FROM GRANTS TO GROUNDBREAKING:

Unlocking Impact Investments

An ImpactAssets issue brief exploring critical concepts in impact investing

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Supporting these business models can be accomplished by combining impact investment funds, which seek both financial and social return, with flexible grant funds, which seek a social return but do not require a financial return. Coordinated grants may not only decrease the risk of transactions but also prepare and support socially driven financing models, thereby enabling impact investment opportunities that might otherwise not be possible. Grants can reduce transaction risk for impact investors in several ways; two examples include through participating in capital stacking and by serving as loan loss reserves. Using grants to pay for demand studies and deal structuring are examples of how grants can lay the groundwork for socially driven financing models.

Living Cities: Coordination of Grants and Investments in the U.S.

Living Cities was established twenty years ago and is comprised of 22 of the world's largest foundations and financial institutions that pool their capital to work on behalf of low-income individuals in US cities. Living Cities deploys a variety of different types of capital—grants, below-market rate flexible debt pooled from member foundations through the Catalyst Fund, and commercial debt from bank and insurance company members. Living Cities capital has been leveraged nearly 30 times, resulting in over $16B of financing that has helped build schools, affordable housing, clinics, childcare and job training facilities, among other community institutions and services for low-income communities.

Over the past five years, Living Cities has experimented with several ways to coordinate different types of risk capital into investments which meet community, philanthropy and investor requirements. One lesson from this experience has been how difficult it is to originate and close deals that deliver social impact, even with flexible, below-market rate debt. Some potential borrowers are nonprofits that have historically raised grant funding but do not have the expertise to structure and close a loan. Other borrowers have limited track records lending to low-income communities and require grants to protect lenders against potential losses. And still others are simply not ready for debt because they require grants to support business planning or other predevelopment activities.

Living Cities, like many fund managers in the impact investing arena, believes risk capital in the form of impact investments alone is not enough to address the enormous social and environmental challenges facing our communities today. Extensive work has been done on the topic of using philanthropy as a strategic bridge to impact investments, primarily in a developing world context; those articles should be explored as well.[2] The intention of this Brief is to provide specific models of domestic collaboration and illustrate how grants may be thoughtfully structured to support social and environmental impact while also attracting additional investment capital.

[2] The most recent example of work in this area is the report From Blueprint to Scale, produced by Monitor Group and Acumen Fund (http://www.mim.monitor.com/blueprinttoscale.html). Other examples may also be found through a brief literature review.

generally require commitments to fund a blind pool rather than a particular set of project investments. As a result, investors are backing a strategy and/or a set of parameters, but not a set of specific investments.

In order to attract investors with different risk and return parameters, the fund is organized in layers, with each layer reflecting a different risk/return profile. The investors in the top layer of the stack get priority for repayment (called seniority). If there are losses, the most senior lender is repaid first, making the levels at the bottom least likely to receive repayment in full.

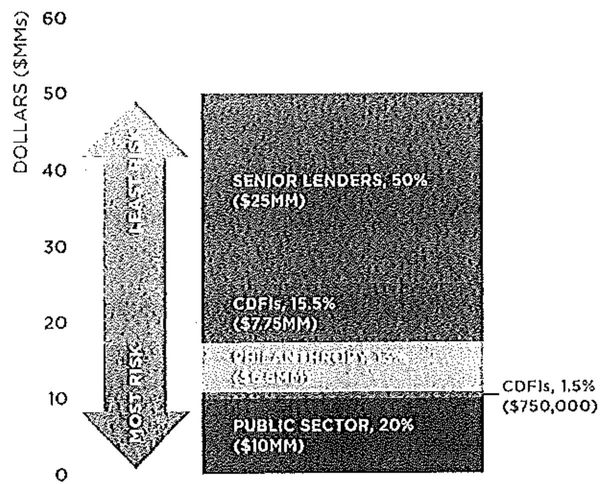
Layered capital stacks are commonly used in project finance. Structured funds with layered capital stacks are less common in the impact investment field. Creating these funds has been difficult and time consuming to create given the highly tailored nature of impact transactions and the individual financial and programmatic requirements of impact investors.

We will use an example of an investment that the Living Cities Catalyst Fund made into the Bay Area Transit Oriented Affordable Housing Fund[4] (TOAH) to illustrate the impact of a layered capital stack.

In March 2011, the Catalyst Fund lent $3MM to the TOAH, sponsored by the Great Communities Collaborative, a 24-member collective of Bay Area nonprofits, national organizations and regional philanthropic entities. The $50 million TOAH provides early-stage financing primarily for affordable housing with some mixed-use developments in mixed-income, transit-oriented development communities. The Low Income Investment Fund is the TOAH fund manager. Six community development financial institutions[5] (CDFIs) serve as the originating lenders for the TOAH.

The TOAH pools four different types of impact investors, with each impact investor accepting a different level of risk. The priority of each investor level is shown on the graph and listed on the following page from least risk to most risk.

BA TOAH FUND CAPITALIZATION



[4] For more details, please see the following website: http://bayareatod.com

[5] Definition from the CDFI Fund Website: a certified Community Development Financial Institution (CDFI) is a specialized financial institution that works in market niches that are underserved by traditional financial institutions. CDFIs provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers, flexible underwriting and risk capital for needed community facilities, and technical assistance, commercial loans and investments to small start-up or expanding businesses in low-income areas. For more information, please visit the CDFI Fund's website: http://www.cdfifund.gov/what_we_do/programs_id.asp?programid=9

Because grants do not require repayment or a rate of return, they can be used more flexibly in transactions. Grants can be used to provide guarantees, fund a loan loss reserve or serve as flexible lending capital (as discussed in the prior section).

When blending grants with loans, philanthropy should coordinate with impact investors to determine the best use of the grant capital. If a lender is lending to a weak borrower, an aligned grant can be helpful in serving as a buffer, or loss reserve, for the loan. But a grant to support programming and capacity building to the same organization, while important, probably would not enable the lender to make its loan.

In 2011, the Living Cities Catalyst Fund made a $700,000 loan to the Neighborhood Development Center ("NDC") as part of the Living Cities Integration Initiative[7] in Minnesota. NDC is a Twin Cities non-profit CDFI[8] established in 1993 that offers training, technical assistance and loans to local small businesses. The loan from Living Cities enables NDC to provide working capital, equipment and real estate loans to locally-owned small businesses located along a light rail transit corridor that is currently under construction. These loans are intended not only to help these businesses survive during construction but also to enable them to expand and grow to capitalize on increasing land values and foot traffic post-construction.

As NDC is a relatively small CDFI that historically used grant funding to make loans to high risk borrowers, this loan was initially too risky for the Catalyst Fund. However, Living Cities was able to provide a $200,000 aligned grant to NDC to mitigate any losses that the Catalyst Fund loan might incur. In this case, the grant funding was the critical capital. Without the buffer for loss, the Catalyst Fund would not have been able to provide a $700,000 loan.

It is important to point out that the use of the $200,000 in grant funding to support loan losses was a more compelling use of capital than simply making a grant to the organization to cover general operating costs or specific programming. The grant enabled NDC to secure the loan from the Catalyst Fund, which is helping the organization build a track record and credit history that will enable it to potentially access larger and more conventional forms of capital in the future. NDC is able to earn interest income on the loans it makes, thereby helping the organization decrease its overall reliance on grants. In addition, any of the $200,000 that is not used to cover loan losses becomes a general operating grant for NDC once the Catalyst loan is repaid, which helps to align incentives and encourage the organization to take appropriate risks. In an increasingly subsidy-constrained environment, we believe that all of these factors are critical for the health of CDFIs like NDC.

[7] Please see Living Cities website for more details: http://www.livingcities.org/integration/

[8] Community Development Financial Institution

During the last two years, Living Cities made over 15 grants to support emerging energy efficiency programs in cities throughout the United States.[9] The initial grants were awarded based on four criteria, one of which was that the grantee was developing an approach toward energy efficiency lending that could scale. These models were in the development phase and it was Living Cities intent that the initial grants to support these programs as they moved from inception to early stage pilots would lead to subsequent loan opportunities for the Living Cities Catalyst Fund.

However, the initial portfolio of grants only led to one loan opportunity for Living Cities. This can partially be explained by the overall challenges of developing energy efficiency financing models; however, another contributing factor was the way the grants were made. These grants served as planning and capacity grants to help catalyze energy efficiency programs. However, the grants had a variety of objectives, and the structure, management and evaluation of the grants were not specifically focused on developing energy efficiency lending models.

The core lessons learned by Living Cities about using grants to facilitate debt financing may be summarized as follows:

- Grants need to be made with clear, prioritized objectives. Too many objectives may muddle the opportunity for later stage impact investment.
- If grants are to seed later stage investment from impact investors, they should be structured with milestones and benchmarks identified as requirements from impact investors.
- Grant-making should not be siloed from lending in organizations such as Living Cities that have the capacity to provide both. Rather, grant making and lending should be constantly collaborating and working across a shared agenda and theory of change.

The intentional sequencing of grants and debt is a promising but developing area for the impact investing field. Based on these lessons learned, Living Cities is in the process of examining its own governance structure and policies to better understand how the organization can shift to better support impact investing through its grant making. Living Cities is also exploring the array of activities that grants can fund (e.g., feasibility studies, demand studies, start-up costs) to enable impact investments. The organization will continue to dedicate time and resources to learn from its experiences regarding the optimal conditions and circumstances for sequencing grants with debt and looks forward to disseminating lessons learned with others in the field of impact investing.

[9] Energy efficiency is the practice of reducing energy consumption. Living Cities made grants to energy efficiency programs that were focused on scaling energy efficiency in buildings, particularly affordable multifamily buildings. Developing a model for energy efficiency lending that uses external capital is believed to be important for the growth of the energy efficiency sector and these programs because many building owners do not have the upfront capital to pay for energy efficiency improvements.