



## The Hard Numbers on Social Investments

HBSWK Pub. Date: Nov 10, 2003

*The field of social-purpose investing is growing and becoming more sophisticated. Should investors expect lower returns to benefit society? A new Harvard Business School study examines the question.* by Manda Salls

In what is believed to be the largest study of its kind, MBA students at Harvard Business School recently analyzed the financial returns generated by 110 early-stage companies backed by Investors' Circle, a national network dedicated to early-stage investments in companies that "deliver commercial solutions to social and environmental problems."

The goal of the study was to help IC, whose members collectively invested \$80 million from 1992 to 2001, the time horizon of the study, develop a fact-based understanding of the financial returns generated by the companies that had received capital through their network. Results would also help IC members discuss the larger question about the relationship of financial returns and social returns. In short, should capital providers expect some lesser degree of financial performance in favor of social returns?

In this e-mail interview, HBS Social Enterprise Initiative executive director Stacey Childress discusses the study and its implications for investors.

**Salls:** Tell us about the study. What did the team set out to do?

**Childress:** A team of three MBA 2003 students, Steven Carden, Hank Midgley, and Carolyn Wolff, gathered data on 110 of the 128 IC investments, collecting both the valuation at the time of the initial investment and the current valuation at the time of the study for privately held companies,

or the exit value for those that had experienced a liquidity event. After collecting and analyzing the valuation data, the team was able to draw some conclusions about how the companies performed individually and as a hypothetical portfolio. They were also able to make some observations about how investor behavior contributed to the success of individual IC members. The students worked under the supervision of Olive Darragh, a director in McKinsey & Company's Boston office, and me, on behalf of the Social Enterprise Initiative here at HBS.

**Q:** Why was it important for the Social Enterprise Initiative to sponsor this research?

**A:** The field of social-purpose investing is growing and becoming more sophisticated. For years an important debate has been raging in the social investing community about the potential of social purpose companies to deliver satisfactory returns to investors.

The conventional wisdom is that capital providers should expect some trade-off between financial returns and social returns, a willingness to accept a social discount to financial returns. However, some in the social investing community believe that this is simply untrue. Because of the increased risk associated with investing in early-stage social ventures, and their ability to dramatically alter conventional approaches to social problems through market solutions, the rate of return on these deals should be at least as high as traditional early stage investments.

The big winners were in the technology and health care sectors, and in another group of companies that were categorized as industrial.

Unfortunately, the lack of data about the actual returns of a specific set of companies in this early-stage category has resulted in an ongoing philosophical

debate that to date has been based largely on anecdotal investor experience. As

far as we could determine in the summer of 2002, this was the largest study ever undertaken to analyze the financial returns of a set of early stage social-purpose companies that had received funding from a discrete group of individual investors.

**Q:** How did the team determine how the companies had performed as a whole?

**A:** The team had an important insight during their work. Because of the variability of individual IC member investment expertise, it was difficult to judge the performance of the set of companies solely on the experience of the members. In an effort to evaluate the companies in aggregate, the team created a portfolio containing the 110 companies. The team used the actual initial and current or exit valuation data of the companies, but constructed two hypothetical investment strategies.

In scenario one, the team used a strategy that assumed an initial investment of \$175,000, subsequent investments averaging \$115,000 in all follow-on rounds, and then cash out, either six months after a liquidity event, or at the current valuation for privately held companies. In this scenario, when treated as a portfolio the 110 companies achieved an IRR of 14 percent.

In scenario two, the team modeled a "buy and hold" strategy that assumed an initial investment of \$175,000 but no investments in follow-on rounds, and no cash out (still holds the investment at the current valuation). In this scenario, the hypothetical portfolio achieved an IRR of 8 percent.

During roughly the same investment period, traditional venture capital returns were 33 percent; the Domini Index (investments in socially responsible mutual funds) realized a 13 percent return, and the S&P 500 returned 11 percent. The average returns of traditional angel investing are hard to determine given the fragmented nature of the investment activity, but the team interviewed industry

experts who estimated the returns to be significantly lower than professional venture investing due to less investor diversification and capital limitations that prevent investment in follow-on rounds. Given this, the team concluded that the set of companies that received investments from IC members had the ability, as a portfolio, to deliver satisfactory returns, relative both to investor expectations and other investment vehicles.

**Q:** How did the 110 companies fare?

**A:** The team collected the current valuation data at the time of the study for companies that were still operating, and exit valuation data for those that had experienced a liquidity event. Of the 110 investments, 95 were operating companies and 15 were other social purpose investment vehicles.

Fifty-five percent of the 95 companies were still in business and privately held. Thirty percent of the companies were bankrupt, 9 percent had been acquired, and 6 percent had experienced an IPO.

The incidence of bankruptcy in these social purpose companies was not unlike traditional early stage companies, but the percentage (15 percent) of companies that were able to achieve a liquidity event either through acquisition or IPO was below average, particularly given the time horizon of the investments (1992-2001).

**Q:** What were some characteristics of social purpose companies that achieved a positive rate of return for investors?

**A:** The big winners were in the technology and health care sectors, and in another group of companies that were categorized as industrial. These categories generated higher returns as a group than the consumer goods category. Some of the characteristics of these winners included having a proprietary technology and/or meeting an established market need in an

innovative way, attributes not unlike traditional successful ventures.

However, all of the companies in the sample also had some social or environmental benefit as part of their mission. Three success stories in these categories were Sonic Innovations (health care), Evergreen Solar (technology), and Energia Global (industrial).

Sonic Innovations has become the fastest growing hearing aid company in the world since its IPO in 2000. Through the development and use of the smallest single-chip digital signal processor platform ever installed in a hearing aid, they bring to the market small, comfortable and reliable hearing aids. When eight Investors' Circle members invested \$2 million in Sonic Innovations, the company had a pre-money valuation of \$5 million; seven years later, at IPO, the company's market value was \$127 million.

Evergreen Solar is a developer and manufacturer of photovoltaic (PV) modules—the engines of solar electric systems—used in remote power and emerging grid-connected markets. The PV modules produced by Evergreen Solar incorporate proprietary crystalline silicon technology known as String Ribbon. In 1996, seven members invested \$3 million; five years later the company was worth \$128 million.

Energía Global developed, financed, owned, and operated environmentally sustainable energy generation and electric distribution facilities in Central America. In 1992, seven IC members invested \$1.4 million in the company, then worth \$4 million. Energia Global was acquired by CHI Energy in 2000 for \$74 million. CHI Inc. is now part of Enel Green Power, part of Enel, the world's largest publicly traded electric utility.

There were positive IRR investments in the consumer goods category, Honest Tea and Zip Car being two examples, but this category of companies in

aggregate did not perform as well as the technology, industrial, and health care categories.

**Q:** Do investors expect the same results from social purpose companies?

**A:** Investors' Circle polled its membership about their return expectations as part of a member survey being conducted at the same time as our study team was conducting the valuation analysis.

The survey showed that 77 percent of members expected an IRR in excess of 10 percent, and that remaining 23 percent expected an IRR between 0 percent and 10 percent. However, in a separate question, 64 percent indicated that they had entered into a deal expecting a lower-than-market rate return in exchange for a high social return.

A key expectation, then, is related to the social or environmental benefit these investments will produce. The member survey indicates that IC members expect a blend of financial and social or environmental returns. Different investors are focused on a variety of social and environmental issues, and the companies receiving investments were involved in businesses as diverse as clean energy technologies, sustainable agriculture, educational toys, and innovative hearing aids.

Our team's analysis showed that only 32 percent of IC members realized a positive IRR on their total investments, 15 percent simply achieved capital preservation, 21 percent experienced a negative IRR, and the remaining 22 percent suffered a total capital loss. These realized financial returns are quite different from the expectations expressed in the IC member survey.

As the field continues to mature, efforts to develop a notion of "blended value," a way to account for social and environmental returns along with financial returns, will be well served by having a clearer understanding of the actual financial

returns that can be generated by these types of investments.

**Q:** Were there common characteristics among successful investing strategies?

**A:** The team grouped the investors into quartiles based on their realized returns, and was able to identify some differences in the investment strategies of those in the top quartile. The team concluded that, much like traditional early-stage investing, diversification and investing in additional rounds was key to the success of individual investors. Those in the top quartile invested in four times as many companies as those in the lowest quartile and participated in 40 percent more rounds of company financing as compared to all other investors. This allowed them to diversify their holdings across a range of companies and to minimize dilution as the companies raised follow on money.

Additionally, the team observed that members who invested in deals that were also receiving capital from professional

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investors fared better, as did those who joined other IC members in investing, as opposed to those who were the single IC investor in a deal. In other words, relying on the due diligence and judgment of other experienced investors was an important success factor.

**Q:** What are the most important things that social purpose investors should learn from this research?

**A:** While the findings are important because they represent the largest study of early stage social investing of its kind, they are not broad enough to generalize to a recommended investment strategy for all social purpose investors. However, the team did make some recommendations to Investors' Circle based on the findings, and these might be useful to others involved in this kind of investment activity.

One suggestion was that IC should consider creating additional pooled early-stage investment vehicles to take advantage of the specialized expertise of some of its members who have been professional investors, and to create some diversification for its members. IC has experimented with one such vehicle, Commons Capital, LLC, and the team saw this as a model that could be replicated.

An alternate suggestion was that the organization consider performing some basic due diligence on all companies that enter IC's deal flow and screen out some companies before they are presented to broader membership for investment. Traditional investment criteria such as proprietary technologies and experienced management teams are also important in social purpose investing.

The most important finding was that if investors follow a disciplined strategy that incorporates diversification and large enough investment amounts, these social purpose companies have the potential to produce positive IRRs. However, because of the unique problem of exit that these companies seem to exhibit, their ability to provide market rates of return as an asset class are limited. A number of talented people in the social investing community are addressing the question of how to solve this problem, and the field would be advanced by a creative solution.

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Article URL: <http://hbswk.hbs.edu/pubitem.jhtml?id=3774&t=nonprofit>

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