

SOCIAL Return On Investment

by Jed Emerson, with Mark Cabaj



Many people in the nonprofit sector feel that their work is not adequately documented and therefore under-valued. Practitioners, in particular, are frustrated because they lack objective, timely data on their programs and services, making it difficult to apply their scarce resources wisely.

The position of the Roberts Enterprise Development Fund (REDF) is that much of this frustration is due in part to an absence of appropriate measures by which the value created by nonprofit organizations may be tracked, calculated, and attributed to the philanthropic and public “investments” financing those impacts.

This article describes REDF’s efforts to create a new method of measuring one specific type of impact generated by nonprofit enterprises: socio-economic value.

REDF is a philanthropic foundation in San Francisco, California that seeks to expand the economic opportunities for homeless and very low-income individuals through the creation of social purpose enterprises. To pursue this mission, REDF offers an array of resources to assist nonprofits that launch and manage such enterprises: core funding, access to business technical assistance, information management, computer and internet services, and marketplace access.

REDF’s current investment portfolio consists of seven nonprofit organizations. They operate nearly two dozen business ventures and employ approximately 600 very low-income individuals in the greater San Francisco Bay area. These ventures generated US\$20 million in sales in 1999 and are set to exceed that mark in 2000.

In keeping with the venture philanthropy perspective of REDF’s founders, two strong ideas shape the organization’s approach to its work.

One is that a philanthropic dollar in-

vested in the social mission of a nonprofit today generates future economic and social returns in excess of the initial value of that dollar. The second idea is that many of the returns created by social purpose enterprises (and many tax-exempt nonprofit organizations) go undocumented. They are therefore largely under-appreciated by practitioners, funders, and policy makers.

It is REDF’s desire to directly tie the impact of an organization and program to the investments required to make that impact. This results-orientation has led REDF to continually search for and refine ways to document and analyze the results achieved by its investee firms.

UNDERSTANDING “VALUE CREATION” IN SOCIAL PURPOSE ENTERPRISE

Practitioners and investors in the nonprofit sector are very familiar with two types of value created through their efforts.

One is *social* value. This occurs when an activity leads to improvements in the

lives of individuals and the community. Social value happens in a variety of ways: improved race relations, the creation of folk art, greater access to services, prosperity for a marginalized residents, great public monuments, etc. Social value is difficult to agree upon and quantify or to assess in terms of dollars. It nonetheless has intrinsic value, and its pursuit is perhaps the primary motivation for many working in the nonprofit sector.

Nonprofits generate *economic* value by creating products or services that have greater market value at the next level of the value chain. The services provided by a landscaping business staffed by hard-to-employ youth, for example, represent added value to the local economy - quite apart from whatever social value the business may also generate. Traditional businesses also create economic value through employment and by engaging in mainstream commerce. Economic value is easily measured in terms of a range of metrics, including return on investment,

and debt/equity and price/earnings ratios.

A third type of value that is often discussed, though rarely understood, is the *socio-economic* value. Socio-economic value builds on economic value and incorporates certain elements of social value. Socio-economic value refers to decreased public expenditures and/or increased public sector revenues (i.e., taxes) that result from a nonprofit's work and its impact on the lives of its clients.

Initiatives that generate socio-economic value commonly provide employment for recipients of public support and divert people away from public systems and towards the market. Job training programs and supported employment programs for the disabled or homeless are some examples.

No measure of socio-economic value can hope to be comprehensive in its quantification of benefits. Nevertheless, a nonprofit should be at least partially credited, and in some cases financially compensated, for the benefits it generates.

SOCIAL RETURN ON INVESTMENT

Social Return on Investment is a simple financial assessment of socio-economic value. SROI compares a project's net benefits to the investment required to generate those benefits over a certain period of time.

The net benefits are comprised of two cash flows. The first of these is generated by the business operation of the social purpose enterprise, and tracks the net income

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of an enterprise (business revenue minus expenses).

The second cash flow is comprised of the total net savings to society and specifically, to sources of public funds such as local or federal government - funds usually spent to support individuals in need. Net savings include:

- the additional tax dollars generated by individuals who are employed and become tax payers.
- the reduction of the costs associated with unemployment (e.g., welfare assistance).
- the new wages of employees.

Grant and philanthropic dollars used to subsidize the organization are subtracted from the total to give the net total social benefits.

Both cash flows are tracked, or forecasted, over a given time period (say ten years). They are expressed in terms of present dollar values using a range of discount rates. The social benefits and business cash flows are then added up to provide a socio-economic value.

REDF currently uses two performance measures to compare the socio-economic value to the original philanthropic investment. One is the Social Return Ratio

(SRR). This is determined by adding up the net social benefits and business cash flow and dividing them by the total amount of philanthropic dollars invested during the investment time frame.

Another performance measure is SROI Rate. This is calculated by performing Internal Rate of Return (IRR) calculations based on the total socio-economic value and total "costs."

These measurements are for the organization and total grant dollars. With some minor modifications, individual investors can measure the SROI of a specific investment as well.

USING SROI TO ASSESS INVESTMENT OPPORTUNITIES

With an SROI framework in place, REDF and its investee organizations are now in a better position to consider the large number of investment options before them.

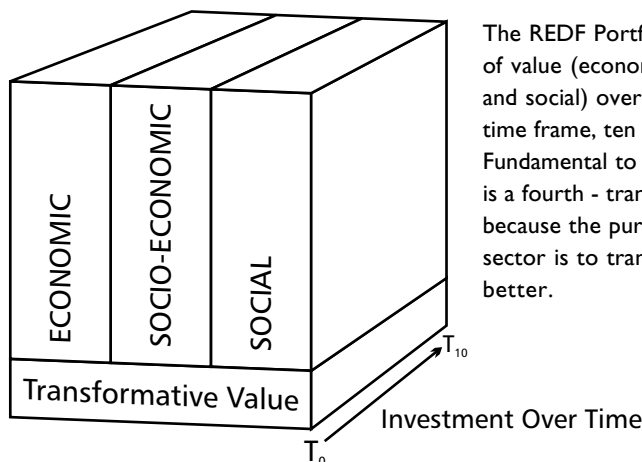
In addition to using a variety of other social and economic investment criteria, the SROI analysis can help answer two simple questions about an investment opportunity:

- How will it impact the bottom line of the business?
- What type of public costs will be avoided and additional tax dollars generated?

With a little extra work, the SROI analysis can also estimate the potential negative impact of not making the investment.

Take the hypothetical example of a nonprofit organization that requests an investment of \$100,000 to purchase a building to house its social purpose enterprise.

A SROI analysis projects that the investment would enable the enterprise to improve sales and net income by approximately 22% and 55% respectively over a 5-year period. Without the investment, the enterprise business performance is pro-



The REDF Portfolio creates three types of value (economic, socio-economic, and social) over a specific investment time frame, ten years in this case. Fundamental to all three types of value is a fourth - transformative value - because the purpose of the nonprofit sector is to transform society for the better.

jected to drop dramatically within a year. When the total business and socio-economic cash flows are projected, the total socio-economic return is estimated to be between \$343,000 (discounted at 9%) and \$520,000 (discounted at 0%). By dividing these returns by the investments required to generate those benefits, an SROI performance measure could be derived.

The potential application of the SROI analysis goes beyond simple planning and monitoring. As nonprofits begin to document the true value of their work, the tenor of their discussions with the public sector and other funding sources can change. The agenda can now include the linkage of funding to demonstrated impact. By so doing, the SROI cash flows are converted into actual, real-dollar funds that can be used to finance the operations of the nonprofit enterprise.

Again, like any measure of socio-economic value, SROI analysis does not attempt to quantify and capture *all* the benefits that accrue from a successful program. SROI just estimates the cost savings or revenue contributions that result from that intervention. But then, no informed investor relies upon a single measure to understand the worth of an investment. So

REDF encourages philanthropists and practitioners to use a variety indicators and tools to assess the outcomes and overall SROI of a nonprofit enterprise.

FUTURE WORK ON THE SROI

While the REDF's work to date on the SROI is significant, the analysis requires a number of refinements. To capture more precisely and accurately the socio-economic value of social purpose enterprises, four major improvements are required.

One is to find a better way to estimate the true "cost of capital" or "discount rate" of the philanthropic dollars invested in an organization. As with any private sector investment, philanthropic investments carry an opportunity cost. Each dollar invested in the social purpose enterprise might have been invested elsewhere, generating another, perhaps better, return. Investors factor this into their calculation as a cost in order to determine the true value of their overall return.

The integrity of the SROI analysis requires that the organization and funder use an accurate discount rate. If the cost of capital is overestimated, the calculated SROI will be undervalued. Conversely, if the cost

is underestimated, the total return will be overvalued.

Determining a discount rate is fairly straightforward in the private sector - one simply refers to historical market returns. But the newness of the SROI and lack of historical "social operating ratios" mean that no such standards exist in the nonprofit sector.

REDF is currently compensating for the lack of industry benchmarks by using different discount scenarios for each investment under consideration. The discounts range from 0% to 25%, each with different assumptions. Though imperfect, this approach provides decision-makers with a better sense of the true value of their investment until a better method is devised.

Ultimately, REDF plans to create its own standards based on the historical performance of its investees. The experience of creating this mini-market, and the standards it generates, will be instrumental later on as the nonprofit sector systematically begins to create its own industry standards.

The lack of data on historical SROI performance also makes it difficult to assess the degree of risk associated with different organizations and programs. A program with a target population requiring complex

TABLE: SROI CALCULATIONS (\$000s, USD)

Time Period											
0	1	2	3	4	5	6	7	8	9	10	Perp
Business Cash Flow											
\$3,182	250	380	420	510	620	750	840	950	1,170	1,290	1,400
Social Benefits Cash Flow											
\$2,373	200	254	328	412	496	589	653	786	816	920	1,000
Net Present Value											

\$5,555 ←

↪ Present Value of the Benefits
Present Value of the "Costs"*

↓
Social Return Ratio

(NPV** Business Cash Flow + NPV Social Benefits)
with Internal Rate of Return calculation provides:

↓
SROI Rate

* Present Value of the "costs" in this case is the grant equity contributed to the organization by government and foundation sources.

** Net Present Value

and intensive support (e.g., previously incarcerated youth) has a higher likelihood of failure than one that serves youth just out of high school who seek employability skills.

Private sector investors can refer to a quantitative measure of an investment's volatility or risk compared to the overall market. Similarly, philanthropic investors should have information that allows them to assess the risk of their investment in a social purpose enterprise.

As in the issue of discount rates, REDF uses a range of statistical models to explore ways of determining co-efficients of risk and factoring them into SROI calculations. When coupled with the discount rates, the result should be an even more accurate SROI analysis.

A third challenge is the difficulty of assessing the relative value of different programs or strategies. For example, one program that employs at-risk teens may have an SROI of 34%. This program is not necessarily better than an adult program with an SROI of 22% that provides transitional employment and educational support. Like apples and oranges, the two cannot be compared.

Over time, such comparisons should be easier as reporting standards are established and similar programs can be grouped into sub-sectors (e.g., microenterprise programs for the homeless and training programs for homeless). Just as the for-profit world recognizes different rates of return between Small Cap and Bond Funds, the nonprofit world could have different expectations of its sub-sectors.

The fourth and final conceptual challenge for REDF, as for every nonprofit, is to determine the degree to which social purpose enterprises are responsible for the improvements in their target populations' lives, and the socio-economic return associated with that improvement.

There is no easy way to determine the causality (or "incrementality") of a nonprofit intervention. The nonprofit sector has struggled with this meaty issue for years. REDF and its investee firms are tackling it through a combination of a high-end client data tracking system and an auditing process in which

organizations attempt to isolate the value added by their program.

RESPONDING TO POTENTIAL LIMITATIONS OF SROI

REDF and its investees are confident that in time they will make these four improvements and tailor Return on Investment principles and measurement systems to fit the realities of the nonprofit sector.

Some practitioners and funders feel otherwise, however. No matter how conceptually sound the SROI may become, they see it is an inappropriate, even dangerous, tool to use in the nonprofit sector. Let's consider three of their major criticisms.

The first is that the SROI analysis presumes that the organizations and programs in question work with people who represent a cost to the public system – those receiving social assistance, for example. However, some people are so far outside society's mainstream that they receive virtually no public support (the chronically homeless, for example). SROI analysis is technically inapplicable to programs which assist such people.

Were REDF to present the SROI framework as a definitive and comprehensive measure of a nonprofit's value, this would be a critical concern. However, REDF proposes the SROI as a way to capture *one* dimension of a nonprofit's work that generally gets overlooked, i.e., socio-economic value. In the right circumstances, the SROI represents a powerful addition to the understanding and tracking of a nonprofit's work. It is by no means meant for all programs in all circumstances. Nonprofits and funders must therefore use the SROI judiciously and in combination with other measures that capture the broader social and economic value that a nonprofit generates.

A second criticism is that once the tools are refined and standards are established, people will discover ways to "cook the books." They will falsely document performance to make their SROI results misleadingly impressive. The motivation to do so will be particularly strong if grants and subsidies are tied to a fee for performance.

REDF's work on calculating return on social investment is a product in development. Its original framework was presented in *New Social Entrepreneurs: The Success, Challenge and Lessons of Nonprofit Enterprise Creation* (1996). The foundation's recent second volume in that series, *Social Return on Investment*, describes many improvements to the tool. In the fall of 2000, REDF will publish an analysis of the methodological challenges of applying SROI analysis, as well as "portfolio reports" that present its analysis of its investee firms. At the same time, REDF intends to post SROI templates for practitioners to use in their own SROI calculations. The advanced version of these templates will allow the user to actually tweak ratios and formulas to reflect local conditions and costs. Read and download REDF's reports and other articles and publications at (URL) www.redf.org. We recommend bookmarking that website to keep track of the latest developments in REDF's work.

This is quite possible. Even the best-intended efforts can easily be subverted by human nature. Some in the private sector misrepresent the value and financial situation of their companies. There is no reason to believe that it won't happen in the nonprofit sector.

As serious as this concern is, however, we must not let it keep us from trying to improve our current systems of measurement. It simply means that the sector must also create an environment that encourages honest dialogue and communication. REDF is creating such an environment by allowing investees to specify the measures they feel best reflect the goals of their program.

A third criticism raised by skeptics concerns the relatively sophisticated information systems required to use SROI prop-

erly. While the SROI may ultimately be a valuable tool, few nonprofits have the financial and human resources required to create and manage those systems.

REDF's position is that if foundations and government funders insist that nonprofit practitioners provide measurable outcomes on their work, they should be ready to underwrite the costs involved in developing and using the necessary information systems. In its efforts to create its information system, for instance, REDF has invested over \$750,000 of its own funds. Another \$500,000 came from the Charles and Helen Schwab Foundation and \$100,000 from the Surdna Foundation of New York.

Each of the concerns described above is valid. But they do not justify discontinuing the development and use of SROI


analysis. Rather, the analysis be applied and supported with good judgment.

INTO THE FUTURE

On the whole, the nonprofit sector has not aggressively addressed how to measure or track the value it creates, social or economic.

The SROI analysis is certainly not the only answer, but it does represent a significant leap forward. SROI introduces more rigorous measurement of nonprofit value creation, and ties that value back to the original investment.

REDF believes that over time, the widespread use of SROI and related tools, and the performance standards they help create, will lead to better program management, improved accountability and community ownership, more

objective performance standards for the nonprofit sector as a whole, and, ultimately, to a greater infusion of much-needed capital into the field. 

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