Impact investment has lately entered the popular lexicon, although it is certainly not a new idea. Advocates of impact investment often use a philanthropy lens to examine the field, viewing it as a useful tool to address social and environmental problems. It should indeed be seen as a complement to philanthropy and government programs, a way to leverage scarce philanthropic and public sector dollars, while harnessing the power of social entrepreneurs and market-based solutions to solve some of the world’s most intractable problems.

There is also a growing movement to define impact investment as an “asset class,” thereby creating a distinct category for institutional capital to shift into. Impact investment fund managers understandably favor such an asset class designation in their quest to attract capital.

However, we at the Capital Institute believe that while there may be practical reasons to apply the term “impact investment” to support the funding of projects that promote positive social and environmental change, we must also recognize that all investment has impact, whether it is a microfinance fund in India, a high frequency trading hedge fund, a wind farm, or the XL Pipeline connecting the Canadian Tar Sands to refineries in the United States. Understanding the impact of all investment at this systemic level is central to our third Field Guide theme: “healing finance.” If we are to achieve the economic shift to a more just and sustainable economy, we need to differentiate our collective investment decisions along qualitative criteria, not just based on modern portfolio theory’s simplistic and flawed risk-adjusted financial return metrics, nor on two-dimensional IRR and payback calculations. New metrics will be important, but so will getting comfortable with more qualitative judgments.

In this our first field study exploring the “healing finance” theme we examine the innovative Patient Capital Collaborative. Some people talk about impact investment. Some people commit. Sky Lance and Tom Balderston have selflessly committed not just their investment dollars, but also, on a full-time basis, their professional experience, to lead this important, catalytic initiative that leverages the “triple bottom line” deal flow and passionate community of Investors’ Circle. My hope is that all the institutions now growing excited about the potential of impact investment will consider supporting, and investing in, as I do, the Patient Capital Collaborative.

—John Fullerton, Founder and President of Capital Institute
An Innovative Funder of Sustainable Companies Seeks to Establish Its Own Business Model

In 2007 Sky Lance should have been enjoying the fruits from his co-founding of a thriving private equity firm. Instead, after a 20-year investment management career, he found himself searching for ways he could use his skills for a higher purpose, as he became increasingly restless working in a commodity-like market where deal-making mattered more than relationship-building.

Today Lance is one of two general partners in an innovative investment practice, the Patient Capital Collaborative. PCC brings to bear the collective expertise of a group of angel investors to help nurture and fund start-up and early-stage companies attempting to make meaningful social and environmental impact in the world.

Now in its fourth year of steering angel investor money into supporting impact companies, PCC is seeking a few visionary institutional partners to ensure that it can continue to fulfill this critical mission.

HOW PCC GREW OUT OF SHIFTS IN CONSCIOUSNESS AND PARADIGMS

“I was moving farther and farther away from the relationship-oriented investing that I had loved,” says Lance, reflecting on his growing dissatisfaction working with ever larger private equity funds where the targets were $100 to $500 million dollar corporations with lots of other funding options. “I looked back at my early career at Bank of Boston and recalled how much I had liked working with small companies. I was only 25 years old at the time but still these companies were eager for my counsel and advice, and I missed that.”

A friend in whom Lance confided his aspirations told him to check out the angel investor group Investors’ Circle. Social venture capitalist Susan Davis had founded Investors’ Circle in 1992 using a networking-strategy modeled on natural systems. By the mid 2000s, IC had established an admirable track record, facilitating the flow of over $145 million into more than 220 companies and small funds addressing social and environmental issues. (Today Investors’ Circle is under common management with long-term impact industry participant SIF Institute.)

“When I joined Investors’ Circle I saw there had been a paradigm shift in the general marketplace,” Lance reports. “Twenty-five years ago the people who were attracted to starting up companies doing good were people with their hearts in the right place. But the quality of companies they established were marginal. As I looked at the companies that were presenting at IC I realized there were people with real management experience moving into this area of social and environmental benefit.”

WHAT’S UNIQUE ABOUT PCC

The “fix” to that inefficiency—the Patient Capital Collaborative—is unique in a number of ways. First, it is perhaps the only committed impact investing vehicle of its kind for angel investors. While the majority of angel groups invite companies to make presentations, they leave the investment decisions up to each individual member. A few angel groups have co-investment funds that provide matching investments if a sufficient number of individual members commit to a given company. PCC, on the other hand, was designed to mimic larger venture capital funds with a committed pool of capital under highly professional, full-time management. (Balderston and Lance have, together, over 55 years of private equity investment management experience.)

The other strikingly innovative aspect of PCC is its collaborative nature. “One of our limited partners refers to PCC as an ‘investor-centric’ rather than a ‘general-partner-centric’ fund,” says Lance. “Most of our limited partners don’t just invest passively and look at a quarterly statement. They have the ability to participate in the due diligence and serve on an investment committee.”

Lance believes this collaborative makes for a better-managed fund. “Tom and I don’t operate in an ivory tower,” Lance reports. “We are pulling in the rich and diverse experiences of our investor group, and the quality of the decision making is reflected in that.”
PCC’s formal structure keeps the momentum going for deals to be consummated after the initial excitement of hearing an entrepreneur’s presentation dissipates. It provides a vehicle for investors who have an appetite to invest into deals outside their area of expertise, allowing them to achieve the requisite diversification to stay in the game over the long haul. And because the fund has full-time professional management, yet offers a unique “collaborative” approach, investors can step in and out of active engagement as their time and expertise allows. “Some people want to be very active and others less so,” says Lance. “It is not required of our LPs, but I give each one a questionnaire to ask them how active they want to be in the process. Some people want to contribute because they want to learn or because they have knowledge to share.” Pooling their capital in the PCC also gives individual investors more “fire power” to influence the decision-making processes of their target companies and also affords entrepreneurs a deeper pool of expertise to draw on.

PCC’s investment in Ocean Renewable Power Company, a Maine-based tidal power technology company, is illustrative of how PCC’s collaborative process works. When ORPC first presented at the Fall 2007 IC conference it was putting the finishing touches on its prototype unit and needed funds to spend the next year to do prototype testing in the ocean, computer modeling of its findings, and design tweaking. Lance quickly sized up which aspects of the business PCC needed to evaluate. He was able to call on the expertise of a PCC limited partner who was a trained mechanical engineer and on another who was previously a partner in the power practice of a major consulting firm. Another PCC LP, through an acquaintance, set up a call with the CEO of a west coast tidal power company that was also looking for funding. Another IC member, a retired Fortune 500 CEO, was interested in helping with the due diligence. “I realized that this is the kind of due diligence team that Kleiner Perkins would love to have,” says Lance. “No one of us could be an expert in all these fields, but together we put together a team that was.”

Initially PCC invested $50,000 in ORPC from its first fund after seeing the company present at Investor’s Circle in 2007. “PCC was the first professional investor,” John Cooper, ORPC’s CFO explains, “up until that point all of our investors came to us through personal or business relationships as angel investors. PCC recommended a structured investment (we raised convertible preferred at that time) and helped us get our act together to be able to approach the market in a more professional way.”

In late 2008, just as the company was about to raise a second round of venture capital, the stock market collapsed. The company was running out of funds while it awaited an infusion of capital promised from a large alternative energy power developer, a $10 million grant from the Department of Energy, and a $750,000 grant from the Maine Asset Technology Fund. “We put some more money in to get them over the hump until those funds were received,” Lance reports. “Today ORPC is a leader in the tidal power industry in the US, if not in the world.”

 Cooper praises PCC’s strategy of investing an initial amount of capital always with the expectation that the company will need more. “They keep capital in reserve for second and third rounds, and that is really critical,” he says. “If you make one shot and go away you stand the chance of losing everything because if you can’t participate in future rounds your original investment can become too diluted for an adequate return—and companies need continuing capital to grow.”

HOW THESE INNOVATIONS WORK IN PRACTICE

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HOW PCC’S POOLED EXPERTISE SUPPORTED OCEAN RENEWABLE POWER COMPANY

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THE WEB OF INVESTOR EXPERTISE THAT SUPPORTS THE PATIENT CAPITAL COLLABORATIVE

Unlike a traditional venture capital fund that raises money at one moment in time and then is closed to new investors for 5 years, the PCC raises a new fund every 18 months. Investors are encouraged to invest across as many PCC funds as they like to create as diversified a portfolio as they want.

The first PCC fund was established as a pilot in 2007 with $1.5 million in capital from 30 high-net-worth individuals committing a minimum of $50,000 each. The 2009 fund raised $1.8 million from 22 investors and the 2011 fund has met its $2 million target with a similar number of investors. “The established VC funds are $100 to $500 million in size and they can’t afford to invest as little as $500,000 in a company,” Lance explains. “We invest in the companies that have grown too big for ‘friends and family’ but are too small for the venture world.”

The PCC fund managers observe IC conference presentations, and PCC’s limited partners rate companies to determine which are worthy of deeper dive analysis. “We talk about the target companies and also affords entrepreneurs a deeper pool of expertise to draw on.

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MANAGING RETURN EXPECTATIONS

“What the managers and LPs at PCC are doing together is applying what has been done in the general capital markets but with a twist,” says Lance. “We look at all the aspects of the business—the quality of management, the validity of the business model, is there intellectual property that creates natural barriers to entry, is there growth in the industry—and piece it all together and apply it to the social space. As a for-profit fund, we determine which companies with social missions will make good investment alternatives as opposed to those that may have a great social mission but you can’t see how they will ever make an appropriate financial return for their investors.”

Structuring the fund to deliver social and environmental impact as well as positive financial return is an art. “There are all sorts of interpretations of how much to incorporate the social mission into the rates of return. In general we are managing the portfolio similar to an early stage venture capital portfolio in that you have to have those companies that make three to ten times your money to offset those you write off in order to leave the limited partners with an appropriate risk-adjusted rate of return.”

INVESTMENT: Solometric Corporation

Solometric makes precision test and measurement equipment for professional solar panel installers. Patient Capital Collaborative made two investments in Solometric, the first in July 2010 and the second in the spring of 2011, giving the company access to the funds it needed to bring new products to market in a more rapid timeframe than would otherwise have been possible through internally generated capital.

Lance reports that Solometric takes its triple bottom line mission seriously. On the day of his and Balderston’s first visit to the company he discovered that half the staff was out of the office installing solar panels on a Habitat for Humanity house. Solometric has purposefully raised only common shares, ensuring that all shareholders are on an equal footing. Employees at all levels of the company are offered share options. “Not only is Solometric producing products that allow for a faster and more efficient adoption of an emission-free energy,” says Lance, “but they are also dedicated to making a positive impact on their community and in the lives of their workers.”

“Most of our limited partners don’t just invest passively and look at quarterly statements,” says Lance. “We are pulling in the rich and diverse experiences of our investor group and the quality of the decision-making is reflected in that.”

INVESTMENT: Rivertop Renewables

Jere Kolstad, President and CFO of Rivertop Renewables, a manufacturer of green chemicals and bioproducts built from renewable plant sugars, talks about what’s unique about Patient Capital Collaborative from a sustainable start-up’s perspective.

We presented at Investors’ Circle in San Francisco in 2008 and were one of Patient Capital Collaborative’s first investments. PCC came in early with us, quite a bit before our business model was fully formed, investing in our Preferred Series A. They made subsequent investments in 2009 and 2010. I knew after one conversation with Sky Lance that this was the right partnership for us. I come out of the high-tech world, had worked for Deloitte, and had been in a number of partnerships for us. I come out of the high-tech world, had worked for Deloitte, and had been in a number of venture-backed deals so I had been around the block on what it takes to raise venture capital. Sky was literally the first person I ran into who had the focus on sustainability but also brought a very high level of sophistication as a venture capitalist to the table.

PCC coming in at such an early stage seeded a lot of other investor money for Rivertop. There are a certain group of investors who are interested in companies like ours because of the sustainability focus but don’t have much financial sophistication. There are also a lot of hard-nosed money people who invest in sustainable companies purely for the business case. Having a firm like PCC, known for really looking hard at sustainability in a very disciplined way, matters for both types of investors.

I should also say that PCC has a name worth commenting on. For a firm like us the “patient” part really matters. If you are going to get involved in the early stage of a company like they did you cannot be expecting a capital event in a year or two or three like a venture firm would. Although PCC will be looking for that in the longer term they are not pushing for it. It’s critical in the early stage not to have to be under that kind of pressure.

The “collaborative” piece has also been extremely valuable to us. PCC is this big group of sophisticated accredited investors with a diversity of expertise. So we get a “twier” with them: both funding and access to a great group of people. With PCC we are only one or two phone calls away from any kind of advice we might need.
GROWING A SUSTAINABLE PCC

While PCC’s mission is to help fund and support companies that will contribute to the transition to a more sustainable economy, Lance acknowledges that PCC itself needs to attract more funds under management in order to be self-sustaining over the longer term. “We must determine how to create a large enough investment vehicle that will generate sufficient fees to pay for itself,” Lance reports. While he and Balderston share in the eventual profits earned by the funds’ investments, they currently draw no salaries from SustainVC and have devoted themselves to the organization primarily as a labor of love.

SustainVC hopes to raise a $25 million fund managed in tandem with its smaller funds and, eventually, to construct an institutional-backed $200 million “fund of impact funds.” Long-term plans include a large buyout fund to act as a holding company, to purchase operating companies while ensuring that the companies’ social missions continue. SustainVC may also develop sector-funds and geographically targeted funds over time.

Lance believes that in order to draw in institutional investors it will be helpful for “impact investing” to be elevated to an asset class. “Big pension funds allocate, say, eight percent to alternative investments, such as venture, buyout and distressed debt funds,” he explains. (According to a recent study by Towers Watson and the Financial Times, alternative assets managed by the 100 top managers on behalf of pension funds grew by 10% to US$952 billion in 2010.) “If pension funds also had another category for, say, 0.5 percent in impact investing that would give them a mandate and a category to talk about…a box to check,” says Lance.

Bringing in institutional investors will give PCC companies access to more capital as they grow, maintains Suzanne Biegel, who remains an active PCC LC. “Also some of these larger players will bring more expertise and strategic relationships from which PCC companies can profit,” she notes.

However, the difficulty has been identifying those “forward-thinking” institutions that will commit meaningful dollars to impact investing. “There is a lot of talk by institutions of their desire to support this category,” says Lance, “but very few that have actually allocated any capital to it.” Lance maintains that there is money to be made in investing in the new generation of social and environmental impact companies. “What is needed,” he maintains, “is one or two ‘thought leader’ institutions to step up to the plate and put real risk capital out there and say ‘we want to foster this category of investment.’” —Susan Arterian Chang

INVESTMENT: New Day Farm

Patient Capital Collaborative’s investment in New Day Farm allowed the northern-Virginia-based organic vegetable producer to build the first four acres of greenhouses on its 75-acre property.

The farm supplies organic produce to the northeast, a welcome alternative to vegetables otherwise trucked in from Mexico and the Southwest. New Day Farm saves the market food miles and provides access to more flavorful and nutritious produce.

It utilizes state-of-the-art cooling and heating systems to provide energy efficient climate control to its greenhouses, allowing them to operate throughout the year.

ABOUT CAPITAL INSTITUTE

This “Patient Capital Collaborative” study, produced in December 2011, is the third in Capital Institute’s Field Guide to Investing in a Resilient Economy series. Capital Institute is a collaborative space exploring the economic transition to a more just, sustainable, and resilient way of living on this earth through the transformation of finance. Find out more about us and access other Field Guide studies by visiting our website, www.capitalinstitute.org.

Graphic design: Marie McCann-Barab

For more information about Patient Capital Collaborative visit their website at www.sustainvc.com.

Organic tomatoes packed for the first delivery to Whole Foods.