

**Donating or Investing? –  
Decision Support for Funding Social Purposes**

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## **Disclaimer**

This guide is an introduction to different financing methods for philanthropic (social, cultural, environmental, etc.) purposes. Describing the most important forms of financial application in the philanthropic sector and assessing each approach by its working processes, pros and cons it offers an orientation for potential donors, as well as existing donors wishing to try out a new approach.

Please note that, written by a German author and published in Germany, the legal provisions and context, the definitions of different charity types and forms of investment and the working processes described in this guide apply to the charitable sector in Germany. For details on regulations and working processes in your country a local expert, e.g. an accountant or lawyer specialised on charitable law, should be consulted as the European charitable sector unfortunately is still lacking consistent regulations.

However the gist and overall message of this guide is applicable throughout Europe: As a modern donor or social investor you can make use of a broad variety of different forms of social investments. Often change can most effectively be enhanced if you choose a combination of complementary instruments that suit your philanthropic goals.

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## Foreword

Not only has the so-called ‘Third Sector’ massively grown over the last years, it has also broadened to something far more versatile than it was 10 or 20 years ago. Where there used to be simply foundations, groups, and the classic charities, there are now social entrepreneurs, charitable ltd. companies, Trust foundations and ‘Spending-down’ foundations, as well as many innovative hybrid solutions. This has caused the line between the Third Sector and the Private Sector to blur, and so too, the barrier between traditional philanthropy and a more entrepreneurial, business-minded approach to giving has been broken down. Perhaps you have already found a cause close to your heart? Now you are faced with the question of how to apply your money to it – donate or invest, for example in the form of a loan, or participation in a social venture? When and to whom does either method apply? What are the pros and cons? How do they work?

These, and further questions, are discussed in this guide. Foremost, it offers an orientation for potential donors, as well as existing donors wishing to try out a new approach. The guide gives a run-down of all the commonly used forms of financial application, and offers the reader a balanced appraisal of each approach. Whilst much of the discussed material is applicable throughout Europe, some, due to the author’s nationality, is more specific or only applicable to Germany. This above all is true for legal provisions, processes and context as well as definitions of different types of charities and investment forms. The author, Anne-Kathrin Kuhlemann, is a management consultant and a social entrepreneur. Her personal convictions, regarding the effectiveness of financially sustainable investment techniques in the charitable sector, are reflected in this publication.

This introduction to different financing methods for social purposes is part of a series of publications for donors, dealing with method- and management competence. With their practical advice and step-by-step instructions, these guides form an integral part of the Active Philanthropy “Toolbox”. Furthermore, the “Toolbox” contains publications on choice themes designed to help donors embark upon a project, and help them find their individual niche, such as ‘Children’ or ‘Climate change’. Alongside this, we have begun developing tools

designed to explain the backgrounds of Philanthropy in a user-friendly and visually-pleasing way. An example of this is our ‘Active Philanthropy Map’.

The guides contain the methodical questions about donating, clearly arranged into sections, all whilst keeping the important complexities of the issues intact. The basis of these comes from either from successful examples and stories of active donors, or advice from experts in the various fields of charity.

As a non-profit forum, Active Philanthropy supports families and individuals in developing and applying a personal giving strategy. The forum offers a safe-haven for donors to exchange, learn and cooperate, as well as find practical advice for improving the concept of ‘donating’ as a whole. This is made possible by a plethora of services: from practically relevant publications, workshops and excursions, to administrative support, as well as individual consultation. The central support of this is the application of gained advice in every new project. What we do is itself made possible by similar means, with charitably involved entrepreneurial families supporting Active Philanthropy with words and deeds.

Objectivity is fundamental to our work, and the effort we put in to this is not spared in our publications. Some examples and pieces of advice are unavoidably drawn from the author’s experience. We would ask you to respect that the presented approaches and organisations can be neither comprehensive, nor are they subject to any assessment or rating by either Active Philanthropy or the author. Much the same, this guide cannot replace extensive consultation with your attorney and tax-advisor – it simply references generic and, for the most part, German, regulatory procedure. Therefore every individual cause or project needs to be consulted with those parties, or a lawyer specialising in the area you intend to enter.

We thank Anne-Kathrin Kuhlemann for her advice, from her career as advisor and social entrepreneur, which has sustained this publication. We owe equal thanks to the donors who read the initial drafts of this handbook – without their constructive advice and criticisms the book’s publication would undoubtedly have been hampered. With his critical judicial appraisal, and his invaluable corrections, Dr. Christian Meyer was also instrumental in the

coming about of this guide. Finally, gratitude must be shown toward the Active Philanthropy team, not least Gabriele Störmann - without her enthusiasm, sensitiveness and diligence, this guide would not have been possible.

We would be pleased and honoured if this handbook were to be able to help donors and social investors find the form of financing appropriate to their aims and supported organisations. The success of this endeavour can be instrumental in broadening the field of impact of the chosen cause.



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## Introduction

For investors looking to support social organisations, there is a broad spectrum of investment opportunities available. Aside from traditional donation-based charities or foundations, „social businesses,” i.e. organisations that are financially sustainable and provide social or community-focused benefits, are increasingly looking for investors.

This guide is an introduction to the wide variety of investment models. It explains the different financing devices that can be used, both directly as well as indirectly, through third-party intermediaries such as banks, mutual funds or Civil Society Organisations (CSOs)<sup>1</sup>.

While corporations can also use these devices to donate money, build foundations or invest in social businesses, this guide is written primarily for private donors and investors.

## Reasons to Invest

The motives to provide money for social causes are as diverse as the people who give. The three main motivations are:

1. social motives, e.g. compassion, a sense of responsibility towards others, or the desire to give back to society or the community,
2. an entrepreneurial spirit, such as the determination to solve problems, often paired with the desire to make use of professional talents, and
3. personal reasons, such as cases of inheritance, or family traditions.

Behind each motive are the goals of correcting a social or public problem and creating positive change. The necessary means to channel such activities are:

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<sup>1</sup> Civil Society Organisation (CSO): sometimes also called NGO = Non-Governmental Organisation or simply Charity. We use Civil Society Organisation or CSO here because we believe that this is the most comprehensive description of the wide range of organisations that are working to provide services for the benefit of society.

- Money: this brochure describes the different options of how to use money for social benefit,
- Knowledge: solid approaches and theories as to how change can be achieved, contacts to the right cooperation partners, etc., and
- People/Employees, usually embedded in an organisation.

Whether the desired effect has been reached by the end must be considered separately<sup>2</sup>.

## **Decision Criteria**

Everybody is different - and so is each person's set of criteria for making a donation to a social cause. To increase transparency and support comparative analyses, this guide presents various devices for social investors, and assesses each tool with regard to the following dimensions:

- Return on investment: The financial outcome of the investment – paired with the risk or probability of reaching this goal: whereas the social benefit or “social returns”, that may be totally different from the financial outcome, will be explicitly noted.
- Influence: The donor's influence over the deployment of the funds
- Time frame: The time span an investor needs to factor in until tangible results are achieved – including issues with liquidity or the duration of the investment commitment.
- Type of project/organisation to which this financial device is best suited.

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<sup>2</sup> Please see Active Philanthropy guides “How do I assess the effect of my contribution?” by Burkhard Gnärig, 2009 and “Philanthropy with Impact – An introduction to evaluative thinking” by Edward Pauly, 2009

As a private donor, one should first prioritise these dimensions according to personal preferences and motives. Each chapter ends with a short checklist based on these dimensions. It illustrates when, where and for whom the relevant device is best suited. Each instrument has its own pros and cons - therefore diversity is key to social investing. Applying different tools to create a mixed portfolio of strategic social and financial investments will increase your personal giving experience and can help to maximise the intended social impact.

### **Types of Financial Investment Targets**

Before explaining each instrument in detail, we should define the organisations that would potentially work to benefit society and that could be an investment target.

- The most common organisations are charities, non-profit associations and foundations serving the public good. These organisations typically rely on donations which are tax-deductible within a certain range. A foundation can also use investment income from its assets under management.
- There are also charitable limited liability companies and associations, as well as a few charitable public corporations. Charitable organisations invest all profits in charitable projects relevant to their cause – in most countries they cannot pay out a dividend to private shareholders. However, it is possible to retrieve an investment by providing debt financing in the form of a shareholder loan. Charities, non-profits and foundations are increasingly generating income by, for example, renting out office space for meetings, or offering training, seminars and other such services.
- The fact that a company – regardless of its legal structure – is not recognised as charitable does not mean that it does not pursue social benefits. To arouse investment interest, entrepreneurs are creating “social businesses” that combine social effects, such as the creation of jobs for disadvantaged or discriminated minorities, with financial returns.

- In addition, there are numerous hybrid models:
  - Foundations with a stake in a for-profit organisation (such as a limited liability company or corporation) that re-invest realised profits for the charitable mission of the foundation.
  - Companies that donate a fixed percentage of their turnover or profits.
  - Socially responsible investment funds (SRI funds) with donation-based funding that make long-term debt or equity investments into “social businesses”. Retrieved investment money can be re-invested into new “social businesses” or other social projects. Alternatively, they can be structured as a regular mutual fund that encourages its investors to donate their returns after taxes.

## Finance Instruments

### Donations

#### *Examples*

The Indian Ocean earthquake on Boxing Day 2004 caused a tsunami that devastated most of the coasts bordering the Indian Ocean. It caused over 220,000 deaths and leaving 1.7 million people without shelter. In response to the humanitarian disaster, more than 7 billion USD were donated worldwide. Private citizens in Germany for instance raised over 500 million Euros. The Norwegian people and government even committed over 36 euros per capita.

In 2003, a small oil painting by Domenicus Theotokopoulos, better known as El Greco, dating from 1567-70, was discovered in Spain. El Greco's birth town in Crete, Iraklion, decided to buy the painting for 1.15 million euros at a Christie's auction in London. While Iraklion citizens collected some 400,000 euros during a fundraising campaign to enable the municipality to pay up, shipping magnate Theodoros Angelopoulos donated another 700,000 euros (his wife was born in Crete).

#### *Short description*

A donation is a voluntary, free allocation of funding, with no liability on behalf of the recipient, to a charitable organisation to help realise its goals. Donations are usually made in the form of funds or material assets, as well as the occasional voluntary service. Donations can either be made out to a specific task or leave it to the charitable organisation to allocate how it sees fit. In 2007/2008, for example, approx. 10.6 billion GBP (approx. 13.6 billion EUR as to October 2008) were donated in the UK.<sup>3</sup>

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<sup>3</sup> NCVO, CAF (2008). UK –UK Giving 2008 – An overview of charitable giving in the UK 2007/2008.

### *How does it work?*

- The donor looks for a recipient or is approached by a charitable organisation
- A financial or material donation is made. Usually these are made in the form of a cash donation; however donations can also be made in the form of securities, life insurances, real estate, books, computers, as well as many other real assets.
- Donations to charitable organisations are tax-deductible within certain limits in many countries. For more details on the regulations in a certain country, an accountant should be consulted.
- A special form of donation is the free provision of services, e.g. pro-bono work by lawyers, accountants or consultants.

The internet has added a whole new sphere of making donations: Online platforms, such as ammodo.com, betterplace.org, giveindia.org, globalgiving.com or razoo.com allow projects to present their cause and goals, while donors can make targeted investments. Usually, 100% of the donations are forwarded to the projects;<sup>4</sup> the platforms are financed through services to third parties and/or support from the founders, as well as large foundations. Conversely, Traditional charitable organisations or foundations collect money from a large number of individual donors and distribute it to charitable projects or other organisations. They take on the role of a broker, often covering parts of their administrative costs with donation money.

- The valuation of material donations for potential tax deductions is quite complex. Where possible, the purchase price is used. Real estate is usually judged by its market value, stock by the company's capitalised earnings value. Due to the lack of a transparent market art is difficult to value. Tax-deductions for larger material donations should be arranged in advance with your tax authorities. For more details

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<sup>4</sup> Up to 10% deduction online compares to up to 40% for traditional „offline“ donations. The deductions finance the operational cost of the organisation collecting donations. Traditional charitable organisations' administrative costs are usually much higher due to the costs for fundraising.

on the regulations in a certain country, an accountant should be consulted.

### *Characteristics*

The financial return of a donation is -100% - the money is “gone”. If the donation can be tax-exempt, your tax obligation is reduced, which should technically be calculated against your donation.

As a donor, your influence on the recipient’s social objectives is negligible, and in Germany it is hardly legally enforceable; charitable organisations are bound to their charter. However, it is possible to make a donation towards a specific project that lies within the spectrum of the charter (restricted donation). Depending on the amount and frequency of the donation, you can build a long-term relationship and monitor project advances. You can also build a close partnership by supporting or openly discussing what is needed most urgently.

Donations allow for high flexibility, as you can determine the amount and frequency at any time. They are a straightforward device for donors to support an organisation quickly, even with smaller amounts, without a lot of red tape.

For recipient organisations, predictability and sustainability of funding is of crucial importance. Donations are most effective, therefore, when you plan to regularly support an organisation. Similarly so, when you can provide goods or services that considerably advance a specific purpose of the organisation.

### *Checklist*

- You have funds available that you do not wish to save, invest or spend.
- You would like to support multiple organisations with smaller contributions or finance a specific project.

- You would like to remain flexible without a fixed long-term financial commitment. You should consider however, that the recipient is interested in a predictable and sustainable source of financing.
- The selected organisation possesses sufficient regular sources of income or your contribution can entirely finance a single project or a critical project phase. Otherwise, there is a risk of the organisation being dependent on your donations in the long-term.
- You have donated less of your income than possible to get tax deductions during the current fiscal year
- You would like to support certain organisations or projects regardless of tax incentives

## Foundations

### *Independent Foundation*

#### *Examples*

In 1917, Knut A. Wallenberg, the chairman of the Swedish Enskilda Bank (SEB), and his wife Alice founded the “Knut och Alice Wallenbergs Stiftelse”. It initially had 20 million Swedish Krona in assets - These assets have grown to almost 50 billion Krona (approx. 5 billion EUR) today, mostly in the form of stock. The foundation controls 17.6% of the capital of Investor AB, Sweden’s largest holding company. In 2007, the foundation awarded almost one billion Swedish Krona (approx. 100 million EUR) in grants to research projects at universities and institutes in Sweden.

The Portuguese “Passos Canavarro” foundation was established in 2000 with the goal to preserve historical and cultural heritage as well as to promote democracy. It focuses on Mediterranean Europe, areas historically influenced by Portugal and Japan. It funds programmes in the areas of art, research and democracy. With only two full time and seven part time staff it is one of Portugal's few small, operatively active foundations. With total assets equalling 3 million EUR in 2006 it was able to issue 8 grants totalling 19,000 EUR as well as to organise several seminars and debates on the theme of "strengthening democracy". As Dr. Pedro Passos Canavarro states "his foundation will open its doors to the cultures' meeting through art, science and democracy where the dialogue and the right to the difference will be the identity passports to present".

#### *Short description*

As opposed to a company or an organisation, a foundation is a legal person without owners, shareholders or members. It is established on a long-term basis to support a (usually) charitable purpose with its funds. The total assets must be sustained – this means that some interest need to be put aside to augment existing assets with respect to inflation. Foundations can be operational, i.e. advance their goals with their own programmes and

employees, or they can support others as grant-givers. In the latter case, they allow third parties to develop and realise projects and initiatives that support the foundation's goals. Today, numerous foundations combine trades of the operational foundations with some of the grant-giving foundation.

In many European jurisdictions, e.g. in the UK or Germany, the term "foundation" has no clear legal definition. The common law countries tend to focus on the charitable character of an organisation, which may take different legal forms (limited or unlimited company, unincorporated association, trust etc). Also in Germany, there are LLCs or associations that carry the designation "Stiftung", such as the Robert Bosch Stiftung GmbH, or the Konrad-Adenauer-Stiftung e.V. Some foundations have been active for over 1000 years. All over Europe there is an increasing interest and a growing number of foundations.

Less than 1% of German foundations have more than 250 million EUR in assets. The majority has at most 300,000 EUR – with a legal minimum of 50,000 EUR endowment, many foundations remain small from the start. A foundation that depends solely on returns from its assets can hardly work effectively with less than 5 million EUR. This is because there is often little money left for the actual purpose of the foundation after inflation and overhead costs have been considered. Two rough calculations to illustrate this:

- A foundation has 500,000 EUR in original assets. At an interest rate of 4.5%, minus 1.5% inflation, 15,000 EUR p.a. remain. With this money, a volunteer committee could award three 5,000 EUR grants. To increase public awareness, a donor might be found to finance a public award ceremony.
- Let's assume the foundation has 10 million EUR in assets. At the same interest rate and inflation conditions, it earns an annual net interest of 3%, 300,000 EUR. These 300,000 EUR are spent on two employees at average labour costs of 50,000 EUR (= 100,000 EUR), office space for 5,000 EUR, and other business expenses such as travel expenses, phone bills, computer, software etc., totalling 20,000 EUR. 175,000 EUR remain to realise concrete projects such as the establishment of a music school and the organisation of an annual cultural festival.

To avoid the extremes of this problem, some countries only allow foundations to be established if they are endowed with a fairly high minimum of capital – e.g. Portugal sets the limit at 250,000 EUR.

Some founders consciously keep the foundation capitalised at a low level and finance ongoing activities through donations. This model maximises the budget for project activities with a limited and manageable allocation of resources.

For a long time, foundations were often founded by bequest, i.e. a sponsor declares in his will that upon his death, a foundation should be established from his funds. In the last decades, sponsors have become increasingly active during their lifetime – they often actively support the foundation’s work and can experience the activities’ effects and results first-hand. The following descriptions apply to the latter model, although bequests are naturally still possible. Another option is a community foundation that is founded by a group of individuals. Very engaged sponsors can actively support the foundation as a multifunctional and complementary team.

Foundations can be established by natural or legal persons, such as corporations. However, this guide focuses on private individuals with a charitable mission. Sponsors can contribute a wide array of their private holdings, such as cash, stocks, or material assets. These assets irreversibly become the property of the foundation, and cannot be retrieved by the sponsor. Corporate foundations as well as non-charitable family foundations are not covered here.

*How does it work?*

- The founder determines the amount of money he would like to commit, the purpose the foundation should fulfil, and whether it will be active in a supportive or operational capacity. Before establishing your own foundation, you should check whether you aren’t inadvertently duplicating an existing foundation’s cause. If you are, consider whether you would prefer to go ahead and establish a parallel foundation, or whether you should simply support the existing one. On the European level, associations like the European Foundation Centre can update you on these

matters. National associations like Danish Foundations or the Slovak Donor Forum can also be of assistance with these investigations.

- If you decide to establish your own foundation, you should draft a charter with competent experts and legal advisors. The charter should include the foundation's purpose, how it will reach its goals, and its organisational structure: How large should the management board or the board of trustees be? Should there be any other bodies and what would their responsibilities be? Check with the tax authorities as to whether the charter fulfils the criteria for charitable organisations. For details on the process in your country, please seek the advice of a foundation advisor, legal councillor or accountant.
- After finalizing the charter, you as the sponsor sign the document in which you bindingly declare the establishment of a foundation and your intention to endow the designated amount of funds. For details on the process in your country, please seek the advice of a foundation advisor, legal councillor or accountant.
- With the foundation statute you apply to your local authority for foundations to have your organisation legally recognised. The foundation is now a legal entity and has the right to receive the funds provided in the statute.
- After requesting a notice of exemption, the tax authorities issue a temporary certification that your foundation is charitable. Only thereafter may the foundation issue a "donation receipt" for your tax deduction. In Germany, for example, charitable foundations are exempt from income, trade, estate, gift and capital gains taxes. For details on the exemptions in your country, please seek the advice of an accountant.
- The foundation finances its operational costs with the return from its assets and additional donations. The return comes from interest on the capital or dividend payments from company shares. Depending on the charter and the organisation, the founder can be actively involved in the work of the foundation.

- In most countries, the public authority for foundations checks whether the foundation's activity is in accordance with the spirit of its charter and whether the assets are managed properly. In Spain, for example, foundations are overseen by the Protectorate, which checks whether foundations are acting in accordance with their statutes and the law. The board of the foundation must present an annual report on their activities and a financial statement to the Protectorate, which it then sends to the Public Register where it is available to the public. In England and Wales, registered charities must make an annual return to the Charity Commission. This must include an updated list of charity trustees, annual accounts and an annual report. If the Charity has an annual income of or over 1 million GBP then a Summary Information Return ("SIR") must also be completed. Simple templates are usually provided electronically by most foundation authorities or the responsible tax authorities.

### *Characteristics*

The financial return of a foundation is the same as for a donation - 100% - which means that the money is "gone". As a founder, you can merely expect a social benefit or social return. However, generally you will profit from a tax deduction, which should not be disregarded.

A Foundation offers its founder a very high degree of influence: by writing the charter, you can entirely determine the activities and focal areas of the foundation. However, it is advisable to avoid too narrow a framework, as it is often a difficult process to revise the charter once the independent foundation is established.

As a founder, you should consider being very diligent and thorough in your work, as you are permanently transferring your private wealth into the foundation's assets - this cannot be reversed. If you find this irrevocability irritating, you should consider a trust foundation (see chapter Dependent Foundation or Foundation Trust, p 23 ff.) or donations.

A foundation is a suitable organisation type for all charitable areas. It is important that new and sustainable routes to a charitable cause are sought. Some foundations may become

obsolete after their goals have been reached, such as the renovation of a church or a cultural landmark. In areas such as research and teaching, permanent financing might well make sense. A ‘limited life’ or ‘spending down’ foundation funds its expenses through interest as well as the continual disbursement of the foundation’s assets. This might be appropriate if you are looking to focus your activities on a specific time period. For more information on a spending down foundation, see chapter Spending-down Endowments or Limited Life Foundation (p. 26 ff.)

### *Checklist*

- You can endow the foundation with sufficient funds for it to run on the interest of its capital. Of course, an annual award ceremony needs much less capital than a permanently running organisation.
- Or you can set up the foundation with little initial capital, and fund on-going expenses with donations.
- You would like to pursue a long-term goal that no other foundation is pursuing in this way and with the means you foresee.
- You can imagine standing by your idea in 30 years. Founders have been known to realise that their focus has changed after 2 - 3 years, or that a foundation might not have been the best way to realise these goals. Please seek competent advice and consultation before establishing a foundation and designing the charter.

## **Endowment Contribution**

### *Examples*

In 2006, investor legend Warren Buffet announced to give away 85% of his stock in his investment firm Berkshire Hathaway to foundations. With an estimated wealth of 62 billion USD, Warren Buffet was estimated to be the richest man in the world<sup>5</sup>. More than 80 percent of his donation is intended to successively enter into the Bill & Melinda Gates Foundation, the world's largest foundation. The first donation payment was worth 1.5 billion USD at the market rate of June 23, 2006. The entire donation amounts to 32.5 billion USD, doubling the Gates Foundation's capital.

Numerous community foundations initially only held little capital. The approx. 200 community foundations in Germany hold around 100 million EUR - their long-term survival depends on contributions. Community foundations often receive endowments and engagements from citizens and companies based in the local community.

Banks with a social, ethical, or ecological focus manage foundations that allow for an easy way to make endowment contributions. Triodos Foundation in the Netherlands, for example, offers numerous funds with different investment targets (e.g. nature and environment, people and society – including projects in education, human rights or health – and UN Millennium goals).

### *Short Description*

An endowment contribution is a voluntary, gratuitous donation to a foundation whose purpose is not short-term financing of an activity, but to increase the foundation's assets that fund its ongoing activities.

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<sup>5</sup> Forbes Magazine, 2008

### *How does it work?*

- The sponsor looks for an appropriate charitable foundation with goals s/he wishes to support. Of course it is also possible to make an endowment contribution to your own foundation.
- The sponsor and the foundation officially agree on the endowment. This shall clarify that the contribution will go towards the foundation's assets and not be used for a short-term purpose.

The sponsor transfers the endowment to the foundation's account. The donation will be added to the foundation's books in the asset column. Naturally, securities, real estate or other material items may be endowed as well if the foundation agrees to this.

### *Characteristics*

The characteristics of an endowment contribution are identical with those of an independent foundation (see p. 15 ff.).

### *Checklist*

- A foundation with the appropriate goals exists already
- And/or your funds are not sufficient for an independent foundation
- And/or the receiving foundation needs capital to reach an operational size. Especially the rising number of community foundations in Germany needs growing endowments to pursue their goals sustainably.

## ***Dependent Foundation or Foundation Trust***

### *Examples*

In 2004, David Pitt-Watson, CEO of an asset management company, decided to let his bonus work for others, giving back to the community. He asked the Charities Aid Foundation (CAF) to set up a trust for him. Since then, the Pitt-Watson-Barnes Trust has supported several charities that assist large companies in having a positive impact in developing countries – and one of the charities that once supported him with a scholarship, the Rotary Foundation. David likes the fact that all administrative tasks are taken care of by CAF Trust, giving him the flexibility to be involved when he has time to spare.

Today, multiple organisations specialise on brokering or offering trust services for sponsors to facilitate the establishment of foundations with low capitalisation. For example, the Charities Aid Foundation (CAF) in Great Britain offers this service: from 10,000 GBP upwards, sponsors can ask CAF to set up a CAF Trust, covering all the administrative tasks and investing the money. The income from the invested endowment is donated to charities and causes according to the founder's preferences.

### *Short description*

Some countries distinguish between autonomous and non-autonomous foundations. Autonomous foundations have legal personality while non-autonomous foundations are administered through another natural or legal person, the trustee. Such a foundation trust is established through an agreement between the sponsor and a trustee. Trustee candidates are mostly legal foundations. The capital is transferred to the trustee and will be managed according to the foundation trust's charter. Since in many countries it needs not to be approved by the public supervisory body little time and effort is needed to establish a foundation trust, as well as for its ongoing administration. However, the conditions of the different trustees vary greatly. The foundation trust does not have any civil rights or legal personality; it cannot execute any transactions or be a party to a contract, but it is represented by its trust. The sponsor can agree with the trustee to convert the foundation trust into an independent or autonomous foundation at a later date.

### *How does it work?*

- Sponsor and trustee (often a foundation) sign a foundation trust agreement in which the sponsor commits to transfer the designated funds to the trustee. In addition, the sponsor writes a charter in which the purpose of the foundation trust and the competences to be bestowed upon the trustee are stated.
- The trustee applies for a temporary certification of its charitable purpose with the tax authorities
- The assets are transferred to the trustee and are managed separately. In addition, the trustee handles all administrative tasks as laid out in the agreement. The new foundation trust utilises the organisational structure of the trustee, which usually reduces administrative expenses compared to establishing an independent trust.
- As outlined in the charter, the board(s) resume their tasks
- Charitable purposes and tax privileges apply to a foundation trust in the same way as to independent or autonomous foundations.

### *Characteristics (in addition to an independent foundation)*

The characteristics of a foundation trust are identical to an independent foundation (see p. 15 ff.). In addition, foundation trusts offer the following advantages and drawbacks:

- + in most cases there are no application process (→ quick establishment possible)
- + on-going activity without supervision by public authorities except charity law (→ cheaper)
- + changes to the charter or even dissolution possible without federal regulation
- legal transactions, such as employment or service contracts, can only be made by the trustee, since the foundation trust is not a legal person

### *Checklist*

- You use the foundation trust as a temporary construct, before transforming it into an independent foundation – either because you want to experiment and gain new experiences, or because you first need to work towards sufficient capital to endow to a functioning independent foundation.
- And/or you would like to reserve a right of withdrawal (e.g. during financial hardships) – as opposed to an independent foundation, you can dissolve a foundation trust and retrieve your capital
- And/or you would like to keep administrative expenses low and focus on devoting your capital to a charitable cause, which no other foundation realises in this manner.

## *Spending-down Endowments or Limited Life Foundation*

### *Examples*

The Irish-American entrepreneur Charles F. (Chuck) Feeney endowed his shares in the “Duty Free Shoppers Group” to the foundation Atlantic Philanthropies in 1984. When the company was sold in 1996, these shares were worth 1.6 billion USD. In 1999, Feeney decided to turn Atlantic Philanthropies into a limited life foundation - he wanted to actively experience the effect of his endowed money and remain in full control of the purpose of the foundation. The foundation must spend its entire budget of 4 billion USD by 2016. The annual budget quadrupled to 200 million USD that will go to charitable causes.

Along with an expert charity fundraiser, Declan Ryan (son of the founder of Ryanair) established One Foundation in 2004. Under the motto of "giving while living", the founders decided to spend down the endowment, estimated at around 100 million EUR, within ten years. The Dublin-based foundation actively supports non-profits improving the lives of young people with regard to poverty, mental health and minority integration, investing funds and skills.

### *Short description*

A spending down foundation is established for a limited time span in which it may and shall spend its entire funds. This is desirable if a social problem can be solved in a manageable timeframe. Legally, this is certainly possible: Legal foundations need not exist forever, but only work towards a sustainable solution for their cause. If the foundation’s purpose is, say, the refurbishment of a historic building, its purpose is fulfilled after the construction work is finished; or a time limit can be set on a professorship, for example, to explore a new academic field.

### *How does it work?*

- The founding process of a limited life foundation is in general similar to an independent foundation (see p. 15 ff.)

- Differences are only in the wording of the charter - the time constraint should be explained. A minimum length of 10 years is recommended in Germany in order to avoid concerns from the official authorities regarding tax evasion.

### *Characteristics*

The characteristics of a limited life foundation are identical with those of an independent foundation (see p. 15 ff.). In addition, it offers the following benefits:

- + The founder can actively take part in the foundation while he is still alive and see a goal completed
- + A limited time frame changes the organisational culture of the foundation: The goal must be pursued with innovative means, efficiently as well as effectively.
- + A limited life foundation often has a more focused goal than an independent foundation that is dedicated to a general charitable cause necessary to society.

### *Checklist*

- Your charitable project can be defined within a limited time span, e.g. 30 years
- You would like to avoid that your foundation becomes a heavily bureaucratic organisation but instead mobilise entrepreneurial spirit, say, by asking: “How can we reach our goal within 20 years?”
- You have sufficient funds to finance the foundation over the designated time span.

## Credits

### *Examples*

Laily Begum was a housewife in Bangladesh, her husband a day labourer. They lived from a little home farming in their garden and the day labour wages, which was rarely enough to properly feed them. In 1997 the Grameen Bank offered them a micro loan of about 20 EUR. With the money, she bought a cell phone to lend to friends and neighbours so they could avoid unnecessary visits to doctor, labour and food markets, should, respectively, the doctor be out, no work available or daily prices too low. Begum charged about twice the amount she paid to her phone company. After a short while, she earned 800 EUR a month, and could repay the loan easily. With further loans, she was able to buy a few cows and calves, five stores which she rented out to barbers, self-service laundries and restaurant operators, as well as a small house comprised of rental apartments. Today, Laily Begum and her family are part of Bangladesh's middle-class, and she wants her children to study abroad.

Nobel Prize winner Prof. Muhammad Yunus is currently founding numerous social businesses in Bangladesh in collaboration with different companies such as Danone, Intel or BASF. The companies have a low capitalisation but the partner company grants an interest-free loan to the social business. As soon as the loan is paid back, all further profits remain in the social business, and the ownership is transferred to its poor customers, effectively turning it into a cooperative. The goal is to eradicate poverty in two ways: (a) The product of the social businesses alleviates the negative consequences of poverty, e.g. vitamin-fortified yoghurt improves valuable nutrition, while (b) the ownership of the social business helps poor and disadvantaged population sections improve their financial situation.

### *Short description*

A credit or loan is the temporary provision of funds (cash, coins, account balance) or goods. The recipient of the funds or goods, the debtor, repays the credit amount back either over the time of or at the end of the period. In addition, there is usually an interest payment for the provision of the loan to compensate the creditor for the liquidity deficit as well as the default risk. Usually, the creditor will ask for collateral from the debtor in case s/he cannot

repay the loan on time. This could be a deposit, a mortgage<sup>6</sup> or a guarantee<sup>7</sup> from a solvent third party. A micro credit<sup>8</sup> usually has an annual interest rate of 20 to 25 percent – and is therefore much cheaper than a loan from commercial money lenders, who charge between 50 and 1,000 percent. A small group of debtors can provide the collateral in case there is a payment deficit or default with one of the group’s members. Charitable organisations can also stimulate low-interest or interest-free loans.

#### *How does it work?*

- The creditor searches for potential recipients within his environment or through the internet, or is approached by them.
- A due diligence of the credit worthiness is performed: Is there a plan to pay back the loan, and what are the details? How realistic is this plan?
- It is important to assess and evaluate the offered collateral, which can be in the form of third-party guarantees or mortgages; for micro credit to the impoverished, symbolic collaterals such as inherited valuables can be eligible.
- The creditor makes an offer for a loan (over the amount asked for or less; in addition, a successive disbursement might be a possible solution). The demanded interest should reflect the default risk, but it can be lower than the usual market rate to encourage and stimulate the social return.
- A credit contract is signed: There is a myriad of possibilities regarding the details and the wording of the contract to take the borrower’s situation into account. Examples are:
  - Loans with a long time span before the first due payment/instalment
  - A maturity loan, which is paid back at the end of the credit period
  - Subordinate (subprime) loans with a high probability of default, should the debtor go bankrupt

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<sup>6</sup> A mortgage is a credit agreement where property or real estate serves as collateral.

<sup>7</sup> Please see next chapter for a definition of guarantees

<sup>8</sup> Please see glossary for a definition of micro credits

- Completely unsecured loans, i.e. loans without any collateral. A long/term relationship with the borrower is advisable in this case
  - Option on credit, so-called “patient capital”: in case of a liquidity squeeze over e.g. 2 - 3 years, the debtor can make use of the credit, but need not to. The debtor can thus hedge against fluctuations in his or her income
  - Loans with individually designed repayment conditions
  - Loans with a very long credit period, e.g. when an organisation, which has been running on donations, is just transitioning towards a profit model
  - Bridge loans, e.g. in the case of subsidies that are disbursed at the end of a project
  - Loans that waive repayment upon successful project outcome
- The collateral is provided by the debtor as agreed upon in the contract
  - The credit is provided, i.e. transferred into the borrower’s account
  - The debtor pays the interest payments and instalments as agreed upon over the credit period
  - Private creditors must declare their profits from interest payments
  - It is important to note that a commercial provision of financial services may require the written authorisation of the relevant financial services supervision authority in your country. In the UK, for example, firms are generally prohibited to issue financial promotions unless they are authorised by the FSA<sup>9</sup> (FSMA<sup>10</sup> Section 21). For Germany, BaFin<sup>11</sup> stipulates that the provision of more than 20 private loans with a credit volume of more than 500,000 EUR is the limit for the non-commercial provision of loans. Disregarding the legal framework is a felony!

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<sup>9</sup> The FSA or “Financial Service Authority” is the regulator of all providers of financial services in the UK.

<sup>10</sup> FSMA stands for “Financial Services and Markets Act”. This law has been governing UK financial market regulation since the year 2000.

<sup>11</sup> The BaFin or „Bundesanstalt für Finanzdienstleistungsaufsicht“ is the national financial services supervision authority in Germany.

On rare occasions, there are social businesses, that provide bonds or fixed income securities, e.g. because they cannot issue stock as a cooperative or for other reasons. Technically, bonds are maturity loans. The creditor can avoid cumbersome negotiations, but instead read the sales documents, which were drafted according to certain guidelines. Then s/he can decide whether or not to provide a loan at the stated conditions.

A foundation can also take on a loan, for example, to pre-finance charitable investments or a business operation. In order to repay the loan, it is important that the foundation has a source of income. Private loans can be transformed into endowment contributions after the creditor has passed away (see p. 21 ff.)

A further option is micro credit, as described in the introductory example. Often micro credit enables people in developing countries without access to a sophisticated banking sector to start their own business. Or micro credit can be used to finance an investment that will spur growth in the business of small entrepreneurs. Micro credit is usually provided by micro credit banks or micro finance institutions (MFIs). One common requirement for micro credit is the grouping of a few debtors with shared liability, which leads to very high repayment rates. The internet offers private persons the opportunity to give micro credit directly to others, e.g. at [www.kiva.org](http://www.kiva.org) or [www.myc4.com](http://www.myc4.com). However, the private creditor bears 100% of the risk. Mutual funds reduce this risk through diversification over different borrowers, but also different countries and micro credit institutions. Examples are Vision Microfinance, Dexia Micro-Credit-Fund, or mutual funds provided by responsAbility.

If you think a direct credit is too complicated you can deposit your money with a socially focused bank such as Triodos in the Netherlands, Belgium, the United Kingdom, Spain and in Germany, the Merkur Bank in Denmark, the Alternative Bank in Switzerland, or the GLS Bank in Germany. These banks only finance companies and projects that comply with the moral conscious of the depositors. In this way, you become an indirect provider of capital, but with a low interest on your checking account.

### *Characteristics*

The return of a credit depends on the demanded interest, and the actual default rate. Inflation and a certain default risk, at least, should be considered.

The influence of the creditor on the business is usually very low. It's possible that the contract foresees a specific use of the money, however this would be hard to control and, in most cases, this is not sensible as it places unnecessary constraints on the entrepreneur.

Loans are usually made over a mid-term time horizon, which can be between a few months (micro credit) or ten years plus.

In addition, debt-financed projects and organisations need to make profits and lay out a business plan of how and when the repayment is possible with the earned income.

### *Checklist*

- You would like your money to “work” for a charitable cause – possibly at an interest that is lower than usual market rates (e.g. only correcting for inflation), but you do not want to part completely with your money.
- As with all investments, you are willing to take on a certain default risk.
- You would like to use your money for multiple causes – e.g. providing another credit after repayment of the initial credit.
- You can gauge the prospect of a business plan as well as credit worthiness, or you have contacts to e.g. accountants that have experience with this; otherwise, a mutual fund is the better option.
- You are convinced that credit is the more appropriate solution than donations for a sustainable eradication of poverty, because the borrower needs to (and can) prove that s/he is not permanently dependent on your funds.
- You are willing to tax your income from interest payments.

## **Guarantees**

### *Examples*

In November 2005, Deutsche Bank founded the “Global Commercial Microfinance Consortium” providing 81 million USD to micro finance institutions around the world. This consortium of a dozen institutional investors was made possible by a guarantee of 15 million USD from the US development agency USAID. This commitment lent credibility to the fund and reduced the risk for numerous investors to engage in the novel sector of micro credit.

A young tumor patient used to work on a small salary as an assistant social worker for children and lived in a small, affordable apartment. When her landlord died, the successor sold the house and the tenants were offered contracts at market-rate prices. The young woman lost her apartment and could not find another one that she could afford from her humble salary. After three months without a resident address, she could no longer be employed. After a few months on the street, she started selling street newspapers, where she developed a relationship with one of her regular customers, who was willing to act as a guarantor to a new landlord for her – she was convinced that the young woman would find a job again. Until today, the guarantee has not been redeemed and the formerly homeless young woman holds a permanent position today.

In numerous European countries, small and mid-sized entrepreneurs can become part of guarantee organisations whose members offer mutual guarantees to receive low-interest credit from participating banks. The oldest organisation is Socama in France, which in 2005 provided more than 700,000 guarantees. The applications are reviewed on a voluntary basis by members from the region of the applicant. The knowledge and experience of these experienced entrepreneurs of the local marketplace and the applicants is valuable information for the banks and an important basis for their credit approval.

### *Short description*

A guarantee is a type of collateral. Legally, it is a contract between a debtor and a guarantor, in which the guarantor makes a one-sided commitment: The guarantor commits to pay for

the borrower, in case s/he does not fulfil his or her obligations (default or delayed payment), e.g. in the case of bankruptcy. The creditor has an insurance against the default risk, assuming the guarantor has a higher credit-worthiness than the debtor. The creditor is usually a bank or a mutual fund (see glossary, p. 45), while the debtor is usually a charitable organisation. Guarantees are a means for social investors to support charitable organisations in loan applications. For one thing, most organisations do not receive a loan without a guarantee; moreover, a good guarantee can lead to low-interest loans.

*How does it work?*

- The debtor/charitable organisation applies for a loan
- The creditor/ the bank demands collateral
- The borrower asks a guarantor for a guarantee
- The guarantor offers a guarantee to the debtor. This can either be made free of remuneration, or the guarantor can require a fee for liabilities and charges, so-called “aval interest,” which is usually much lower than the loan interest.
- The conditions are agreed upon between the bank, the debtor, and the guarantor. For the guarantor it is important to know all the details of the credit contract, since s/he is liable for the responsibilities of the borrower. Usually, guarantees are capped at a certain amount - unlimited guarantees are possible, but highly risky. Guarantees can also insure against future liabilities resulting from the bank-debtor relationship – which significantly increases the risk for the guarantor as well. If you as an investor would like to avoid personal liability, you can also offer material assets as collateral, which the bank can access in case of default. Moveable objects, such as art or vehicles, are subject to lien<sup>12</sup> (or are transferred as collateral), while real estate is subject to land charge or a mortgage<sup>13</sup>.

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<sup>12</sup> **lien** is a claim a person can make over an item of property to secure the payment of a debt or performance of some other obligation

<sup>13</sup> Land charge is an interest in land that imposes an obligation on the landowner in favour of some other person; land charges will normally bind purchasers of the land.

- It is very important to have detailed and transparent agreements laid out in a written contract: Which liabilities are you responsible for as guarantor? What is the maximum amount of liability? When are you actually liable for the debtor's obligations? Does the bank need to file a law suit against the creditor first, or can it immediately call upon the guarantor in case of default on a single loan payment? When will the liabilities be erased again? This is the only way for you to limit your risk as a guarantor. All options should be considered in drafting a contract - which makes the case of non-default even more pleasant.
- In case of default or delayed payment, the bank can make the guarantor liable for the debt.
- If you have to take over a payment for the debtor, you have a claim to compensation from the borrower – you inherit the problem from the bank that could not claim its demand from the debtor. As guarantor, income from fees is subject to taxation, however, in case of default, you generally cannot claim these expenses on your tax statement.
- As in the case of credit, is it important to note that a “commercial” provision of financial services requires the written authorization of the relevant financial services supervision authority in your country. For Germany, BaFin stipulates that the provision of more than 20 private loans and/or guarantees with a credit volume of more than 500,000 EUR is the limit for the non-commercial provision of loans. Disregarding the legal framework is a felony!

### *Characteristics*

If the guarantor can keep the effective default risk at a minimum, e.g. by applying strict approval criteria, it is possible to receive a return at the usual market rate of a checking account. Since there is no transfer of money (until the case of default) the same liquidity can, theoretically, be used to guarantee more than one credit. In the case of a 10% default risk, the amount of the guarantee could, in theory, be used up to ten times. However, this calculation is severely impacted by only one additional default and the guarantor has to pay for an additional guarantee. The return is also diminished by transaction costs associated

with the debtor selection, such as analysing the goals and activities of the charitable organisation, and assessing its work and creditworthiness. The time invested in this process should be calculated at an appropriate hourly rate and figured into the return on investment. On the other hand, it is possible to contractually oblige the debtor to share a portion of the profits with the guarantor. This creates an equity-like relationship (see glossary, p 45; chapter Private Equity., p. 38 ff.), since the return of the guarantee is bound to the success of the debtor.

Generally, your influence as a guarantor on the (social) activities of the debtor is very low - however, it is possible to set conditions in the contract, which can be freely negotiated.

In general, a guarantee exists until the loan is fully repaid. The guarantee contract usually allows a premature termination only if another collateral of equal value is provided. However, it is possible to set a time limit on your guarantee, or agree upon a different framework for termination.

Guarantees are only applicable for projects with debt investments that are likely to achieve a return to repay the interest and the loan amount. This is applicable to many of the recently emerged social businesses. Projects in the conventional charitable sector usually do not have an income as they spend 100% of their money. Since they cannot repay loans, guarantees are usually not applicable for this type of social finance. In the past, typical recipients of guarantees are e.g. micro finance institutions (MFIs). Other examples are investments in the area of foster care or other social services, or the financing of private schools or day cares.

### *Checklist*

- You know the borrower well, and can estimate the risk better and more precisely than the bank. This informational advantage benefits the debtor: it reduces the costs for capital procurement as a guarantee is often a positive signal for additional creditors or investors.
- You are seeking a secure remuneration for your money, such as a fee or a share of the profit (speculative), should the projects generate profits in addition to its social benefits.

- You would like to support projects in other countries while minimising your exposure to exchange rate risks. Only in the case of default do you need to exchange money.
- You are willing to tax your income from being a guarantor

## **Private Equity (Seed and Venture Capital)**

The British "Ethical Property Company" buys property and buildings and turns them into affordable office centres for charitable organisations. Since 1999, several public issues of shares have taken place, supported by Triodos Bank. Small investors can thus put their capital into the company, enabling Ethical Property to buy further buildings etc. During the past eight years, an annual dividend of, on average, 3% was distributed. However, shareholders are offered the possibility of passing on their dividend into a waiving fund, which in turn supports the charitable customers of Ethical Property Company.

The socio-ecologically oriented investment fund BonVenture in Munich took up an investment with JobTV24 GmbH (~ltd.) in October 2005. In mid-January of 2006, JobTV24 went live as a TV channel with a video portal and the sole focus on job-, career- and entrepreneurship consulting. BonVenture supported the company both in its search for investors for second round financing at the end of 2006, as well as in its transformation into a pure video portal in early 2008.

### *Short description*

Seed and venture capital or "private equity" is provided as share capital in (newly established) companies. Usually, capital is given in the form of equity, meaning that it is at the disposal of the company and its creditors and cannot be recalled by the investor/shareholder. A different form is a subordinate, equity-equivalent loan, so-called mezzanine capital.<sup>14</sup> Depending on the life cycle phase a company is in, capital is required to finance the start-up phase, during which product development, for instance, is still under way, or a growth phase. Investors can be both private persons as well as companies, or even foundations, whereby the latter can usually only invest assets rather than use parts of their annual budget. You can of course also become active as a founder and entrepreneur yourself. Often, credibility towards further investors is higher if you, the founder, are willing to bring in

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<sup>14</sup> Subordinate loans are credits which are treated 'subordinate' or lower-ranking compared to normal debt capital. In case of a liquidation or bankruptcy, subordinate loans are considered only after other debtors but before the shareholders. They are considered an intermediate form between equity and debt capital.

your own money as well.

Private equity allows robust and competitive private sectors to emerge, which in turn creates jobs, thus raising living standards as well as increasing tax revenue. A robust sector of medium-sized businesses is essential to the economic development of many countries. Donations applied carelessly, on the other hand, can create financial dependencies or in extreme cases even ruin existing companies through subsidised competition (e.g. donated second-hand clothing in the textiles sector).

*How does it work?*

- The founders of a social business approach potential investors and describe their intentions.
- If the investor finds the project outline convincing, a personal meeting follows.
- Further documents like a company presentation and the business plus financial plans are evaluated to see whether the business idea appears well-thought-out. It is important to remember to check the intended social return: will the company's activities really cause something positive, i.e. a benefit to society? Are the causal assumptions between economic activity and intended effect correct, e.g. will fair salaries for parents in a developing country really lead to children going to school instead of having to work to increase family income?
- Experts should carry out a more detailed analysis of the investment respectively project (analyses of strengths/weaknesses, opportunities/risks, references, etc.). This so-called "due diligence" gives you as the potential investor a sound overview of the business concept and the related opportunities and risks. It allows you to estimate what the enterprise is "worth" financially, but also socially.
- On this basis, a contract regarding the investment is negotiated. Subject of the agreement are among other things the percentage of shares held by each investor, the amount of money to be paid for these as well as the future distribution of earnings. In general, both founders as well as investors are shareholders of the company. In addition to the capital brought in, investors often pay a premium or

"agio".<sup>15</sup> In return, they receive preferential pay-outs of earnings, until their investment has reached a defined minimum return. Another important item is the distribution of voting rights; often, an advisory board is established which is authorised to issue directives towards the management in certain areas.

- The company is established and begins operations. Its owners or shareholders participate in the profits generated and, depending on the size of the investment and related voting rights, often influence the strategic development of business activities. If a company makes a loss, the owners might have to inject fresh capital. If further investors join in at a later point in time, or not all existing owners participate in a capital increase, voting rights can change. This is also called "equity dilution". A bankruptcy and therefore the loss of all capital invested is also possible. Hence, specifically foundations should calculate the risks involved in an equity investment very carefully.
- Distributed profits are taxed, after they have been offset with losses from other capital investments.<sup>16</sup>
- To regain the solvency of the capital invested, you as an investor would have to sell your shares. An initial public offering (IPO) is one possibility, but also selling the shares to external investors or the existing other shareholders.
- More difficult is a direct ownership of a charitable company. These usually cannot distribute profits to their shareholders, what makes the shares financially worthless. In these cases, investors can participate in the economic success of a company via subordinate loans, with interest rates and amortisation at market rates. Instead of a fixed interest rate, a share of the revenues generated is also possible. If you are also an owner of the company and would like to participate in a charitable company in this way, you should make sure that the terms of the loan provided are truly market rate. In most countries, the charitable organisation has to be able to prove that it is not using increased interest rates as a hidden dividend. If the company is a social enterprise, this problem usually does not exist: despite pursuing social goals, social

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<sup>15</sup> The premium or agio is an additional charge to the nominal value of the investment and is usually stated as a percentage. In the case of company shares / participation, the agio is booked as capital reserve of the enterprise and therefore becomes part of the equity. Capital reserves are surpluses from commercial activity, reserved for specific future purposes.

<sup>16</sup> The amount of taxes will vary from country to country.

businesses or social enterprises are usually not recognised as charitable by the relevant authorities and therefore do not receive tax privileges.

Less risky than seed capital but only rarely possible is the purchase of shares of existing social enterprises, i.e. venture capital. Even more secure is an investment via so-called "venture capital funds", which spread the risk between several companies, often in different phases of their life cycle. However, funds can generally be recommended for middle and long-term investments of five to ten years.

For companies, Joint Ventures<sup>17</sup> are a suitable possibility to establish a social enterprise. Firstly, they don't carry the full commercial risk, and secondly, their own activities have a considerable impact on the success of such a "social joint venture".

### *Characteristics*

In the conventional private equity business, returns of 15 to 25% and more are usually aimed for, considering the high risk involved in investing in young companies; including the failure rates, a return of 10% is probably realistic. Social enterprises often take higher costs of production into account to fulfil their social and where applicable ecological goals, e.g. by paying fair salaries or investing in infrastructure and education, the pay-offs of which are rarely seen in the short term. As such, a lower return is almost the norm. However, you should consider rewarding the social enterprise's social "return" by limiting the dividend received, e.g. to a compensation for inflation or around 2-3% above prime rate of the European Central Bank (ECB). The majority of profits are then available for the growth of the company, thus allowing an even higher "social return" to be generated.

Depending on the size of the investment, you as an investor have a significant influence on the strategic focus on the social enterprise. Especially seed investors often take on a role as "mentor" or "business angel" and usually find their expertise and experience is more than welcome.

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<sup>17</sup> Joint Ventures are enterprises established by two existing organisations. Often, both companies hold 50% of the shares. In the social sector, Joint Ventures can be the optimal form of cooperation between an NGO (non-governmental organisation) and a regular business. A popular example is Grameen-Danone: Danone is expert for yoghurt production, Grameen has the access to and knowledge about the market and the needs of the poor in Bangladesh. The Joint Venture produces yoghurt enriched with vitamins lacking in the everyday nutrition of most poor people there – at a price the target segment can actually afford, using an adequate distribution system to effectively reach children and families.

Institutional investors often retreat from a company after two to five years. There is basically no data for the socio-ecological sector. It appears desirable, however, to consider longer durations to enable the aspired long-term social change to take place. Shares in funds should also be held for five to ten years.

Similar to loans, share participations are only appropriate for enterprises that can generate positive cash inflows. Unlike loans however they are especially suited for young companies which cannot yet estimate, when exactly what revenues will be earned and how much. In most countries, the legal form is still a hurdle for social enterprises: they have to operate as normal, profit-oriented companies because charitable organisations cannot distribute dividends. Their activities, just as your investment, are not considered charitable. As such, your investment will be treated like any share transaction at the stock market and cannot be deducted from your taxes like a donation.

#### *Check list*

- You don't shy away from taking risks: when you will receive your money back is uncertain, and your claim will be subordinate to any creditor.
- You wish to put your money to good use several times, i.e. either the dividends or the money received back after selling your shares will be employed again as a 'social' loan, guarantee or private equity investment.
- You can imagine letting the company participate from your professional know-how. Ideally, you have experience from a similar business sector.
- You want to use your influence as owner and shareholder to ensure the social values and goals of the enterprise remain the focus of all activities.
- You are either convinced of the success of the enterprise and/or want to take the higher risks associated with private equity for philanthropic reasons. You would consider a loss of your capital equivalent to a donation.

## Summary and Outlook

There are numerous possibilities to invest in an ethical and sustainable way. Today, investors, creditors and guarantors can do just as much 'good' as donors and benefactors. As an investor the choice of financial instrument remains yours, depending on your social goal and the way you think social change can be enhanced most effectively. This guide is meant to encourage you to think beyond classic charity, when and where this is possible and sensible.

Overview of direct and indirect financial instruments (details in brackets are examples only)

<b>Form</b>	<b>Direct spending by investor</b>	<b>indirect, i.e. via third parties or persons (intermediaries)</b>
<b>Donation</b>	Direct donation, internet platforms (betterplace.org, elargio.de, globalgiving.com, ggiveindia.org)	Registered charities, foundations, Civil Society Organisations (Oxfam, Save the Children, UNICEF)
<b>Foundation</b>	Independent Foundation  Limited life foundation  Foundation Trust	Endowment contribution
<b>Credit</b>	Personal contact, Internet platforms (kiva.org, myc4.org)	Banks with ethical focus (Triodos, GLS, Umweltbank), Micro finance funds (Vision Microfinance, Dexia Micro-Credit-Fund, responsAbility)
<b>Guarantee</b>	Personal contracts	Guarantee societies (GLS Bürgengemeinschaft, Socama, Confidi, Cesgar – also refer to their European Association <a href="http://www.aecm.be">www.aecm.be</a> )
<b>Private Equity</b>	Direct Investments, business plan competitions (bidnetwork.org)	Investment funds (BonVenture, Bridges Community Ventures, NESsT, New Profit Inc.)

## Summary

This table is meant as a rough and quick overview. The amounts and timelines given are merely meant for guidance to assist your orientation.

	<b>Rate of return</b>	<b>Influence</b>	<b>Time span</b>	<b>Capital required</b>
Donation	-100% plus fiscal benefits	Generally very low, appropriation possible	-	from 1 EUR
Independent foundation		100% will of sponsor	forever	D: 50,000 EUR, E: 30,000 EUR, P: 250,000 EUR, UK: none, recommended: min. 5 million EUR
Endowment contribution		choice of foundation	forever	approx. 3,000 EUR
Foundation trust		100% will of sponsor	>5 years	approx. 10,000 EUR
Limited life foundation		100% will of sponsor	<30 years	as for independent foundation; recommended: min. 1 million
Credit	~ up to 8%	Low, contractual freedoms	months (Micro) up to ca. 20 years	15 EUR (Micro) up to 500,000 EUR
Guarantee	~ up to 3%	low	>1 year	~ 1,000 EUR
Private Equity	~ up to 10%	Depending on voting rights	>3 years	~ 30,000 EUR

## Glossary

(Private) Equity: The equity of a company, calculated as the value of all assets less all liabilities. Investors are usually private individuals, sometimes via private equity funds as an intermediary.

Funds: Open investment funds are a type of financial investment. Money of numerous investors is pooled and invested according to the principles and goals of the fund. Shares of funds can be traded similar to company shares; investors are therefore owners of the funds.

Charitability: activities advancing society as a whole in material, spiritual or moral / ethical areas in an altruistic manner (e.g. arts and culture, education, science and research).

Microcredit: a small loan between one and several hundred dollars, given without collateral. Usually, the goal is to support an entrepreneur in a developing country, increasingly in developed markets as well. Often granted by NGOs or specialist financial service providers.

Rate of return: In this guide, the term always refers to the financial return of an investment. Independent of this is the social return of an investment. Every project, be it a foundation's or a social enterprise's, has to prove its social effectiveness.

Social enterprise: a company whose goal is to realise a social or charitable goal with entrepreneurial, financially sustainable means. Examples are "Dialog im Dunkeln", a company that creates jobs for the blind while increasing awareness for interactions with disabled among broad sectors of the population, "Belu Water" that sells premium priced bottled water from the UK in the UK and donates most of its profits to water purification projects in developing countries, or Aravind in India, a chain of eye clinics which treat the poor for free and secures its income from the treatment of richer patients.

Foundation – community foundation: A foundation, from citizens for citizens, which usually engage for local or regional welfare. They usually have broad purpose so as to be able to get involved in numerous ways. Contributors to the endowment can be involved in the foundation's strategic decision processes via advisory boards etc.

Foundation – Company foundation: so-called company-related foundations hold large parts of a company's shares or even operate a company. In case of charitable status, the dividends distributed by the company have to be put to use to further the foundation's charitable goals, similar to interest received.

## Recommended Reading

Adloff, Frank; Schwertmann, Philipp; Sprengel, Rainer; Strachwitz, Rupert Graf (2004): Visions and Roles of Foundations in Europe – The German Report (Arbeitshefte des Maecenata Instituts für Philanthropie und Zivilgesellschaft, Heft 15), MAECENATA VERLAG, Berlin

Bolten, Margaret; Kingston, New approaches to funding not-for-profit organizations; Charities Aid Foundation (CAF), 2004

Brealey, Richard A.; Myers, Stewart C.; Allen, Franklin (2008): Principles of Corporate Finance, 9<sup>th</sup> edition, McGraw-Hill Higher Education

Clark, Catherine H.; Gaillard, Josie T. (2003): RISE CAPITAL MARKET REPORT: The Double Bottom Line Private Equity Landscape in 2002/2003, Columbia Business School (obtainable as pdf at <http://www.riseproject.org> → Reports and Case Studies)

Koch-Weser, Maritta; van Lier, Tatiana (2008): Financing Future, Innovative funding models at work, 2<sup>nd</sup> edition, available via [www.gexsi.org](http://www.gexsi.org)

Mitchell, Louisa; Kingston, John; Goodall, Emilie (2008): Financing Civil Society – A Practitioner’s view of the UK Social Investment Market (obtainable as pdf at <http://www.cafonline.org> → For charities → Funding solutions → Venturesome → For the wider market - publications)

NCDO (2008): Venture Capital and Private Equity for Development Index 2008, Amsterdam

Nicholls, Alex; Pharoah, Cathy (2008): The Landscape of Social Investment – A Holistic Topology of Opportunities and Challenges (obtainable as pdf via the website of Oxford Said Business School [www.sbs.ox.ac.uk](http://www.sbs.ox.ac.uk) → Faculty and Research → Skoll Centre for Social Entrepreneurship → Research)

Yunus, Muhammad (2008): Creating a World Without Poverty – Social Business and the Future of Capitalism, Public Affairs

## The Author

Anne-Kathrin Kuhlemann is Managing Director of Konvergenta InterZero, a communication agency for ethical and ecological change. As founder of Social Stock Exchange Germany she offers a platform for growth capital for sustainable businesses and as Executive Chair of Social Stock Exchange Association e.V. networks similar initiatives. She is a visiting lecturer at Fachhochschule Münster and recently initiated a "Social Investment Fund".

After her studies of "European Business" the doctoral candidate gathered experience both in the private as well as the third sector, among others as Managing Director of GENISIS Institute for Social Business and Impact Strategies, consultant with Bain & Company, founder of Portal Consultants (UK) as well as with World Bank and the German Embassy in Brazil.

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