Investors' Perspectives

Is more debt the answer?

Clara Miller

The social capital market is revving up in the wake of the spectacular nosedive of the global capital market. In the US, a number of foundations are exploring philanthropic debt for the first time, providing PRIs (programme-related investments, generally loans made from the grant budget) and MDIs (mission-driven investments, including loans and equity investments in both for-profits and non-profits, sometimes from the endowment itself). Community Development Financial Institutions (CDFIs) are shifting from financing housing alone to lending to non-profits. Internationally, there is continuing enthusiasm for 'social debt', 'social business' and 'social enterprise'. All this leads to the inevitable question: is more philanthropic debt the best (or only) answer to inadequate and unbalanced social sector capitalization at this time?

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At Nonprofit Finance Fund (NFF), we have provided both debt and non-debt capital to social sector organizations for 25 years.[1] I believe that the current unbridled enthusiasm for more debt represents a kind of 'irrational exuberance'.[2] Here are four observations from NFF's experience in the US 'social capital market' (the market I know best), where debt presents both opportunities and limitations. In my opinion, there's also an emerging role for philanthropy in providing critically important philanthropic equity.

1 *Debt is not a good fit for many capital needs.* Debt can never be a *substitute* for revenue. Debt helps reconcile the timing of revenue and expenses when there is a mismatch. For example, if you build a homeless shelter, all the expense occurs prior to occupancy and the revenue comes in over time. A mortgage, working capital loan or loan against receivables, such as government contract payments, can work well for these straightforward business needs. For debt to work well, however, income to repay it must be adequate and reliable.

2 *Transaction profitability, not repayment risk, is the biggest barrier to mainstream debt access for social sector organizations.* Structural changes in the economy have led conventional banks to reduce exposure in, or withdraw from, this market mainly because most transactions are too small and complex to meet profitability requirements. Foundations and financial intermediaries should use innovation and partnership to bring them back rather than attempting to build a parallel banking system for 'social needs'.

Development finance is a way to bring excluded groups back into the mainstream economy and make sure they have access to the full range of banking services. Success means mainstream banks will take on these markets and CDFIs and similar 'social bankers' will typically exit. Social sector bankers nearly always play an ambivalent role: while we provide debt to excluded borrowers, we also want to graduate them from dependency.

In emerging economies, the situation is different. Financing tools such as microenterprise finance represent a huge market opportunity for mainstream commerce. Nigh on 40 years of investment by philanthropy and development banks has laid the groundwork for a retail banking industry where none existed to serve an emerging middle class.

3 *Conventional debt finance may push capital into the wrong activities.* The debt market (primary and secondary) favours large, secured transactions with a reliable source of revenue – think homes for the mentally ill or long-term elder care facilities. Loans thus tend to be focused on care and remediation rather than prevention, which is more expensive and less desirable. Organizations working to prevent social ills are more likely to need technology or personnel, and the debt instrument appropriate for these needs (if any) is unsecured working capital for overall enterprise growth.

4 *Debt is less critical than equity.* Charitable donors and social investors can make a major contribution by providing 'philanthropic equity', a form of growth capital analogous to equity investment in the for-profit world. Although debt is an appropriate tool in many cases, most organizations are in greater need of equity-like investment to assure operating health and adaptability.

New entrants into the social lending world should worry not about the repayment risk but about the risk to the field itself of overly high levels of debt. The wrong sort of debt can cripple even large organizations, depriving the public of the benefit of their programmes and services. But the right combination of philanthropic equity, debt and enterprise knowledge can assure adaptability and effectiveness in the current environment. @

1 Debt capital includes mortgages, working capital, receivables finance, bridge loans and tax credits. Non-debt capital includes replenishment capital, philanthropic equity and growth capital.

2 This is what Alan Greenspan, ex-Chairman of the US Federal Reserve Bank, called the recent financial bubble on Wall Street.