather with the way grants are being used (i.e. not as risk capital)'.

Issues with equity and debt

Easier to fund at beginning with convertible loans than with equity…

In Wolfgang Hafenmayer's experience at **LGT VP**, it is easier to fund a project at the beginning with convertible loans instead of equity, as one can then avoid lengthy valuation discussions. When investing in early stage companies valuation discussions are inherently difficult. Exit can also be difficult from an equity investment when there is no clear exit market.

… but avoid compulsory convertibles

Furthermore, Wolfgang recommends avoiding compulsory convertibles as 'if you have to convert at a higher valuation than you would normally want to then you are not in a good situation'. To avoid this issue **LGT VP** only invests in convertible notes without the obligation to convert.

Think early about bridge financing and what it means for the capital structure of the SPO

When investing via a convertible note, the organisations may not develop as fast as first thought, which means additional bridge financing rounds are required. **LGT VP** has faced in the past the situation where there are too many convertible notes so very little new

54. **Hehenberger, L., Boiardi, P., Gianoncelli, A.,** 2014, "*European Venture Philanthropy and social investment* 2013/2014 *– The EVPA Survey*". EVPA.

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money comes into the SPO at an equity raise. Their learning is to think earlier about bridge financing and what it means for the capital structure of the SPO. This may result in it being preferable to raise an equity round earlier if you really believe in the SPO. These points should be discussed upfront with any co-investors.

Co-investment policy

Co-investment has advantages – but make sure co-investors' objectives are aligned with yours

Many VPOs co-invest as a means to leverage their limited resources and share risk with other funders. The latest EVPA survey reported that on average VP/SI organisations co-invest in 66% of the cases; 67% of respondents have co-invested in the past and 14% say they are interested to do so, even if they have no done so yet.[55] An example of co-investment comes from the work of **Inspiring Scotland**. According to current CEO Celia Tennant, Inspiring Scotland is able to leverage around a double the amount that it invests through co-investments: 'The size of the funds available is doubled thanks to this leveraging effect, which means that much more impact is generated!'. The leverage effect is also why the Scottish Government supports Inspring Scotland's work; the money the Government gave attracted another 8–10m to support the social causes.

The interviews on failures revealed that it can be risky to invest with co-investors that do not have similar objectives. There were several accounts of difficulties arising during the investment period when co-investors prioritised financial return above social return (or due to other misalignments). **PhiTrust** explains that one major failure occurred when it invested in an organisation that had other non-socially oriented investors. When the deal needed to be restructured or refinanced, it was difficult to reach an agreement due to the misalignment in investor objectives. This led to one portfolio write-off and one difficult – but ultimately successful – exit. Given this experience, PhiTrust now only co-invests with other social investors, as a way to mitigate potential risk. This strategy also implies that the organisation is forced to pass on some potentially profitable investment opportunities. A specific example of misaligned goals among investors relates to an equity investment the organisation made in a company dedicated to providing a service to help reduce electricity costs in social housing. PhiTrust's overarching motivation was the social impact the technology could have, but a few other investors were more driven by the financial prospects. When it came time to reinvest in R&D, the misaligned goals became clear, and the company had to fold. In addition to losing the promising idea of the company itself, additional, 40 members of staff were made redundant. In another example, PhiTrust invested in an organisation that had clear social objectives but continual financial losses. The co-investors all had the same objective, and worked together to invest the necessary time and resources in order to reinforce the management and turn the company around.

55. ibid.

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Similarly, a failure for **Noaber** was an investment in a financial inclusion organisation: there was a problem of insufficient information on the sector, but also of misalignment with the co-investors. Noaber invested €500,000 in equity upfront. The other investor was an impact investor but less concerned about the impact. The investor provided a subordinated loan of €1,250,000 with €250,000 upfront and the rest against milestones. The other investor decided not to provide the follow-on funding and the company went bankrupt. The conclusion was that one should only go in with other investors when the same conditions apply to all co-investors. Noaber co-invests if it can partner with organisations in the same field (healthcare).

According to Wolfgang Hafenmayer, for **LGT VP** issues with co-investors come down to differences in how seriously they take the SPO valuation. Foundations and other more socially oriented funders may not care about the level of the valuation versus LGT VP's slightly more 'pessimistic' investor view. This can result in LGT VP missing out on a deal as the SPO will generally go with the higher valuation. The opposite problem can occur with overly commercial investors that push for tougher terms and lawyers that can almost kill the deal as they are not sufficiently 'social' in their approach. However, the situation is never black and white, and it is difficult to know when these types of issues will lead to problems and when not. In Wolfgang's experience sometimes you can agree with different types of investors on terms and valuations and sometimes you can't (generally in cases where investors are 'too commercial' or 'too social').

A seeming frustration for **LGT VP** is also when working with co-investors without a local presence in the geographies where they invest, which means that LGT VP does the 'job' and co-investors 'free-ride'. For Wolfgang Hafenmayer, it is vitally important to be on the ground and close to the company to add value. If co-investors are 'free-riding' disproportionately then LGT VP will monitor over time if the relationship is value adding, and if not they may stop co-investing with that organisation.

As reported in EVPA's research on exit strategies[56], a recommendation before engaging with co-investors is for the VPO to assess co-investors' investment strategy and objectives, financial/impact trade-offs and exit plans, to make sure they are compatible and aligned. A misalignment in the investment strategy of the co-investors can generate issues throughout the investment period and at the time of exit. **D. Capital**, for example, makes sure it builds strong relationships with co-investors before investing, to ensure that investor misalignments are avoided and minimise issues at the time of exit.

Non-financial support

Non-financial support is generally seen as a key component and value-add of the VP approach. However, the sector still struggles to justify the high costs of the VP engaged approach, as expressed above by **Inspiring Scotland**, and the challenge is still pending for many. The EVPA survey asked VP/SI organisations whether they measure the perceived

56. **Boiardi, P.** and **Hehenberger, L.,** 2014, "*A Practical Guide to Planning and Executing an Impactful Exit*". EVPA.

value to their investees of the non-financial services provided. Only 22% of VPOs measure this important data. Out of those VPOs that measure the perceived value of non-financial support, 74% reported that their investees perceive the non-financial services to be as valuable as financial support and 16% thought that non-financial support was more important than financial support.[57]

Another issue with non-financial support is how to provide it effectively when the operations of the VPO are spread out geographically.

Massive need for non-financial support - generally difficult to quantify its impact or value add

Chris West at **Shell Foundation** concurs that there is a massive need for non-financial support but the issue is that it is still very difficult to quantify its impact or benefit. The issue is that most businesses don't know what they need to know, so the role of investors is often to challenge people around things where they themselves are not aware that they don't have skills or competence. Unfortunately it is not usually a question of, 'We need support in issue x', but more a blend of challenging the entrepreneur and the team's preconceived ideas and then providing the support where needed. Shell Foundation is certainly trying to get smarter about how they deliver non-financial support and how they assess whether it has a value. Unfortunately, unlike financial support where financial returns can be calculated, it is difficult to quantify the value of non-financial support. So far they have only really done so in qualitative terms:

1. Inputs: Shell Foundation tracks inputs via people's time dedicated to an organisation as they don't generally outsource or bring in third parties where it is easier to track costs.
2. Outputs: these are much more difficult to measure. However, intuitively Shell Foundation knows the model works and non-financial support is important. It is just a matter of being smarter at valuating it.

Attempts are being made to better understand the value of non-financial support. **Inspiring Scotland** participated in an independent research study[58] conducted by Noah Isserman where Inspiring Scotland's 78% of the investees answered that they believed that the added value created by non-financial services outweighed the cost of those services. The **One Foundation** commissioned independent feedback from their grantees through a quantitative survey, carried out by Centre for Effective Philanthropy (CEP) every second year. The Grantee Perception Report® (GPR) shows an individual philanthropic funder its grantee perceptions relative to a set of perceptions of other funders whose grantees were surveyed by CEP. This report clearly showed that grantees placed a high value on the non-financial supports provided, and that ONE performed well compared to other (mainly USA-based) grant-makers on this measure e.g. ONE 'rates higher than 95% of funders for helpfulness of non-monetary assistance in strengthening grantee organisations'. It is important to note that ONE was the only VPO to participate in the study.

57. **Hehenberger, L., Boiardi, P., Gianoncelli, A.,** 2014, "*European Venture Philanthropy and social investment 2013/2014 – The EVPA Survey*". EVPA.
58. Additional details of the report that can be found here: http://evpa.eu.com/wp-content/uploads/2013/12/Inspiring-Scotland-report2013.pdf

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Link between non-financial support and social impact generation must be a clear objective

The **King Baoudoin Foundation (KBF)** invests in VP by paying consultants who go and work on specific capacity-building issues inside the SPO (from strategy, to governance and more operational issues). Benoit Fontaine at the King Baudouin Foundation explains how they have learned through failed investments that they could not create enough value in the organisation and could not see the clear link between the intervention of the consultant and the resulting impact, unless the consultants providing the non-financial support focused on strategy, governance and social impact assessment. More peripheral activities such as on the communication and marketing side of the SPO will no longer be the core part of KBF's value proposition. So, now the focus for KBF is only on strategic, core issues that will help the SPO generate greater impact. Furthermore, KBF will adapt the intervention on the basis of the level of development of the investee (i.e. start-up, growing phase, etc.). Benoit also highlights the risk of investing in too small an investee organisations that may not have enough 'absorptive capacity' to learn from the consultant offering the non-financial support, so that the consultant ends up doing the work as a finite project rather than transferring knowledge and advising.

Crucial to be close to investees for capacity building work – not just geographically

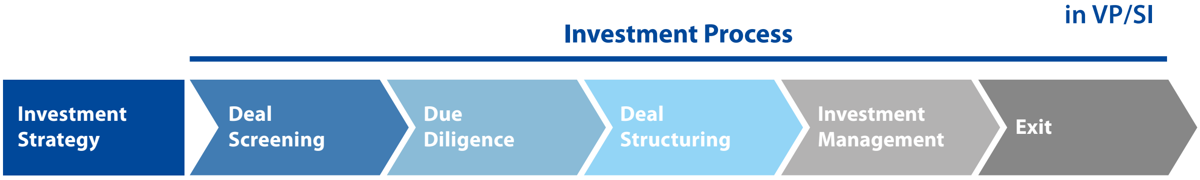
Erwin Stahl from **BonVenture** explains that, similarly to venture capital, in VP/SI, 'you can't invest as lead investor if you are not physically close to the investor (i.e. if you cannot reach it by train, car, etc.)'. Matthijs Blokhuis at **Noaber Foundation** agrees that you need to be geographically close to the investee: 'You need to have someone on the ground – or don't do it!' Noaber does not co-invest with someone with local presence to get around that problem and instead has local branches where they invest – in Israel, Netherlands and the US. Similarly, for Wolfgang Hafenmayer at **LGT VP**, 'local teams are essential for the success of the investment and for achieving impact'. **PhiTrust** echoes LGT VP's thoughts on the importance of local knowledge and contexts, and chooses to address this challenge by co-investing in social enterprises that are far away from their Paris-based team with other like-minded organisations who have a local presence.

Richard Gomes from **Shell Foundation** further comments that 'close partnerships and high levels of non-financial support are *crucial to risk mitigation*. It takes an intimate understanding of an SPO in order to provide the *flexible* support required for it to succeed – and to understand if further innovation is required or if the model is simply unviable'. Indeed, building close partnerships with the investees is at the core of the VP model and an effective way of knowing if the investment is on track or needs further support.

Failures in the execution of the investment strategy

For each investment, the VPO goes through an investment process as outlined below.

Figure 12: The investment process in VP/SI



Mistakes can be made at any point in the investment process: when screening and selecting new deals, when conducting due diligence, when structuring the deal, when managing the investment and when exiting. Identifying execution risk means that the VPO can learn to safeguard its activities so that mistakes can be prevented. Such mistakes may result in failed investments or sub-optimal outcomes of the investments.

Deirdre Mortell from the **One Foundation** raised the topic of execution risk in the second round of interviews, when reflecting on the trajectory of the One Foundation (which was a limited life foundation that closed after ten years at the end of 2013). These learnings are also reflected in the One Foundation's "*Impact Report*"[59] that reflects on 10 years of work. A key conclusion was that 'Most of what we got right was about Strategy, and most of what we got wrong was about Execution' (page 56).

From Deirdre's perspective, *execution risk* is in your hands to manage – and you can manage it well or manage it badly. She reflected that The One Foundation had sufficiently deep understanding of the issues it worked on (e.g. immigration) that it was able to identify and manage strategic risk, but if the investment strategy is not implemented well, things just don't work out well. This was the big learning curve for ONE in the first five years – how to identify and manage execution risk. It is important to consider and address them separately in the discussions. Most failures occurred in the first five years. For example, during its first five years, when ONE considered whether or not to finance an SPO, the investment papers included a section on risk assessment and risk management. In the second five years, this section on risk assessment was developed to consider separately strategic risk and execution risk. Here, ONE examined what the risks were and which plans were put in place to manage them. In some cases the risks could not be mitigated, but at least the board knew that the management team had thought about it and it had a mitigation plan. Concretely, the execution risk identified questions like:

- Have you made the right size of investment?
- Have you structured it right?
- Is it the right amount of money at the right point in time and structured in the right way?
- Do you have an exit strategy that is 'incentivized', not just written on paper?

59. **The One Foundation**, 2014, "*One 10 – 2004–2013 Impact Report*".

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- Is the management the right team? If it isn't, what can we do?
- Is the right board in place?

Chris West from **Shell Foundation** says it's important to note that supporting social enterprises that are doing new things in emerging markets is inherently risky. This means getting comfortable with some level of failure. As Shell Foundation explain in their 2014 report, "*Accelerating Access to Energy*"[60], 'The word 'failure' belies the iterative learning we gain when things go wrong. While we work to mitigate these risks through improved partner selection and due diligence, our view is that failure is a necessary step towards disruptive innovation. We believe failure is acceptable provided you learn, learn quickly and share lessons widely'. The foundation has several examples, from clean cookstoves to consumer financing gaps to last mile distribution, where the co-development of transformative solutions was entirely dependent on the learning of failed pilots and market trials. As an anecdote, Chris mentioned that he reported to the Board that in the last 7–8 years just under 20% of the capital invested was terminated because it didn't achieve scale and sustainability, i.e. the rate of failure was approximately 20% of capital. This appears a reasonable balance to him: a clear use of risk-tolerant capital to take risks while acting in such a way as to mitigate failures and deliver successful development outcomes.

In what follows, we will present some of the issues identified by the interviewees in terms of failed investments, elements of execution risk and advice on how to mitigate that risk.

Deal screening and selection

Challenge is selecting good opportunities and saying no to inappropriate ones

Finding opportunities for investments is not a challenge for **Shell Foundation**: the real challenge is rather to spot the right opportunities and to say no (an early no) to appealing but unpromising ventures. Even more difficult – and of utmost importance – is to distil this skill into a code of practice, that is to develop the knowledge and skills to have a feeling for what is right, a sort of screening skills apprenticeship. To achieve this ability, you will need to build up experience – and experience stems from attempts, or as Chris West puts it: 'It's like being a child in a sweet shop. In the beginning everything looks amazing and there are so many wonderful options – but as you grow up and try some you realize not all taste that great. It's important to taste some sweets that don't taste nice to be able to learn!'

Be careful when investing in new product or service…

Inspiring Scotland invested in a larger SPO that wanted to create a brand new product/service, based on what they believed would happen. Therefore the product / service risk was high. But due diligence also threw up an organisational fit risk on whether the management and board truly embraced the VP approach and would share and collaborate and grow etc. There was a high risk on 2 sides. Unfortunately the results were not at the levels projected and IS exited after 2–3 years. The learning for IS was that you can't as a VPO assume a high level of risk on both of these factors (product/service offering and organisational fit).

60. **Shell Foundation**, 2014, "*Accelerating access to energy – Lessons learned from efforts to build inclusive energy markets in developing countries*".

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LGT VP has also made the mistake of overestimating the demand for the service and product and therefore expecting too high revenues. An issue of being too optimistic on future market scenarios is that it leads to too high valuations and underestimating worst-case scenarios. **Shell Foundation** also identified investing in a new product or service (or new technology) as a leading cause of failure in their 2014 study *Accelerating access to energy*. Sometimes the technology just doesn't work or other new products or services are quicker to reach the market, or at a lower cost.

... learning through pilots is crucial in high risk activity

In **Shell Foundation's** experience, despite selecting a competent management team with an aligned vision, early failures can often result from a lack of market knowledge to develop an appropriate technology and product or service, especially when working in emerging markets. This creates a decision point – whether to provide larger and more patient support to continue to trial new customer offerings or whether to conclude the market is simply not there and exit. To mitigate this risk, Shell Foundation works to identify market failures then proactively seek partnerships with whom to test a variety of new high-risk solutions. They agree on relevant performance metrics (social and financial) which they track against agreed milestones, and use this data to validate demand and assess opportunities for growth. This then allows them to provide patient and flexible support to pioneer social enterprises with the greatest potential to scale.

Do not invest if you don't understand the sector or the country

Noaber invested in an organisation working on financial inclusion – with bank accounts in both Egypt and Nigeria. The initial setup consisted in €500,000 invested in cash and €10,000 in incurred expenses. Noaber did not have enough knowledge about the area and the sector and could not add enough value through its network. The company failed and went bankrupt. Noaber then facilitated a restart and found an investor with knowledge of the market to be able to add more value. This experience made Noaber conclude that it is wiser not to invest if you don't understand the sector, and it is even more important to avoid making investments in geographical areas where the VPO has no experience. In the specific case of the electronic payments' business in Egypt, Noaber's sub-optimal knowledge of the electronic payments business did not help, but ultimately the failure was due to Noaber's lack of understanding and presence in the Egyptian market. Noaber's inability to understand the culture, habits, politics etc. of that country was the main driver for failure.

Oltre Venture has a similar failure story. It invested in an organisation dealing with alternative energy in Southern Italy in 2010 and lost €1m. The company worked for three years, and then a sudden change in the legislation forced the company to close. What Oltre Venture learned from this experience was not to enter into an opportunistic situation without knowing the industry well. It is better to think long term how the investment fits with investment strategy and if the team can add value.

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Do not invest in businesses where the risk of not creating impact is too high

LGT VP recommends not investing in businesses where the risk of not creating impact due to the financial profile of the business is too high. In Wolfgang Hafenmayer's view, it is better to invest in a company where they already have impact from day 1, even if in the long term the business might not work out financially, e.g. investing in a health care company which is growing its reach from hundreds to thousands of patients. The business may not succeed after 5 years but you will still have had an impact on those patients.

Reduce risk of mission drift if financial and social drivers aligned

In 2005, **BonVenture** invested in JobTV, a start-up TV portal that offers jobs and activities for unemployed people – with the mission to promote employment and opportunities for less active people. In 2006, it shifted from TV channel to IPTV and launched a website. In 2009 it became a technical tool and software service to stream videos – no longer was social impact its main focus. It is now financially successful but generates social impact only with a small part of the activities.

Noaber recounts an investment it made in a microfinance asset manager. Noaber invested €130,000 alongside impact investors and is now selling its stake for €750,000 to private banks for a good financial return. When financial drivers are related to social drivers, the mission drift is less of a risk.

Do not invest to fill quotas – and without adding strategic value

Benoit Fontaine from **KBF** explains an example of a failed investment due to a need to fill a quota of investing in the French-speaking part of Belgium. It was a failure because the relationship with the director was not good and there was no real open attitude of trust. It resulted in the director not being transparent and saying that things were going well, when they actually weren't. Another consideration was whether the need that was funded was strategic enough. KBF funded the implementation of an IT system but later reflected that this was not strategic enough to call for KBF support.

Don't invest if VPOs' competences and SPOs' needs are not aligned

According to **LGT VP,** SPOs need different skills at different stages of development. It is thus important to know beforehand the SPO's strategy, what it wants to achieve and who is on the team. Aligning the added value the VPO can offer and the value-added the investee needs is crucial. Start-up and turn-around stages often cost more relative to the social impact achieved.

Due diligence

Understand investee governance (e.g. role of board) and protect yourself

Nat Sloane recalls that **Impetus** in its early days significantly underplayed the significance of charity boards vs. the CEO (as a 'backable' leader). Impetus took the view that as long as boards didn't do harm then it was good enough. This proved to be a mistake although not crippling. A key part of the SPO's resilience and capability is the calibre of the board along with the CEO. They were too fixated on the calibre of the executive leader. One example was when, two years in an investment, the CEO decided to move on because the growth strategy didn't fit what he was aiming to do. The board recruited a good new chief executive but the board didn't drive the search as effectively as they could have and Impetus hadn't built good enough connections with the board. Another example was an SPO that was interested in the elements of diversity on the board, but missed some of the skills needed, and then got into financial difficulties. If Impetus had been more active around board development, perhaps they could have avoided or mitigated the problem.

Similarly, **PhiTrust** mentioned as a failure case an investment in a hybrid non-profit/for profit organisation where essentially 3 years of the investment were lost due to a dysfunctional board, whose governance was dominated by one man who simply did not listen to anyone. Olivier de Guerre emphasized the difficulty in understanding the dynamics of the governance of an investee during a due diligence process. As a VPO, he mentions the importance of spending the necessary time needed on this issue before any investment occurs, and to not shy away from outlining changes in governance to be a condition of an investment. In general, social entrepreneurs – like classical entrepreneurs don't want to lose power. As a VPO, protecting yourself from the consequences of a bad governance structure is crucial.

Benoit Fontaine from **King Baudouin Foundation** reiterated the importance of looking at the governance of the SPO first because 'without good governance, nothing works'. He explained a story of failure where KBF invested in a two-year old umbrella organisation with two employees. Admittedly, KBF was 'charmed by the CEO' who left the organisation after one year. Then things went wrong and KBF paid €80,000 for a consultant to develop a strategic plan and increase financial resources by developing services for members and recurrent subsidies. The Chairwoman quit after six months and no other board members wanted to be chair. One of the KPIs defined at the beginning of the investment was to have a better board and governance in place. KBF now believes that it is too risky to invest if there is no governance to start with.

Conduct thorough due diligence on management team – management difficult to change

LGT VP has experienced some difficult investments where the founder and CEO were not able to manage the team. LGT VP's learning was that they had not conducted sufficient due diligence on the management team. It is easy to overestimate the capabilities and entrepreneurial spirit of the management team. Therefore, it is important to do extensive

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reference checks. Wolfgang Hafenmayer explains that LGT VP tries to avoid investing in management teams without significant relationships, as entrepreneurs will rarely manage to build a company without proper support systems.

Antony Ross at **Bridges SE** fund further explains that they invested in an organisation with an inadequate management team. The consequence was that capital and time were wasted in getting the right expertise in place; the management team is difficult to change.

Determine investees' readiness for VP approach – and manage expectations and needs

According to Olivier de Guerre at **PhiTrust**, social entrepreneurs need to understand that working with a VPO it is not always a comfortable path of least resistance, and expectations on impact, financial return, governance, management etc, must be clear from the beginning. Lack of clarification and unstated assumptions has led to difficult situations for PhiTrust that required a lot of individual attention in order to be surmounted.

Similarly, **Inspiring Scotland** has brought in SPOs that were not ready for the VP model (and focus on scaling) and didn't have the internal capacity to deal with it, which created challenges and tensions. Inspiring Scotland then tried to find the right type of funding partner (it took six months) who would be less challenging, less demanding and more philanthropic in nature. The learning was that Inspiring Scotland had been too keen to scale the SPO when they were not ready.

It is Chris West's (**Shell Foundation**) view that taking long-term bets with people requires something like a 'dating phase' to test each other out. Unfortunately investors tend to get married quite quickly to investees and then you have to learn to give, take, compromise, as you need to make it work! Taking the analogy further you could say that Shell Foundation has married around 30 people or more. To avoid problems you must be smart early on about whether a relationship will work and most importantly be aligned on what you want to get out of it. Openness is key. Chris doesn't mind if things go wrong, 'that's part of life, but it shouldn't be a surprise'! Transparency and the willingness to deploy resources to achieve a shared goal are vital. As Chris says: 'At the end of the day we're all people and to be effective and efficient we need to be smart in the networking and dating phase'.

Deirdre Mortell at the **One Foundation** adds that it is important to make sure that the management team of the SPO has the resources and the skills to do the job. If the team is inadequate (unprepared or too small), it is up to the VPO to identify this and seek solutions.

Deal structuring

Social entrepreneurs cannot always be trusted – VPOs need protection through contracts

One of **BonVenture**'s failed investments was in a non-profit organisation that set up a for-profit company as a supplier to the non-profit organisation. The learning from this experience was that social entrepreneurs are not always 100% good people and the VPO needs to protect itself with tougher contracts.

Be realistic about risks and do not invest at too high valuations

Wolfgang Hafenmayer at **LGT VP** explained that the VPO had often been too optimistic, and did not take into consideration how difficult the sectors / regions are. This situation is compounded by the fact that entrepreneurs are generally optimistic, so it can be difficult to have discussions where you suggest that they will achieve only 20% of their plan. LGT VP has become more realistic over the years as the team has matured and attitudes of people have changed given the experience of going through turnarounds, etc. In practice they just can't accept crazy valuations and projections, as they need to build a solid portfolio.

Olivier de Guerre at **PhiTrust** further comments that sometimes social entrepreneurs have very high expectations on valuation – but then must promise high returns in compensation. This situation will attract classic investors and finance-first impact investors who offer too high valuations and inflate expectations. PhiTrust made the mistake of investing at too high a valuation – which resulted in a financial loss at their exit. Learning from this error, PhiTrust is very careful when it comes to valuation of any potential new investments. Social investments cannot be valued in the same way as purely financial investments, simply because their exit strategies and opportunities are not similar.

Important to keep social entrepreneur as shareholder for retention – incubator can be a problem

One of **BonVenture**'s failures was the investment in an email charity. BonVenture invested €250,000 in equity and loan. Most shares were held by an incubator company. The CEO changed twice, the social entrepreneur was no longer there, and the market broke down. There was the choice between investing more or letting it go bankrupt. The incubator with 80% of shares would not invest more and BonVenture was forced to exit. Following this failure, BonVenture decided not to invest any longer with an incubator as a shareholder if the social entrepreneur is not the main shareholder.

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Investment management

Give investees the permission to fail – and help them not to

According to its final Impact Report[61], the **One Foundation** was better at giving permission to fail to its own team than to its investees. The success metrics were usually tightly defined (growth in service users, income growth, or policy changes achieved, etc.) and left little room for failure, although sometimes failure leads to success. As Deirdre explains: 'VPOs need to be careful about allowing some room for experimentation and failure, because we learn more from failure than from success!'

ONE typically made a three-year investment commitment with quarterly payments. If the quarterly performance objective was not achieved, ONE had the right to withhold payments until it was. But sometimes this is not so straightforward. Deirdre argues that 'if the investee was supposed to work with 5,000 kids and it worked with 4,000 kids, it is difficult to say that you don't get the money until you get to 5,000... it's not like no impact has been made!'. The purpose of retaining the right to withhold payments was to incentivise behaviour to achieve the impacts jointly agreed between the VPO and the SPO. The One Foundation would withhold payments only if they thought it would make a difference in behaviours to drive impact. As Deirdre explains; 'If they are struggling already and they are doing all they can, what sense does it make to withhold the money?' Withholding money can be a trigger for a conversation on the issues and should only be considered if the delay can help achieve more quality or more impact. The One Foundation found that already having the payment delay as a 'threat' was enough; it rarely needed to use it.

Board seats on investee important in long term partnerships

In early days, **Impetus** actively chose not to take a board seat. The rationale was that they didn't want to confuse the role of VP funder vs. role of charity board as fundraiser. If Impetus were on the board they thought the motivation to raise additional funds would be lower. In 2002, there was a lot of suspicion around private sector people entering the social sector, and Nat Sloane recalls that Impetus thought it could 'spook' the boards. This was probably a misjudgement. Impetus-PEF now has a staged process, working with the investee for around a year to get to know the organisation. There is no board seat at this stage but Impetus-PEF communicates that in the next stage they would want a board seat.

They then move through a 'funnel' model, where only a certain number progress through each subsequent stage of investment all the way up to scale funding. Impetus-PEF may ask for a board seat in later funding stages. So far they have insisted that investment directors are not the ones taking the board seat so as not to confuse the relationship between investment directors and CEOs. If a VPO is genuinely committed to a long term partnership and impact, why wouldn't you be on the board?

Similarly, **LGT VP** believes that taking a board seat and being part of the board allows the investor to have a voice. LGT VP uses the board meetings to exert an influence, but

61. **The One Foundation, 2014, "***One 10 – 2004–2013 Impact Report***".**

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Wolfgang Hafenmayer also points out that investee boards see LGT VP's people 'not as outsiders, but as partners'.

Exits

As EVPA's research team has recently analysed in its *Practical Guide to Planning and Executing an Impactful Exit*[62], a big challenge is defining the right timing of an exit. Exit readiness is determined by analysing the three dimensions of financial sustainability, organisational resilience and social impact.

Importance of having an exit plan from the beginning and no surprise exits

First of all having an exit plan that is realistic is crucial and ideally it will take into consideration more than one scenario. An example of this recommendation was given by Deirdre Mortell of the **One Foundation**. A start-up SPO One Foundation invested in had a three year business plan largely financed by One Foundation. Though the SPO was not performing up to the expectations on a number of dimensions, it could not be considered either a complete success or a failure. However, at the time of exit it was clear that the SPO needed refinancing. One Foundation was open to another three years of funding subject to the implementation of a tight performance measurement system, but when presented to the investment committee, the proposal for renewal of funding was not approved. This generated a new problem as suddenly the SPO found itself not having a fall-back plan for follow-on funding. As usually proposals that come to investment committee didn't fail, no other exit plan had been made: the SPO had not built an exit plan because One Foundation management had indicated it was willing to continue as a funder.

Inspiring Scotland found that, in one case, when they made the decision to exit it seemed that the SPO had never had that conversation before. Exits are necessary, as the funding relationship cannot go on forever. Andrew Muirhead's view is that many SPOs survive although they shouldn't as resources are going to places where they are not achieving results and that some funding inertia exists which is not healthy for the SPOs nor the sector.

Revise exit strategies when exit option disappears

The **One Foundation** invested in several organisations in the migrant support sector (a sector in which the State had not put any money). The exit strategy in the first five years relied on the State stepping in after the exit, once the investees had demonstrated the quality and value of their services, which were much in demand. However, the State never did and, as the economic crisis developed, it became clear that it would not do so. The One Foundation had to work on new exit strategies. There was a consolidation of the sector because there was no other money in the market (philanthropic or state or revenues). The new focus became: How can you achieve your mission with a much smaller pool of financial resources? The result is a number of mergers and strategic alliances that will maintain critical services with much fewer resources (staff, buildings, etc.).

62. **Boiardi, P.** and **Hehenberger, L.**, 2014, "*A Practical Guide to Planning and Executing an Impactful Exit*". EVPA.

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Risks of exiting too early – financial sustainability vulnerable

Another risk that **Shell Foundation** is aware of is to cut things before the organisation has reached a tipping point. It has even got to the stage that the Board is now worried that Shell Foundation exits too early. Chris sees 'exiting as an art': you may have projections on when the social enterprise will achieve financial sustainability which forms an exit point – but then an issue happens e.g. poor season of product, a major client or investor drops out etc., which puts everything in doubt. The concept of a 'tipping point' for investment when the partner reaches financially viability is not perfect as even when a social enterprise is profitable there can still be a role for organisations such as Shell Foundation to help them overcome fragilities, enter new markets and support product development. A major risk for impact investors is that social enterprises won't have the tolerance to survive these difficulties. VPO involvement can offset these risks in order to raise adequate capital to innovate, adapt and implement solutions to improve sustainability. It is a fine balance.

For the **One Foundation**, they had an exceptional exit challenge in its last year of operations. Being a limited life foundation, the One Foundation knew that it would need to perform a final exit from all its remaining investments in 2013. As Deirdre Mortell explains 'in normal circumstances, you might want the SPOs not to fail, so the risk is that you stay invested for too long. When you have a limited life fund you do not have any other option'. One year in advance One Foundation knew already what was going to happen. For some grantees, timing was a bit artificial: 'exiting 12 organisations on the same day is probably not the most natural way to do it'. Deirdre does not have hard data on what has happened since, but is scanning the environment for evidence. The successful exits are the ones for which the exit plan worked, i.e. it achieved the planned step change in impact, and the organisation became sustainable at this new level. While there is no doubt that some organisations have reduced their operational capacity since exit, in a number of cases this was planned as the impact has already been achieved (e.g. a change in law or policy was secured). As far as Deirdre knows, there are no closures yet (but there are mergers, and some are sure to come...). The One Foundation co-funded significantly with Atlantic Philanthropies (most of the investments in children, youth, mental health and immigration) and Atlantic Philanthropies will close in Ireland in 2016 (3 years after ONE), so where ONE exited, in some cases Atlantic Philanthropies invested for another three years (2014-16). In 2016, it would be worthwhile to taking another scan to see the outcomes at that stage.

Continue monitoring investee post-exit to ensure lasting impact

As explained in EVPA's exit strategy report[63], in the last step of the exit strategy process 'the VPO does not only need to assess to which extent the goals have been reached, but it also needs to carefully think about how to make the impact last post exit and possibly on how to follow up with the SPO'. One pertinent case is that of Barnardos. The **One Foundation** successfully exited that investment several years ago, having helped the organisation to build its fundraising capacity so that it could continue without ONE's ongoing support. However, due to the economic crisis, the Irish government has substantially reduced funding for frontline services (for children) and Barnardos has channelled remaining funding to the front line, literally using up the funds generated with the intention of maintaining capacity at a higher level than before on e.g. communications, finance etc. This is an example of an apparently successful exit that later became a failure due to external circumstances.

63. **Boiardi, P.** and **Hehenberger, L.**, 2014, "*A Practical Guide to Planning and Executing an Impactful Exit*". EVPA.

Conclusions – Overcoming failures: lessons learned from past mistakes

CONCLUSIONS – OVERCOMING FAILURES: LESSONS LEARNED FROM PAST MISTAKES

This report on "*Learning from failures in venture philanthropy and social investment*" aims at collecting the lessons learned from the first 10 years of VP/SI, to **learn** from strategies and investments that **failed** and **mistakes** made in organisational set-up and **help** VP/SI organisations avoid **repeating same mistakes.**

Causing ***intelligent*** **failures** is natural in environments where **experimentation** and **creativity** are core values, such as VP/SI, so the generation of social innovation is fostered in environments where there is the 'permission to fail'. We thus hope that this report will help the VP/SI sector promote a **culture of transparency** and **open dialogue** around failures, and promote a culture of experimentation - while providing important tools to lower failure rates.

We grouped the causes of failure into three main categories: issues related to the internal organisation of the VPO that are identified as ***organisational risk***, misalignments in the development of the investment strategy of the VPO which we denominate, ***strategic risk***, and failures in the execution of the investment strategy labeled, ***execution risk.***

We then delved deeper into each cause of failure by means of practical examples provided by the VP/SI organisations that joined this research project. The cases served to distil some important lessons learned that can guide VPOs not to repeat the same mistakes again. For each source of failure we provided recommendations of how to decrease the failure rate in VP/SI rather than to eliminate the inherent risk. Risk is embedded in the nature of the work of VP/SI so VPOs should not always try and reduce it to the minimum, but should embrace a certain level of risk (and thus of failure) as an essential component of the innovative nature of VP/SI.

Below we summarise the lessons learned that emerged in each of the three groups of failure causes.

Lessons learned on how to avoid failures related to **organisational risks** are:

Funding model:

- Add peripheral activities (such as consultancy) to raise more resources.
- Find ways to recycle capital.
- If managing funds, generate economies of scale in the management fees (by raising larger funds).
- Raise awareness around the VP method to increase investors' sophistication.
- Look for the right investors based on the investment strategy chosen.

Governance of the VPO:

- Balance the mix of experiences in the Board of Directors.
- Make sure that board members have a specific pool of characteristics, including especially entrepreneurial spirit, patience and the capability to listen to people with different backgrounds.

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Staff of the VPO:

- Create teams that have a mixed background (both social and financial/business), with the final goal of creating a specialized pool of human resources for the VP/SI sector to end the existing dichotomy between social and financial/business backgrounds.
- Give more power to the management teams, as they are the ones closest to the investees and knowing all the details of a deal (and can thus take more informed investment decisions).

Engage other key stakeholders and especially:

- The government – as it has the resources to grow and scale projects.
- The final beneficiaries – to achieve meaningful impact.
- The pro-bono supporters and volunteers – hiring a manager to oversee that external human resources are properly employed.

Experimentation mostly happens at the level of the **investment strategy**, so a certain degree of uncertainty and some failures have to be accepted. However, **misalignments in the investment strategy** of the VPO can be avoided or minimised by following these suggestions:

Investment focus:

- Develop an investment strategy, but keep it flexible, so it can be revised.
- Focus more on a specific sector, geography or thematic area to add value and to generate and demonstrate more impact.

Models of intervention:

- Invest in larger organisations that can achieve disruptive impact.
- Invest massively in the winners – that can scale-up massively – and in entrepreneurs that are willing to scale.
- Use patient capital to find the right balance between financial sustainability and social return.

Types of SPO

- Be aware that non-profits are difficult to move to sustainability. Use investee's ability to earn income as indicator of potential to deliver impact at scale.
- Invest in disruptive (new) organisations – with the right attitude- to achieve scale and financial sustainability.

Financing instruments:

- Grants:
  – Disburse according to milestones;
  – Request matching grants;
  – Use grants as risk capital.

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- Debt:
  - First fund with convertible loans as one can then avoid lengthy valuation discussions;
  - Avoid compulsory convertibles not to risk to having to buy at too high valuations;
  - Think early about bridge financing and what it means for the capital structure of the SPO.

Co-investment policy:

- Perform a thorough analysis of co-investors before investing to:
  - Align objectives (especially in terms of balance between social and financial objectives);
  - Avoid free-riding linked to not having a local presence.

Non-financial support:

- Build close partnerships with the investees – at the core of the VP model – as an effective way of knowing if the investment is on track or needs further support.
- Try to improve the valuation of non-financial support (although it is hard to track the value of inputs and outputs). This can also help proving the value of the VP/SI method, so it is really crucial.
- Focus non-financial support on core issues (such as governance and strategy) first – and then focus on the rest at a later stage.

Mistakes can be made at any point in the **investment process**; when screening and selecting new deals, when conducting due diligence, when structuring the deal, when managing the investment and when exiting. Identifying **execution risk** means that the VPO can learn to safeguard its activities so that mistakes can be prevented. The VPOs that participated in this research project identified the following recommendations to avoid making mistakes when implementing the investment strategy:

Deal screening:

- Beware of investing:
  - In SPOs with a high product/service risk (this risk can be mitigated by investing through pilots);
  - In sectors you do not understand;
  - Where the risk of not creating any impact is too high;
  - To fill quotas.
- Align social and financial drivers.
- Say no to appealing but unpromising ventures (for example by developing a ‘code of practice’).
- Embrace a certain level of risk (because if no one does there is a risk of systemic failure)!

CONCLUSIONS – OVERCOMING FAILURES: LESSONS LEARNED FROM PAST MISTAKES

Due diligence:

- The board of the SPO is crucial, as is understanding the governance of the SPO.
- Perform thorough due diligence on both the board and the management team and implement changes where needed, being objective.
- Do not overestimate the capabilities and the entrepreneurial spirit of the management team of the SPO; do extensive references' checks.
- Be prudent and try not to get carried away when doing valuations; do not overestimate the development of the market.
- Clarify the expectations from the start; explain to the SPO that the relationship will not be a clear path.
- Be smart early on in assessing whether a relationship will work and what both parties want to get out of it.

Deal structuring:

- Protect yourself through solid contracts.
- Always have adequate legal support and always think of the worst-case scenario.
- Be realistic about difficulties in some sectors and geographies.
- Always go in with co-investors at the same conditions.

Investment management:

- Withhold payments only if it can make a real difference.
- Remember that taking a board seat is important in long-term partnerships.
- Have a 'staged' process to get to know the SPO.

Exit:

- Have an exit plan, so there are no 'surprise' exits.
- Revise the exit strategy when exit options disappear.
- Continue monitoring investee post-exit to ensure lasting impact.

One last important remark to make for what concerns investment management relates to the SPO having the 'permission to fail'. Social innovation only happens where risks are taken, and risks generate higher probabilities of failure. Only acknowledging and accepting this risk, the VPO can act to support the SPO and help it not to fail.

At EVPA, we have aimed to provide important lessons learned from failures, and have supported the information provided by our interviewees with other sources of data where possible. However, our future objective is to build on these learnings to enable an even more solid understanding of the difficulties and challenges faced by VP/SI practitioners and potential solutions. EVPA is committed to continue the research and promotion of best practice in the key components of the VP/SI model and reiterates the importance of a collaborative approach to developing the sector. We would be delighted to hear from readers as to their views on the failures identified in this report, the lessons learned and / or on any additional thoughts or comments. Any comments or suggestions can be sent to lhehenberger@evpa.eu.com.

Appendix

APPENDIX

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APPENDIX

Websites

- http://www.admittingfailure.com/
- http://www.briljantemislukkingen.nl/en/
- http://www.communityleadershipproject.org/
- www.envirofit.org
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EVPA
EUROPEAN VENTURE PHILANTHROPY ASSOCIATION

Rue Royale 94
1000 Brussels, Belgium
Tel: +32 (0) 2 513 21 31
Email: info@evpa.eu.com

The European Venture Philanthropy Association (EVPA)

Established in 2004, EVPA aims to be the natural home as well as the highest-value catalytic network of European Social Investors committed to using venture philanthropy and social investment tools and targeting societal impact.

EVPA's membership covers the full range of venture philanthropy and social investment activities and includes venture philanthropy funds, social investors, grant-making foundations, impact investing funds, private equity firms and professional service firms, philanthropy advisors, banks and business schools. EVPA members work together across sectors in order to promote and shape the future of venture philanthropy and social investment in Europe and beyond. Currently the association has over 190 members from 24 countries, mainly based in Europe, but also outside Europe showing the sector is rapidly evolving across borders.

EVPA is committed to support its members in their work by providing networking opportunities and facilitating learning. Furthermore, we aim to strengthen our role as a thought leader in order to build a deeper understanding of the sector, promote the appropriate use of venture philanthropy and social investment and inspire guidelines and regulations.

http://www.evpa.eu.com

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