THE IMPACTASSETS HANDBOOK FOR INVESTORS

GENERATING SOCIAL AND ENVIRONMENTAL VALUE THROUGH CAPITAL INVESTING

Edited by
JED EMERSON

3

Seed Stage Investing: High Impact, But Not for the Faint of Heart

Tim Freundlich, Jed Emerson and Lindsay Smalling

To meet a promising entrepreneur, be convinced their venture will thrive in the market, and subsequently invest at the ground floor; this is the exciting vision of seed stage investing.[1] In this chapter we will explore some of the opportunities and "how to's" of investing in seed stage companies. Although a risky proposition, seed investing has nonetheless attracted investors who want to put their capital where it may be the only chance these ventures have to build and grow a potentially great solution to some impact challenge. An entire ecosystem of venture capital and angel investing has developed to support seed stage technology start-ups and other companies with large-scale potential.

As the market for impact investing has grown, however, it would appear the capital available for seed stage investing has not kept apace.

In the authors' conversations with industry players, it is clear that many believe social entrepreneurs need capacity-building support to make their ventures "investment-ready," and point to accelerators or incubators as a solution. Others advocate for philanthropic dollars to fill the funding gap while an organization tests its product and establishes a customer base. On the capital side, many interpret the seed stage gap as an investor issue; the economics of investing in a round of $500,000 or less in an early stage social venture just doesn't make sense considering the extensive

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

due diligence, term sheet negotiation and ongoing monitoring of investments required by this type of investing. In addition, it can be very difficult to generate the deal flow to match an investor's financial and impact-based expectations as well as their geographic or issue area focus.

Compounding these issues, the whole discussion can be somewhat opaque, with outsiders gaining little visibility into funds, investors, ventures and deals within the seed stage landscape. This creates a level of uncertainty and reluctance to invest in the absence of such transparency and data. Each of these factors contributes to the frustration experienced by both investors and entrepreneurs trying to increase funding flows between impact investors and promising social entrepreneurs. But there are, nonetheless, opportunities in the exciting, risky, "deep end of the pool" that is seed stage impact investing. And for many, "going direct" is what impact investing is all about. Let us walk through some of the characteristics, both the challenges and opportunities, in this category of investment practice.

There are a multitude of sound reasons why many investors do not pursue seed stage investing in the impact space. By taking a closer look at those reasons, this daunting gap can be broken into specific obstacles so the needs and concerns of investors may be more directly addressed.

An Intrinsically Risky Business

Any early stage investment—whether traditional or impact—and especially seed funding, is a fundamentally risky investment. The way this type of risk has traditionally been managed is by making many "tiny bets" and thereby playing the odds that, through wide diversification, one of those bets will result in generating the exponential returns that more than compensate for any lost investment in the other investments of an angel portfolio.

For this approach to make sense, all of the initial investments must have the potential to scale up and produce a return of multiple times the invested seed capital, although only a small percentage will actually do so.

This presents a challenge for seed stage impact investing because the return on the investment is not purely financial. Both

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

the social and environmental impact of social ventures may dramatically outperform previous solutions, but many of these ventures will still have fairly slow and steady financial growth; many more will sputter out, as is true of their conventional counterparts. In fact, the slow and steady growth pattern is a commendable outcome that produces financial return and sustainable impact. These are great impact investments, but someone still has to take the risk at the seed stage, before the business and impact model is fully proven and financial returns generated. There are investors who are willing to take that chance, but it is with full recognition they are taking on high risk that may not result in a correspondingly high financial return.

At this time there are few high impact-oriented ventures that have produced the kinds of multiples of financial return on investment that the venture capital industry has experienced in traditional sectors, especially technology and web-based business models. Importantly, the objective of impact investing is different from traditional investing at its core in that it seeks both financial and social or environmental returns. Impact investors are accepting *both* impact risk and financial risk, and should subsequently evaluate return with a blended approach.

But there are some bright spots! After all, companies such as Honest Tea, Happy Plant and Seventh Generation were once someone's yesteryear seed stage investment. And a growing number of private equity funds offering “broad” as opposed to “deep” impact have come to market in recent years that will offer investors more significant financial return with perhaps lighter impact than direct, seed stage investing may offer. The long-term outcomes and risk-return profile of seed stage impact investing are still somewhat of an experiment at a cultural and market level, with each funded venture providing a new data point. As part of the enthusiasm for social entrepreneurship and impact investing, more and more individuals are being drawn to early stage solutions that have the potential to build a better world. However, they want some benchmarks around risk and return. Over time, the development of better market-wide data on the aggregate return profile of seed investing will allow investors to make more informed decisions regarding the risks they must be willing to take to realize future impact.

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

Investment Size and the Realities of Allocation

As a risky investment, the allocation to a seed stage investment strategy is typically a small percentage of an investor's portfolio. Within that limited allocation, a common way to decrease the risk is to diversify that segment of an investor's portfolio with multiple small investments, as previously mentioned. An investor with $1 million might reasonably allocate $200,000 to private or alternative investments (and even that would be a quite healthy percentage). Even if all of that is allocated to impact investing, likely no more than a fraction, say 20 percent, would be for seed stage investing. So now such an investor might have $40,000 to place. With reasonable practicalities related to transaction size, this would yield investment in at most one to two ventures, which does not provide sufficient diversification from an overall portfolio perspective. Accordingly, this inability to fully diversify risk may decrease investor appetite for such an allocation.

For an entrepreneur trying to raise a seed round, a significant amount of time goes into cultivating each investor. The relatively small amount they are trying to raise (average range of $250,000–$500,000) falls below the range of consideration for large investors, and raising money from individuals results in piecemeal investments requiring significant time of both entrepreneur and investor. Identifying an investor who can make a sizable contribution of capital out of a diversified impact portfolio is a clear challenge for seed stage ventures.

Expense to Source, Analyze, Monitor Deals

Closely tied to the challenges of investment size, there is often a disproportionate expense associated with making seed stage investments. Regardless of size, these investments must be sourced, undergo thorough due diligence, be negotiated on different, often unique terms and continuously monitored after the initial investment is made. The process is very time consuming and requires special expertise; this level of work could easily require full time attention, either on the part of the investor or her staff. The expense of a single deal is potentially even greater for seed stage investments because the business models are often less developed, requiring additional research and conversations to establish confidence in the investments.

These costs do not scale in relation to the size of the investment, which makes seed stage investments very expensive relative to the amount of capital being put to work. One of the key reasons large investors do not consider investments below $500,000 is that the economics of engaging in due diligence of those deals don't make sense, whereas the same costs are easily accommodated were a multimillion dollar investment under consideration. There is a clear need to streamline seed stage investing; to shrink the hurdles between an investor who believes in the potential of a social venture and their ability to make and monitor such an investment.

Investment Readiness

The cause most often cited for the gap in seed stage impact investing is lack of investment readiness by social ventures. This has prompted the rise of accelerators and incubators tailored to social enterprises, to fortify their business plans, make their financials presentable and polish their pitches. We have only seen the initial swells of a growing wave of social enterprises that in the future will require extensive mentoring and support to develop into viable impact investments. The efficiency with which high-potential ventures and strong leaders can become investment ready is what will set the pace of deal flow.

To be fair, investment readiness also applies to investors. One of the strengths of the venture capital industry is that practitioners are quite ready to invest when an opportunity presents itself and are unabashed in turning away ventures that do not meet their criteria. When an investor makes a personal connection to a social enterprise based on its impact, however, they may extend the conversation with an entrepreneur even if an investment is not on the horizon. This is wasted time that the entrepreneur could spend cultivating other seed stage capital opportunities. Therefore, one of the best things one can do as a seed stage investor is get to "no" quickly, saving both sides wasted time. Furthermore, being clear about whether one is able to jump right in, or needs to follow a lead investor, is also crucial and worth putting on the table.

On the entrepreneur's side, expectation management and an understanding of process are also both significantly important. Investors and their advisors received numerous requests for funding each week. If you're an entrepreneur who is told your proposal is being brought forward for review, you might certainly celebrate—but don't assume you will receive funding! It is not at all unlikely that in the course of the investment committee's discussion what was sincerely viewed as a "good fit" may, for any number of reasons, turn out not to be. This is not the "fault" of those who had been leading due diligence but a natural outcome of a review process. Entrepreneurs seeking capital need to assume there may be interest along with an inability to fund due to any number of factors. Don't forget—the same investor who turned you down this time may be the one who introduces your company to their future seed investor or takes a position in a future round, so be sure not to burn your bridges when told of an unanticipated declination.

These are just some of the reasons why it's hard to do seed investing as well as some perspective on the approach that can help alleviate these challenges. Let's turn our attention to some practical solutions to mitigate the challenges and approach what is still—with its challenges—one of the most exciting propositions in impact investing.

Use a Seed Stage Fund

Finding a seed stage fund can be a way to reach a large, professionally managed portfolio of ventures, allowing investors to place more capital, better and faster. A fund may make upwards of 20 company investments, and may accept as little as $50,000 minimums (though many will be higher than this).

Seed funds anticipate many of their investments will fail, they know the ventures will require extensive mentoring and support and they are willing to accept proxies as evidence of an entrepreneur's capability and potential. Seed funds have found their best investments are often sourced by referrals from prior investees. Many of the strongest prospects don't identify as social entrepreneurs or even realize there are investors specifically seeking social or environmental return. An entrepreneur getting a new business

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

off the ground oftentimes looks to his or her peers for actionable business advice rather than spending time to understand the landscape of investors. For this reason, established entrepreneurs often have the first glimpse into the next great businesses. To identify promising early stage deals, seed funds have built field networks, in addition to their portfolio companies, to gather this street level intelligence. All in all, funds can add a lot of value to investors.

Camp onto an Accelerator Program or an Angel Network

For those investors with a high level of appetite to do direct company investments, but need help in sourcing and diligencing, an accelerator program can be good way to tap into an ecosystem of investment deals, ride along with high engagement support programs and find coinvestors to share in diligence. However, though leveraging program and networks may help reduce some of the pain points, investors are still left with making somewhat sizable investments. There is increasing viability in the area of direct investing, with the JOBS Act increasing access of nonaccredited investors to direct company investments, and development of crowdfunding infrastructure to drive down per deal sizes to as little as $5,000.

The table below is an informational selection of ***seed funds*** *and* ***accelerators*** *with impact orientation, and should be viewed as only a jumping off point for deeper exploration of current options (as the landscape is quickly evolving).*

ORGANIZATION	WEBSITE	HQ LOCATION
Agora Partnerships	agorapartnerships.org	Nicaragua/DC
Ashoka	ashoka.org	Washington, DC
Better Ventures	better.vc	Oakland, CA
Civic Accelerator/ Points of Light	pointsoflight.org/civic-incubator/programs/ civic- accelerator	Atlanta, GA
Code for America	codeforamerica.org	San Francisco, CA
Echoing Green	echoinggreen.org	New York, NY

(*continued*)

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)

(*cont.*)

ORGANIZATION	WEBSITE	HQ LOCATION
Fledge	fledge.co/	Seattle, WA
Global Social Benefit Incubator	scu.edu/socialbenefit/entrepreneurship/gsbi/	Santa Clara, CA
GoodCompany Ventures	goodcompanygroup.org/ residency/ program	Philadelphia, PA
Ideaxcelerator/Idea Village	ideavillage.org	New Orleans, LA
Impact Engine	theimpactengine.com	Chicago, IL
Investors Circle/ Patient Capital Collaborative	investorscircle.net	Durham, NC
NESsT	nesst.org	San Francisco, CA
New Ventures	new-ventures.org/	Washington, DC
Rock Health	rockhealth.com/	San Francisco, CA
Unreasonable Institute	unreasonableinstitute.org	Boulder, CO
VentureWell	venturewell.org	Boston, MA
Village Capital	vilcap.com	Atlanta, GA

Use a Donor Advised Fund to Mix and Match

ImpactAssets has seen an increasingly wide range of its clients using their donor advised funds (DAFs) to reach both seed funds and direct company investments in concert with accelerator relationships. Because DAFs aggregate up among multiple accounts, they can drive down minimums even further. And, since individuals receive a tax deduction when they open a DAF (since it is in fact a charitable donation), one might view the tax benefit as an initial "return" of sorts at the point of investment, and then have more support for patience over the long term that these early stage investments demand. See Targeted Impact: Donor Advised Funds and Impact Investing in this volume for more on DAFs.

In Conclusion

Investing in early stage, impact businesses requires specific, often industry or market-level expertise on the part of the investor, as well as portfolio diversification. Therefore, this type of investing has intrinsic challenges for small and large investors alike. Simply put, it is not for the faint of heart. But by leveraging seed funds, accelerator programs and investor networks that can provide support, reduce investment sizes and bring greater diversification to the investor, all the while exploring new modalities available through crowdfunding platforms and DAFs, seed stage investing is at least plausible and increasingly viable for those who find it compelling.

Accelerators are iterating their models to more accurately match entrepreneurs with investors and providing ongoing services to support follow-on financing. In addition, relationships between seed funds and accelerators are being developed that provide a more immediate and ongoing feedback loop between entrepreneurs and investors, in addition to the more efficient vetting resulting from accelerators sharing experiential knowledge of the teams and their ventures.

When all is said and done, there remains a tremendous opportunity for innovation and for intermediaries to alleviate the friction in seed stage impact investing. A small shift in the allocation of capital can make a significant difference, and it is the authors' hope that new products and services will continue to be developed to support increased seed stage impact investing. Directing a steady flow of capital toward promising early stage ventures is critical, for otherwise how will we see the great companies of tomorrow get funded today!

Notes

This chapter was revised and adapted from an ImpactAssets Issue Brief entitled "Seeding the Future: Challenge and Opportunity in Early Stage Impact Investing," originally authored by Jed Emerson, Tim Freundlich and Lindsay Smalling.

1 For the purposes of this chapter, we will consider seed stage to be a venture that is raising an amount of capital less than $500,000 with little to no revenue recognition.

This chapter has been published in 'The ImpactAssets Handbook for Investors' edited by Jed Emerson (Anthem Press, 2017)