

Assessing and Managing PRI Risk: Nothing Ventured, Nothing Gained

A Closer Look

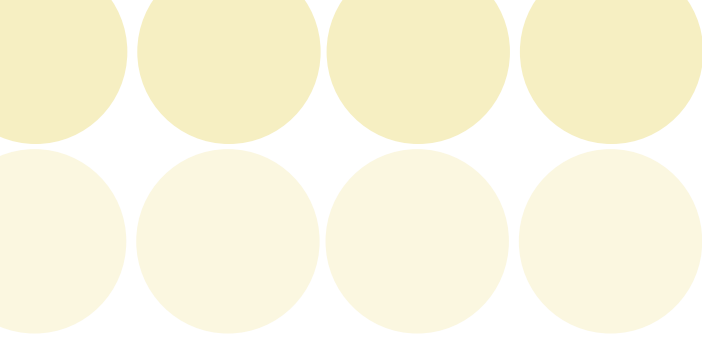
Grant makers frequently ask us for more extensive discussion of various issues that come up in our guides. Our response is a new web-only series, *A Closer Look*.

For each edition, we'll invite several experienced grant makers to explore a specific topic in the context of their foundation, and to answer questions about how it shapes and impacts their work. This virtual roundtable will supplement the guide that inspired it, and offer a range of perspectives, approaches, and tools to help you in your own practice.

Neil Carlson is the author of this edition of *A Closer Look* as well as our guide, *Program-Related Investing: Skills & Strategies for New PRI Funders*, now on the web at www.grantcraft.org.

When grant makers talk about assessing and managing the risks associated with program-related investing, they're referring to both financial and programmatic concerns. GrantCraft asked five experienced PRI makers how they think about risk, how they weigh and balance different sorts of risk, and how they mitigate risk in their PRI portfolios:

- **Shari Berenbach, executive director of the Calvert Social Investment Foundation.** The foundation is a nonprofit intermediary that manages an \$82 million diversified portfolio of loans to 200 community development and social enterprises in the U.S. and abroad. Calvert Foundation is a leading provider of investment research on PRIs.
- **Frank DeGiovanni, director of the Ford Foundation's Economic Development Unit.** DeGiovanni oversees a diverse \$160 million portfolio of PRIs, including investments in low-income housing, community development finance, independent media, microfinance in developing countries, education, and a variety of social enterprises.
- **Robert Jaquay, associate director of the George Gund Foundation, one of Ohio's largest family foundations.** The foundation currently has over \$8 million invested in 13 active transactions, including a "green" office building that serves as an anchor for neighborhood revitalization and houses many of the foundation's environmental grantees.
- **Debra Schwartz, director of program-related investments at The John D. and Catherine T. MacArthur Foundation.** The foundation currently has \$140 million in outstanding PRIs, half of which supports 34 U.S.-based community development financial institutions, specialized intermediaries that provide financial products and services to low-income and underserved communities. Another \$34 million supports Window of Opportunity, the foundation's national grant and PRI initiative designed to help preserve affordable rental housing.
- **Tom Trinley, director of finance and administration for the Chicago-based Gaylord and Dorothy Donnelley Foundation.** The foundation supports efforts to conserve land and foster artistic vitality in Chicago and the Lowcountry of South Carolina. About 5 percent (\$10 million) of the foundation's \$200 million in assets is invested in PRIs.



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Q: WHEN PRI MAKERS TALK ABOUT RISK ASSESSMENT, WHAT ARE THEY TALKING ABOUT? WHAT IS “RISK” IN YOUR LINE OF WORK?

ROBERT JAQUAY: The first step is to gauge whether or not the organization will achieve programmatic effectiveness; that’s the mission part. But we’re also responsible for determining whether the foundation could lose some or all of its investment. To do that, we measure the accuracy of the revenue streams coming into the organization to see if it will be able to repay the foundation. If the deal is collateralized, we want to be sure the collateral has value that we could use to reclaim payment if things, unfortunately, don’t work out. In many ways, the financial analysis complements our evaluation of mission. Together, they constitute our risk assessment.

TOM TRINLEY: We look at four things. First, before we even get into true risk assessment, we make sure the project is something we couldn’t do with a grant. Second, the project has to fall within one of our two program areas: arts or land conservation. The third thing we look at — and this really gets to due diligence and monitoring, which are both parts of risk assessment — is that the foundation has a funding history with the organization. We would simply not make a PRI to a first-time applicant. We wouldn’t know their history of keeping good budgets, of spending according to plan. We wouldn’t know their fundraising history. We wouldn’t know their operating style. We wouldn’t know their board capacity in several important areas: fundraising, governance, management. Finally, we would want to make sure there’s a designated cash stream for the payback of the PRI. All of these variables are either understood from history or are reviewed as the first step of our PRI process, which we call assessment.

DEBRA SCHWARTZ: What we’re really driven by is a set of programmatic goals, but that framework complicates the way you analyze financial risk. In a traditional investment model, you compensate for risk with price: the higher the risk, the higher the pricing. That relationship is pretty much severed, if not inverted, with PRIs, because of the issue of programmatic importance. Sometimes the things we think are most important programmatically are the most risky financially. We may give them very attractive pricing because we’re trying to help the organization be as successful as possible. So risk assessment for PRIs can really be about the complex interplay between program goals and project finance.

SHARI BERENBACH: As a funder, one of the biggest risks I face is to make sure the PRI will successfully accomplish its mission objectives and contribute to our broader goal of helping to end poverty through investment. That said, there are some straightforward financial risk elements that are actually very similar to the risk you might find in lending to any small enterprise. Your return might fall short of expectations, or you might lose the asset entirely. To get our hands around financial risk, we look at indi-

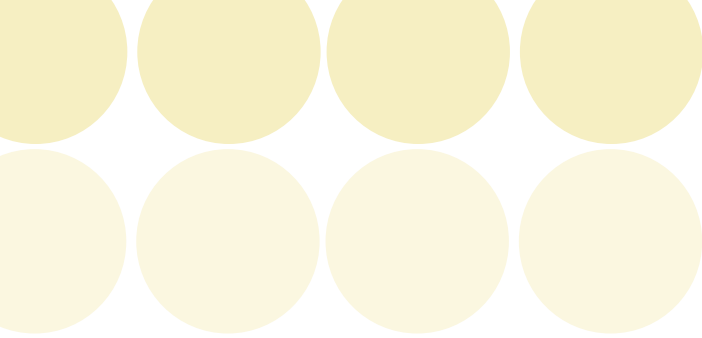
cators like operating income, cash flow, and net assets. If a nonprofit has operating losses, insufficient cash flow, or thin net assets, it can become very vulnerable to downturns.

Q: HOW CAN A FOUNDATION FIND ITS TOLERANCE FOR MISSION AND FINANCIAL RISK? AND HOW DO YOU TALK WITH YOUR BOARD ABOUT IT?

FRANK DEGIOVANNI: First, you need to be sure the board understands why the foundation is doing PRIs, what you hope to accomplish program-matically, how you want to use PRIs as a tool, and why taking financial risks may be necessary to achieve the program goals. Second, management has to figure out the foundation's risk tolerance, the level of loss they're willing to accept. That's a critical one, because you need to know going in how much of your principal you're willing to lose. That sets the parameters within which you can make your investments.

TOM TRINLEY: I have to say that presentation is so important. That may sound flippant, but it's true. One of our earlier and largest PRIs was a \$10 million guarantee on the purchase of a conservation easement that protects 14,000 acres of prime wetland in the Lowcountry of South Carolina. When the three nonprofit partners involved came to us, the way they presented the materials to our program and assets committee was a little confusing. We helped the partnership rework the project narrative, and I put together a spreadsheet that laid out, in very simple terms, how the financing of the installment payments would be made and the foundation's associated liability over the term of the guarantee. On the face of it, \$10 million was a huge potential outlay [in the event of payment defaults], but having it presented well made it much easier for the board to swallow because they understood the benefit versus the risk. What it all came down to was comfort level and the time value of money: we knew our partners, and if we didn't do the deal now the land would be lost forever. Would you rather be more conservative with your money, and therefore be more conservative with your mission, and lose out on potential deals like this? Or are you willing to move now and carry out a big piece of mission that may have taken 30 grants to accomplish?

ROBERT JAQUAY: Our tolerance for risk — or perhaps I should say our willingness to accept non-performing loans — is shaped by the fact that so much of our work is local. That gives us an advantage to some extent, in that we can check our deals with a fairly regular drive-by. On the other hand, it's a small community, which means that all our PRI recipients know what we have on our books. How we treat one deal becomes the expectation for how other deals get treated. We are loath to convert a loan to a grant, to forgive repayment, because everyone else will expect the same treatment. To maintain discipline, we're pretty tough. We are not easy in our forbearance.



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Q: WHAT DO YOU LOOK AT WHEN EVALUATING INDIVIDUAL INVESTMENTS?

DEBRA SCHWARTZ: In our case, we’re usually making unsecured, long-term loans, which forces us to be very holistic in how we look at the organization. It forces us to place an enormous emphasis on qualitative issues, like the board, the senior management, the systems of the organization, business practices, and the strategic plan. We have to think about the whole organization, because even if the pieces we’re interested in supporting succeed, we might not get paid back if the organization as a whole is struggling.

FRANK DEGIOVANNI: Much of risk analysis is nonfinancial. Credit risk is only one factor. For example, what’s the market risk? Within the systems that the PRI is trying to influence, what are the market-wide parameters that facilitate or hinder success? We’re getting ready to invest in a loan fund that will facilitate acquisition of the public broadcasting stations. At the same time, we know that the Internet is having a huge impact on the media. Who knows what the conventional broadcasting market will look like in five years? Another factor is the organization itself: Does it have capacity? Does it have good managers who know the business? Are those managers turning over? What is the leadership like? Does it have strong systems in place to make and implement decisions and monitor results?

SHARI BERENBACH: We tend to focus pretty tightly on the finances. First and foremost, I’m looking at the quality and experience of the board and management. Next, I am looking to the universe of supporting institutions. Whether it’s a community development financial institution or a housing developer or a community development organization, most of the groups we invest in are not financially self-sufficient. They need a continuous stream of subsidies and grant support, so I want to know that the pantheon of supporters will be there to provide the grant support. That’s number one. Number two, those stakeholders are also supervising the organization more intensely than I can. Their oversight provides an imprimatur that tells me that the organization’s programs really do meet the needs of their communities.

Q: ARE THERE SPECIFIC THINGS YOU DO TO REDUCE THE RISK OF FINANCIAL OR PROGRAMMATIC FAILURE?

DEBRA SCHWARTZ: It’s critical to have a clear understanding of the challenges facing each PRI recipient on the front end, but that’s got to be followed by open, candid dialogue on a regular basis. All our PRI agreements require periodic reporting, and we fully review and rate each PRI at least annually. That process has been helped considerably by the new CARS rating service for CDFIs [community development financial institutions] and by reports we purchase from [the] Calvert [Foundation]. Other ways we mitigate risk include disbursing PRIs in stages, with future funding tied to good

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progress and financial health, and using covenants to address particular concerns, such as liquidity levels or replacement of key personnel.

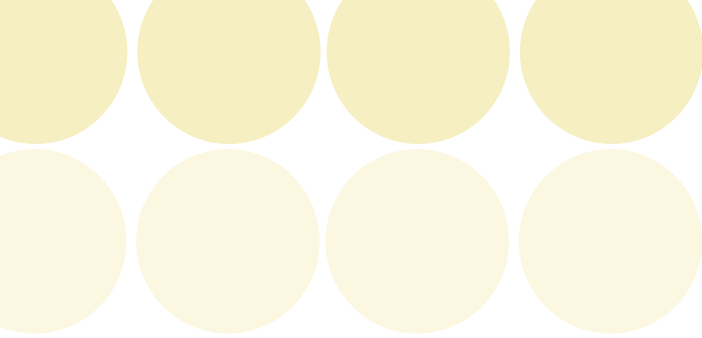
FRANK DEGIOVANNI: We use any number of tools in the structuring and monitoring of deals. If we’re concerned about the strength or weakness of an organization’s capital structure, we often provide a grant equal to 10 percent of the loan amount, which they can use as a net asset. The grant can’t be spent – it has to go on the balance sheet as a net asset, the equivalent of equity. But that helps contribute to the overall financial strength, lowering the cost of commercial credit and improving the chance that we will get paid back, too, since fewer of the organization’s resources will be going to debt service. A second thing we do is disburse the money in stages, or “traunch” the PRI. If we have lingering concerns about management, or performance, or the market, we peg distribution to different milestones. The organization has an incentive to meet its targets, and if something goes bad we’re not fully exposed. On the monitoring side, we set performance targets on things like liquidity, net income, net assets, portfolio quality, or inventory, and require quarterly reports to track the borrower’s overall financial performance and progress in meeting the performance targets. Those serve as early warning indicators that something is either going well or not. We also assign a risk rating to each PRI. If we see that a PRI is doing poorly, we will put it on a “watch list” so we can track it more carefully. We also recommend that the reserve we have for that PRI be increased, a move that signals to our senior management that the investment is in trouble. Twice a year, in April and at the end of the fiscal year, the foundation’s senior management meets to discuss all the loans on the watch list. We try to identify what the issues are and discuss what we propose to do about them – foreclose, renegotiate the terms, or suggest changes in the organization’s operations.

TOM TRINLEY: We ask for updated financials every quarter, so we can make sure the project is on track. Another important piece is that we make sure that the fundee provides us with letters of commitment from their other supporters. We know they’re not legally binding, but that doesn’t matter to us. We want to know that the fundee’s other supporters are willing to sit down and type a letter that says, yes, we’re going to be here to support this organization with this specific project.

Q: ANY PARTING WORDS OF ADVICE YOU’D LIKE TO OFFER?

SHARI BERENBACH: Be prepared for an engaged process. PRI making is different from grant making, where the emphasis is on getting money out, with a little bit of post mortem to see if things worked out. The investment process is much more engaged, and it really needs to be thought of in that way.

ROBERT JAQUAY: Focus on your organization’s strengths. Small foundations and locally based foundations have the potential to be really great



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PRI makers. There’s a sort of word-of-mouth network that is more readily available to local PRI makers than to national ones. We have a more direct connection with our deals and our market, and that allows us to understand the details or circumstances of our investments a little more readily.

TOM TRINLEY: Try to streamline the process as much as possible. Our PRI projects tend to come to us on an emergency basis, and we like to be nimble. That doesn’t mean that the investments shouldn’t be well thought out and well researched: they should. You need good assessment up front. Make sure all your application materials, informal though they may be, are complete. On the monitoring side, try to be sure the financials are as clear as possible, so your committee has the big picture. They need to see the allocation of financial assets, the cash reserves, and the impact on your foundation’s mission. But don’t lose them with too many details. Finally, try to view PRIs as another tool at your disposal to carry out mission, rather than as a separate process or department of your foundation. Psychologically, this is one way to break down the “firewall” between program and investments.

DEBRA SCHWARTZ: Do the best you can with what you’ve got. Even our due diligence process, which I think is pretty good, is relatively unproven. For our housing preservation initiative, we’ve been able to create some benchmarks because we’ve funded about 14 to 15 groups in the same field. We think we know what looks like strong and what looks like weak. But we’re not sure, so we’ll continue to revise our approach as we gain experience and the portfolio matures. As I say to some of my grantees, it’s fine that your mission is to live on this financial tightrope, but you’ve got to see the rope. You’ve got to see when you’re about to fall off of it. I feel it’s the same with the PRIs. It’s fine to be using a risky investment tool if you’re doing it for the right programmatic reasons. But if you’re not paying attention, you’re doing your grantees a disservice, and you’re going to do the PRI tool a disservice, too.

FRANK DEGIOVANNI: Be willing to take lots of risk, but be hardnosed about assessing it and doing what you can to mitigate it. I view my responsibility as making sure I’ve done everything I can for the foundation to understand risk and the programmatic benefits of the proposed investment, so that we can separate the smart risks – those where the programmatic “upside” warrants taking the risk – from those that seem unwarranted, and then to put safeguards in place to minimize as much of the risk as possible without jeopardizing the programmatic thrust.

Due Diligence Checklist

A methodical due diligence process is an opportunity to assemble a complete picture of the financial and managerial soundness of a prospective PRI recipient – and an essential step in risk assessment. The following checklist, derived from materials developed by Francie Brody (www.brodyweiser.com), is used by the Ford Foundation. It's among the templates available to members of the PRI Makers' Network at www.primakers.net. The Network's website also includes a range of useful publications and resources that are freely available to all visitors. GrantCraft's guide, *Program-Related Investing: Skills & Strategies for New PRI Funders*, is another resource for due diligence and can be found at www.grantcraft.org.

A SAMPLE DUE DILIGENCE CHECKLIST

Elements of Due Diligence (Stage 1)

<input type="radio"/>	FINANCIAL STATEMENT ANALYSIS	<ul style="list-style-type: none">• Undertake ratio and trend analysis of historical financial statements• Compare financial performance with industry (utilization, capital structure, business performance, self-sufficiency, liquidity)• Explore differences between budgets and plans and actual performance
<input type="radio"/>	ORGANIZATIONAL ASSESSMENT	<ul style="list-style-type: none">• Follow-up on key organizational underwriting issues raised in Early Stage meeting
<input type="radio"/>	OPERATIONS EVALUATION	<ul style="list-style-type: none">• Probe for indications of current or past capacity to undertake PRI project• Review plans for expansion or start-up (including staffing, technical expertise, technological needs, administrative and financial management support requirements, etc.)
<input type="radio"/>	MANAGEMENT ASSESSMENT	<ul style="list-style-type: none">• Collect resumes and meet briefly (in person or by phone) key management personnel• Probe for continuity and ability to attract talent• Review board structure and level of engagement
<input type="radio"/>	INDUSTRY/MARKET ANALYSIS	<ul style="list-style-type: none">• Review market analysis• Ask for sensitivity of market analysis assumptions to economic risks (business climate, capital markets)• Probe for any regulatory issues• Assess competitive pressures
<input type="radio"/>	REPAYMENT ANALYSIS	<ul style="list-style-type: none">• Assess long-term solvency (debt and capital structure, investor terms)• Assess short-term liquidity• Assess sustainability of operating support

A SAMPLE DUE DILIGENCE CHECKLIST

Elements of Due Diligence (Stage 2)

<input type="radio"/>	PROGRAM IMPACT ASSESSMENT	<ul style="list-style-type: none"> Review impact assessment of credibility and verifiability
<input type="radio"/>	SITE VISIT	<ul style="list-style-type: none"> Meet with key staff (senior management, financial and accounting managers, IT manager, evaluation and assessment staff, project management and staff) Meet with key stakeholders (board members, customers, beneficiaries, funders, evaluators, and governmental officials) Visit operations site Review operations infrastructure — files, financial management system, etc. Undertake with legal staff and/or other program officers as appropriate requirements, etc.)
<input type="radio"/>	QUESTIONS ABOUT BUSINESS/ PRODUCT	<ul style="list-style-type: none"> Review market, competition, and demand assumptions. Meet with current and prospective customers/user. Review production and margin assumptions. Meet with operations or lending staff.
<input type="radio"/>	MANAGER BACKGROUND CHECKS	<ul style="list-style-type: none"> Meet with current funders, public sector officials, and others who can gauge the strengths and weaknesses of current managers Talk with past employers, for recent hires Discuss directly with managers their longer-term aspirations and plans
<input type="radio"/>	INFORMATION ON EXISTING CREDITORS	<ul style="list-style-type: none"> Review current debt schedule. Assess current state of compliance, terms of debt, likelihood for capital sufficiency in the future Meet with selected creditors during the site visit, if at all possible
<input type="radio"/>	REFERENCES FROM FUNDERS, CUSTOMERS, LAWYERS, REGULATORS, SUPPLIERS	<ul style="list-style-type: none"> Meet on site with these constituencies as possible Where face-to-face meetings are not possible, collect names and contact information and conduct telephone interviews
<input type="radio"/>	QUESTIONS ABOUT IDENTIFIED RISKS	<ul style="list-style-type: none"> Key risk areas to probe: program risks, economic risks, business risks, financial risks, capital structure risks, transaction risks
<input type="radio"/>	SENSITIVITY ANALYSIS WITH FINANCIAL PRO FORMA	<ul style="list-style-type: none"> Ask for multiple scenarios with key assumptions varied Assess worst case