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# INVESTMENT-READINESS OF NON-PROFIT ORGANISATIONS

## Criteria to diagnose the investment-readiness level of a non-profit organisation

**Most non-profit organisations (NPOs) are used to receiving donations or state funding. They are highly skilled at fundraising or negotiating subsidies. However, in recent years, a new type of funding has emerged: social investors are following a different logic to solving social problems and financing projects. If NPOs want to secure a share of this increasing market, they have to understand how to present themselves as investment-ready.**

### 1. INTRODUCTION

In a recent survey, Swiss non-profit managers were asked about the future challenges facing non-profits. The three most pressing issues were "achieving financial sustainability" (60%), "raising awareness of our charity/cause" and "reductions in public/government funding" (Hengevoss/Berger 2018). Interestingly, positions 1 and 3 were identical in a similar study conducted among non-profit managers in the UK (CAF 2017). Additionally, recent scientific papers emphasise the changes in non-profit finance. New findings on topics such as administration costs (Lecy/Searing 2015), revenue diversification (von Schnurbein/Fritz 2017) and financial success (Helmig et al. 2014) are presented. An emerging field is the research on impact investing. Nowadays, many donors are operating as investors, i.e. they expect some kind of return for their charitable contribution. This return does not need to be financial, but it can be. As such, a project has to prove its impact, which leads to questions of evaluation and measurement. Building on this shift from donations to investments, new forms of support for NPOs have emerged, most notably social impact bonds (SIBs). However, impact investing goes far beyond SIBs. According to the GIIN 2018 Annual Impact Investor Survey, over USD 228 billion is invested in impact-related vehicles and projects. While private donations and state subsidies have been stagnating at a high level in recent years, impact investment assets are increasing rapidly. Hence, Veugelers (2011) points out the risk of an investment-ready gap, referring to undersupply of investment-ready projects. Previous studies have shown that NPO leaders lack substantive knowledge on new social finance instruments, whereas social enterprises are very much up-to-date in terms of attracting social finance investors (Hebb 2012). Given the increasing amount available in impact-investing vehicles, NPOs should rethink their sceptical perception of impact investing. NPOs must therefore understand the core aspects of impact investing in order to make themselves attractive as investment partners. First, they have to know the concept behind social investment and the language and expectations of social investors. Second, they have to be able to prove that their organisation is "investment-ready". This includes answering questions such as (Knowles 2014): Can you provide a business case capable of repaying investors? Can you isolate the project the investment will fund? Do you have robust measurement reporting for this programme? Do constituents support the idea of impact investment?

The aim of this paper is to provide a systematic concept of investment-readiness for NPOs that want to attract impact-investing funds to finance their operations. In the following, the theoretical concept and the term "investment-readiness" are explained. This concept is then adapted to the specific characteristics of non-profit organisations. We close with an outlook on the future of financing for non-profits.

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### 2. INVESTMENT-READINESS

The term investment-readiness emerged from the field of SME and start-up financing, where investors often lack in-depth information on the firms of interest. Generally, it is defined as "…an investee being perceived to possess the attributes, which makes them an investible proposition by an appropriate investor for the finance they are seeking." (Gregory et al. 2012, p. 6).

From a theoretical perspective, investment-readiness can be explained based on agency theory as a means of dealing with imperfect information and reducing information asymmetry (Hazenberg et al. 2015). Imperfect information refers to the low quality or even absence of information on investment projects. Information asymmetry highlights the difficulties investors experience in finding objective, comparable information before making their investments, as SMEs or start-ups are not compliant with stock market standards or other more transparent regulations. Both imperfect information and information asymmetry lead to substitution of proven facts by personal characteristics of people involved and gut feeling evaluations (Ferrary 2010).

From a business perspective, investment-readiness helps to build trust among the parties involved and facilitates risk management for the investor. Answering questions on investment-readiness makes NPOs aware of the needs of potential investors and enables them to provide adequate information and undertake preparations (Fellnhofer 2015). Hence, investment-readiness includes both the supply and demand sides of financing, creating a holistic understanding of investing in non-profits (Clarkin et al. 2014).

However, the existing literature focuses heavily on the investor side, explaining why investors prefer investments with a solid investment-ready valuation (Hazenberg et al. 2015). This article puts the emphasis on the NPO as an investee and a contributor to investment-ready reporting.

### 3. CONCEPT OF INVESTMENT-READINESS FOR NPOS

In many ways, financing of NPOs resembles the situation of investors in SMEs and start-ups. There are few or no publication obligations, standards of accountability are simple and internal planning capacity is kept at low level due to a focus on the organisation's social mission. To date, NPOs have paid little attention to financing methods other than private donations, membership fees or state subsidies. They specialise in fundraising, grant writing or member value, but are ill-equipped to answer the demands of the new social investors. As shown before, this means neglecting a growing stream of revenue. NPOs should therefore start to improve their own investment-readiness in order to build trust with social investors and to better understand their interests and demands.

> *«Besides trust in the organisation and the people involved, investors' decisions are based on a thorough understanding of the funded project.»*

Given the categories and areas of investment-readiness as presented above, the following concept structures NPOs' investment-readiness into three categories: internal, problem and solution, and finance and investment (see *figure*). As shown in the literature review, the aim of investment-readiness is to reduce the information asymmetry between investors and investees and the uncertainty for investors about an investment project. An NPO must therefore provide information about itself, about the given project and about its expectations for success, e.g. the purpose-oriented and financial outcomes.

Figure: **ELEMENTS OF INVESTMENT-READINESS**
(author's compilation)

**Internal**
The management of your organisation

- → Stage of development
- → Team and competencies
- → Legal requirements and governance
- → Documentation (project, financial forecast, impact evaluations, etc

**Problem and solution**
Your theory of change

- → Demand
- → Advantage
- → Stakeholders and market
- → Leverage and scale

**Finance and investment**
The financing model

- → Preferences on financing instruments (debt, loans, guarantees, equity, etc.)
- → Potential for revenues
- → Financial forecast and growth plan
- → Key indicators

**3.1 Internal.** The reduction of information asymmetries implies that NPOs have to be able to provide general information about themselves. For investors it is important to know what *stage of development* an organisation is at. Recently established organisations are more flexible and more open to change, but at the same time an investment harbours greater risk of failure. Organisations in a growth stage are very dynamic, whereas those in a consolidating or mature stage are more stable and risk-averse. Depending on the type of investment, the different stages will be a better or worse fit. Additionally, the organisation has to provide information about the team and competencies. As there are no hard figures on the potential success of a project, investors will decide in large part based on the competencies of the people involved. Only when they trust the project leaders and organisational representatives, they will make a positive decision. As such, an investee has to provide information about the competencies, experiences and recent achievements of the people involved. Another factor of internal investment-readiness is information about the legal requirements and governance structure. Alongside general information about the legal structure of the organisation, legal requirements might contain specific information from tax authorities, e.g. how possible returns will be treated. The governance structure is of great importance, as social investors sometimes want to be included in the supervision of the project. The investee needs clear regulation as to how such inclusion will be arranged. Otherwise, an investor might gain more influence than necessary or justified. Finally, the project needs to be well documented, not only in terms of facts and figures, but also in terms of communication and style. Investors are used to being sold ideas, and they are not convinced by principles or mission alone. Nevertheless, the documentation must address the most important financial, organisational and methodological aspects.

From a more general perspective, the development of industry standards of investment-readiness or different investment levels might be a useful approach, enabling individual organisations to access knowledge on how to improve their fit with investor demands.

**3.2 Problem and solution.** Besides trust in the organisation and the people involved, investors' decisions are based on a thorough understanding of the funded project. Starting from the needs on the part of beneficiaries, investees have to highlight the advantages of their project over existing projects, the potential stakeholders and the potential for leverage or scale. Social impact projects should have the potential to become sustainable. This is only possible if the project meets a real demand among beneficiaries. For example, a nutrition project based solely on an educational effort founded on assumptions may not necessarily meet existing demand, whereas a project reducing malnutrition following scientific findings on the ground might address better people's needs, and hence lead to greater involvement of beneficiaries in the future. The question of advantage is connected to this demand. The project is only attractive for investment if it creates leverage of utility, quality or other considerations compared with existing projects. Naturally, the investee cannot prove this advantage if the project has never been carried out before. A substantive description of the expected progress or advancement and a clear distinction versus existing projects

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is therefore needed. Me-too projects have their justification, but often they are better suited to grants than to investment support. In addition to the demand and the expected advantage, a comprehensive overview of the market and the stakeholders allows an investor to assess the project's potential for success. Highly frequented areas with many actors and constituents have the advantage of collaboration and acceptance. The downsides are oversupply and little improvement compared with existing projects. Areas with little attention show more potential for improvement and more attention in the event of success, but an investment is risky, as existing knowledge for support is scarce. The usual way of providing all the above information is the logic framework. It explains in a normative way the relationship between input, activities, output and outcome/impact for a given project.

Frumkin (2010) highlights the importance of leverage, change and scale in connection with the logic model of a specific project. Leverage increases the resources available as input for a given project, change defines the activities, output and outcome, while scale refers to the capability to extend the consequences and realisation of the project beyond one's own organisation. Especially as an NPO is usually not able to provide hard facts on future results, it should be able to answer questions on the intended impact. In that context, non-profits might develop different realisation and result scenarios for their theory of change depending on the organisational development, different institutional frameworks, etc. For instance, a change in legislation might make a project's initial aims obsolete. In that case, the NPO should be immediately able to provide a different theory of change reflecting this institutional change.

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**3.3 Finance and investment.** Before approaching an investor, an NPO should be clear about the types of financing it is seeking. The preferences might be very different, depending on the type of project, the beneficiaries, the risk level, etc. Debt and loans involve less risk and serve as an enlargement of the financial potential, but have to be fully repaid. Guarantees reduce financial pressure and may serve as an accelerator to start the project, but full activation of a guarantee is not usually expected. Other options such as equity are infrequently used and might cause many legal difficulties. As such, the investee has to be clear about what it can offer and what to expect in return. Closely connected to the choice of investment vehicles is the question of returns. Impact investors other than foundations are looking for projects that offer a below-market return (or even more, if possible). As such, the investee must present information about cash flows connected to the project. The question of returns relates not only to the size of returns, but also to the source of cash flows. For example, in a typical social impact bond, the returns are not generated by the beneficiaries or the non-profit actor, but by the state.

The investee must also present a financial forecast and growth plan. Often, returns only materialise once the project output has been scaled up. Even though it is not the primary focus of a social project, investees should be familiar with special language such as breakeven, profit contribution and marginal costs. A growth perspective (or the absence thereof) is not only essential in financial terms, but also a basis for storytelling. Finally, the project description should contain some key indicators that the investee considers important in monitoring the development of the project. This will facilitate communication and understanding of the progress of the project between investor and investee.

## 4. OUTLOOK

As pointed out at the start, the way NPOs are financed is changing, and NPOs are feeling more pressure to secure their funding. One solution to this problem is the increasing interest among investors in investing in social impact projects. However, these new investors are not to be considered as substitutes for foundations or state authorities. In order to attract financial resources from social investors, NPOs have to meet their requirements in terms of financial information, project outlook, and wording and communication. In particular, the responsible bodies of a NPO have to understand the logic behind a social investment, including trust-building information flow, the potential for return and a comprehensive logic model that wins out in a contest between many promising projects. The concept of investment-readiness presented in this article makes no claim to be exhaustive or accurate in every respect. However, it does give an idea of potential issues that NPOs should address if they want to attract money from social investors. Further research will be needed to show how non-profits respond to demands on social investors and if they are able to provide the necessary information, programmes and structures to win them over. Given the difficulties in securing state funding and enhancing private donations from individuals or foundations, further investigation of social and impact investment offers new opportunities for NPOs. ■

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