CAPITAL MISSIONS COMPANY

Creating Investor Networks for a Globally Accountable Economy

Social Venture Financing
Best Practices Survey

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Survey created by:

Capital Missions Company

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Foreword

Over the last 12 years, Capital Missions Company has created 10 networks of socially-responsible investors. The first, Investors' Circle, brought together the leading practitioners of social venture capital to create an efficient marketplace for this new niche of finance. Nurtured by the Circle, a number of social venture capital funds sprang up and most have now prospered.

Early in 2001, CMC conducted qualitative interviews with these leading practitioners, asking what are the best practices you have actually used with your portfolio companies which have most enhanced your triple bottom line (financial, social, environmental returns)?" Their answers were organized by theme in this report to help other venture investors seeking triple bottom line returns. CMC president Susan Davis will be speaking on "Best Practices for Social Venture Capital" at the "SRI in the Rockies" conference in October, 2002 and the "Private Equity" Conference of Strategic Research Institute in January 2003.

The costs of this survey were underwritten by Solaria Corporation, a solar company with breakthrough solar technology which desired to exemplify social financing best practices. Solaria has closely followed the guidelines presented in this report.

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Social Venture Capital Best Practices Survey

Executive Summary of Social Venture Financing Best Practices Survey

Summary of interviews with 26 leaders of venture capital best practices.

1. A deal is a good deal when it is good for all concerned. In particular, treat seed investors fairly for having taken the early risk.

2. Do business only with people with absolutely the highest level of integrity.

3. Be patient—entrepreneurs need time for the team and business strategy to jell.

4. Don't string entrepreneurs along or make them sign "no shop" provisions or term sheets before the due diligence is done.

5. Insure before investing that the entrepreneur(s) want professional managers brought in.

6. Have entrepreneurs do due diligence on your venture fund and design the process collaboratively.

7. All employees get stock options for common stock, while all investors of cash get preferred stock with anti-dilution and veto rights.

8. Venture investing is an interpersonal game, not an intellectual one—not just a way of working, but a way of being a person.

9. All parties are proactive in telling each other bad news and are generous in designing win-win solutions.

10. The optimal composition of boards for early stage companies is a balance between inside directors, investors and independent experts.

11. Institute socially-responsible practices including code of ethics, disclosure policy, information sharing, mission statement, diversity, progressive personnel practices, stock options for all, recycling, progressive environmental practices, and fair investment terms. Monitor adherence to these principles. Consider adopting the Earth Charter principles.

12. Discontinue using excessive liquidation preferences; they may be common today, but they demotivate management teams.

13. The largest business opportunities of the millennium spring out of its largest social problems.

14. Private equity firms should voluntarily operate in the spirit of Sarbannes-Oxley and the new stock exchange listing requirements as follows:

    a. Boards and their committees (specifically the audit committee) of portfolio companies should be filled by qualified independent individuals.

    b. Audit Committees must understand the financial reporting process of the portfolio company and the internal control process.

    c. The audit committee must understand the implication of key accounting policies and their impact on the reported results.

    d. Use of auditors for non-audit services should be carefully reviewed.

    e. Private equity firms must understand that failing to comply with Sarbannes-Oxley and listing requirements could limit their future financing and exit strategies.

Social Venture Financing Best Practices

March 2002

Guiding Principles

In my days steeped in technology and on Wall Street, I put profits first and social factors second. I've learned now I must reverse that. Moreover, I now want not only that the practices are socially-responsible, I want the product itself to be socially-responsible. I believe that the largest business opportunities of the Millennium are related to the largest social problems of the Millennium.
Alan Kay – investor

Remember that 80% of social venture best practices are just using good ethics and integrity in executing traditional venture capital. The other 20% comes from the pioneer social venture investors who are adding value with environmental and social best practices.
Nick Parker—Parker Venture Management

Ultimately your reputation of being highly trustworthy and value-added is going to get you the best deals.
Nancy Floyd—Nth Power Technologies

Make venture investing an interpersonal game instead of an intellectual game. Venture is not just a way of working, it's a way of being a person.
Barbara Santry—Capstone Ventures

Human relationships are key to business, so we look closely at the people behind the company - what they stand for, their background and their track record in supporting the triple bottom line principles.
Peter Heller—PerEnergy Fund

Walk the company management through the whole financing scenario all the way through going public, showing theoretical valuations and the most likely sharing of financial returns among all the parties. Teach the management team they need to focus on their share price, not on their percentage of ownership.
Bob Shaw—Arete Corporation

As social investors, we can be too narrow, looking mostly at environmental sensitivity or another specific factor. But in most companies, the environment is just people working with people. The concept of helping people work better with each other and producing things more efficiently is at the core of the belief systems of social entrepreneurs.
Willy Osborn—Commons Capital Management LLC

Social best practices are often best practices period—particularly as they regard corporate governance, core culture and mission, balance of stakeholder interests, and attention to resource use, efficiency and indirect costs. This will be the way everyone does business and there will be no need for a special terminology. In the very early stages of a venture, so much depends on people rather than code and process. It's the mindset and determination of founding management that will encode the company's DNA with ethical, sustainability-oriented values. With a good team, the trick is then to help create an environment that will keep the values going as the company manages growth and complexity.
Steve Moody, Calvert Group

Guiding Principles (cont.)

Raise funds from progressive capital sources,
Mark Donohue—Social Capital Partners, Inc.

Without having a deep understanding of the changing economic, social and environmental drivers, venture capitalists will miss the boat on the next generation of opportunities. Ten years ago, who thought the internet would be the big thing? What's the big thing coming now? Businesses who respond quickly to dramatically changing values towards society and the natural world around us - that's the big thing. It's not just what you do, it's how you do it.
Nick Parker—Parker Venture Management

If entrepreneurs are just in business for the money, we don't consider them. They have to be passionate about using business to change the world and to see that the business model can effect a major change in the world. In their actions and behavior, we have to see that they love the game of business and that they see the potential of business to make a significant contribution to society.
Willy Osborn—Commons Capital Management LLC

Social venture best practices are pure and simple the highest standards of ethical business practices. Tell the truth. Model a strong work ethic. My favorite business book is the Bible, particularly Proverbs.
Peg Wyant—Isabella Capital

Today, good business practices are not in conflict with society. Thus don't change your normal principles of operating with high ethics and with win-win relationships with everyone in the deal.
Vin Ryan—Schooner Capital Corporation

Adopt a general policy of "doing unto others as you would have done unto you."
Mark Donohue—Social Capital Partners, Inc.

Whether working with my students or entrepreneurs that I am coaching, I always advise them that the most important decisions they will make are, "who to trust". The people decisions they make will have the greatest effect on outcome. Who to approach for funding, who your advisors should be and most importantly - who you should hire will determine the course of the company. It's important that everyone you bring onto The TEAM share the same vision for the business, have a common ethical foundation and be "A" players. This is critical because As hire As and Bs tend to hire Cs.
Audrey MacLean—Challenger Venture Consulting

How Venture Capitalists Should Treat Entrepreneurs

Strong Theme: **Be Patient**

> Give the management team time, their most important asset, as it lets the team jell and it makes for a better business strategy. Recognize that strategies evolve over time and encourage flexibility.
> **Ann Partlow—Rockefeller & Co., Inc.**
>
> Building companies takes time: Expect to be involved with the company for five to seven years.
> **Harry George, Henry Newman, Fred Bamber—Solstice Capital**
>
> Set long-term vs. short-term financial goals for your investments.
> **Mark Donohue—Social Capital Partners, Inc.**

Strong Theme: **Don't string an entrepreneur along**

> Companies really benefit from straight talk from venture investors because venture funds often try to maximize their options by stringing a number of companies along. One important social venture best practice is to be absolutely forthright with the entrepreneur from the initial contact regarding what his/her chances of funding are.
> **Sona Wang—Inroads Capital Partners**
>
> In reviewing deals, say no immediately and don't waste the entrepreneur's time. This applies in two ways - area of expertise and goal of the entrepreneurs. The venture firm should look immediately at its time and experience resources. If you can't do the due diligence or know someone who can, say no then. A venture investor doesn't have the time to come up the learning curve. Second, look at the goal of the entrepreneurs. Say no immediately if it is a lifestyle company or an opportunity for a family. Particularly in social venture deals, make sure there are realistic expectations on all side. Most of us have been burned on this one.
> **Wayne Silby—Calvert Social Investment Fund**

Only invest in industries you know deeply or you're doing a disservice to the entrepreneurs you invest in.
Bob Shaw—Arete Corporation

Most venture funds could write a better business plan than the entrepreneurial team but that would deprive the team of having to go through the learning and negotiating process of doing it themselves. Through their struggle with writing it, it comes to express their deepest beliefs and bonds them to each other in a more powerful and lasting way.
Barbara Santry—Capstone Ventures

Support empowerment of women in the executive ranks,
Mark Donohue—Social Capital Partners, Inc.

Be cautious when insisting upon strategic investors as they can often be double-edged swords for the company. Often the investing arm of such strategic investors lack the commitment from the operating divisions. A strategic alliance is often a better solution and delivers what was sought, i.e. confirmation that one of the big players accepts the value proposition and is willing to play a role in commercialization.
Gina Domanig—Sustainable Asset Management

How Venture Capitalists Should Treat Entrepreneurs (cont.)

When a company is distressed, the investor group willing to come in can negotiate in a very tough way. They have to walk a fine line however, because if they take too much advantage, the entrepreneurs will be resentful and may be so demotivated that the company can fail.
Noel Perry—Baccharis Capital

Establish an operational discipline. Now that our fund is officially closed, we have created and intend to adhere to internal targets for turning deals around. For example, the initial prescreen is to be completed withina maximum of two weeks of receipt of the business plan, and the first phase of the due diligence (preliminary assessment in our terminology) to be completed within one month of passing the prescreen. All of this is of course dependent upon the timely receipt of proper information but it will help us keep our process efficient and will satisfy the entrepreneurs' needs for quick decisions.
Gina Domanig—Sustainable Asset Management

Make clear efforts to deliver on the synergy potential of the fund (e.g. forums with investors and portfolio companies).
Gina Domanig—Sustainable Asset Management

Entrepreneurs need to choose venture funds who can stay the course and back the company through successive rounds. Entrepreneurs can't get it in writing but they should have verbal assurances that the funds have earmarked money for future rounds.
Willy Osborn—Commons Capital Management LLC

The devil's in the details. I've been in situations where I've gone into companies and given blood, sweat and tears to back the management team. At the end of the day, the managers weren't right and couldn't see it themselves. Then you have to do the tough thing in moving management aside. That of course breaks the circle of trust. You operate on the highest principles you can but the world does get messy and sometimes you must make decisions that are not win-win in the short term.
Nick Parker—Parker Venture Management

I'm not interested in community involvement or charitable contributions. It's not about that, it's about how your total turnover affects the world around you - your employees, your investors, your customers and your suppliers.
Nick Parker—Parker Venture Management

Using the Golden Rule, we treat our staff well, as we would like to be treated. For example, we took our staff to Club Med with spouses after our success with Envirotest. We pay for air fares for employees at times of death or illness.
Liz Harris—UNC Partners, Inc.

How Entrepreneurs Should Treat Venture Capitalists

Be brutally honest with your investors and, equally importantly, be PROACTIVE in telling them bad news. Don't wait for them to ask you. Have an agreement when they make the investment that there's always lots of bad news with growing companies and that investors want the bad news along with the good so that trust can develop.
Sona Wang—Inroads Capital Partners

Be extremely open to advice and contacts your investors provide.
Sona Wang—Inroads Capital Partners

A solar company I invested in hit some snags last January and the management team announced to investors they were all going off payroll until they could come back to the investors with a turnaround. It literally brought tears to my eyes. Now they're strongly back on track but meanwhile they have engendered a deep loyalty in me. I believe that when entrepreneurs treat investors with generosity, the investors will reciprocate when the entrepreneurs really need it.
Alan Kay – investor

Doing Due Diligence

Strong Theme: **Probe Heavily on Integrity**

Because you will be with the company for 5-7 years, make sure you are comfortable with management. (We will often have known the management of our portfolio companies for years prior to an investment.) Unquestioned integrity is essential.

Harry George, Henry Newman, Fred Bamber—Solstice Capital

Only invest in people you deeply believe in, have a strong sense of camaraderie with and want to spend substantial time with. If you feel you have to do integrity checks, it's probably a bad sign.
Bob Shaw—Arete Corporation

On very early stage deals, we like to have the key employees personally warrant that they have disclosed all material known facts. If they have a problem with this, then it is a red flag for us.
Gina Domanig—Sustainable Asset Management

Do background checks on the key management members. Even if you don't find a deal breaker, it is helpful to know the key management members' individual strengths and weaknesses so that you can better support and guide them in the future.
Gina Domanig—Sustainable Asset Management

Really check the entrepreneurs' resumes and references since the going often gets tough before or whether the sun shines at the end of the tunnel. Know the real character of the team you're backing.
Liz Harris—UNC Partners, Inc.

Doing Due Diligence (cont.)

I do a background check of each crucial person because I have been burned. I expect complete and collaborative compliance with that. If a manager objects, it's a red flag to me. I disclose the review and ask for the person's social security number. I retain a fiduciary to do this at a cost of $100 to $1,000, depending on whether the search is local,

state or federal. Since integrity is the core element of social responsibility, this is particularly appropriate for social investors but many investors don't take this step.
Willy Osborn—Commons Capital Management LLC

Strong Theme: **Do Due Diligence Before Signing Term Sheet**

Our practice is to not sign term sheets with the entrepreneur until you've done the majority of your due diligence. Often firms will sign a term sheet to lock in a deal, making it contingent on them doing the due diligence later. Then they'll cite negative factors to alter the terms to dramatically favor their firm. Meanwhile, the term sheet will provide for them to have an exclusive position as lead investor, so the entrepreneur is locked out of approaching a more fair firm. We've never lost a deal by doing our due diligence before signing the term sheet. If you don't strike a fair deal, you disincent management.
Nancy Floyd—Nth Power Technologies

Strong Theme: **Insure the Entrepreneur Wants the Professional Manager**

Since investors almost always have to bring professional management into a start-up, and since conflicts between entrepreneurs and professional managers constitute one of the highest venture risks, don't invest in a company unless an entrepreneur who is inexperienced says s/he wants a professional manager brought in. It never works to try to move the entrepreneur aside.
Bob Shaw—Arete Corporation

If the entrepreneur doesn't have the capacity to perform as a the long-term CEO, discuss this openly before investing or don't invest.
Nancy Floyd—Nth Power Technologies

When an entrepreneur is fighting about giving up control, it means they don't view their investors as partners but as enemies. Let the buyer beware.
Bob Shaw—Arete Corporation

Strong Theme: **Have Entrepreneurs Do Due Diligence On You Too**

Understand that due diligence is a reciprocal process and that entrepreneurs and potential co-investors need to check your references too.
Liz Harris—UNC Partners, Inc.

We always encourage entrepreneurs firm to call other entrepreneurs we have financed as well as those we have turned down. The entrepreneurs should do due diligence on you as well as vice versa.
Nancy Floyd—Nth Power Technologies

Doing Due Diligence (cont.)

Be very careful to look at the ecological footprint. There are two ways to deal with environmental issues - as a cost item or as a way to reduce cost. Choose companies that have the latter view and deeply understand the eco-efficiency story that costs are reduced not increased by enlightened environmental practices. It's not just the compliance story……choose companies that have turned their environmental obligations into a way to improve the overall health of the company.
Nick Parker—Parker Venture Management

Time is a crucial factor we leverage. I'll watch a company for as much as a year before I begin a due diligence process. Then I'll take a month to do the due diligence and 30-60 days to pull the deal together.
Willy Osborn—Commons Capital Management LLC

Collaborate with the entrepreneur in the design of the due diligence work plan and in the formulation of a schedule. Set realistic time frames and budgets for the conduct of due diligence.
Liz Harris—UNC Partners, Inc.

The VC management team should have unanimous decision-making and each member should participate in the due diligence. It is easier to kill a deal that you personally worked on and it is more likely that each member will continue to support the company into the future.
Gina Domanig—Sustainable Asset Management

Ask each partner to participate in the due diligence on a deal once the partner who's the point person recommends the deal. This way the partnership can make smarted and quicker decisions, and when the company hits a speed bump, each partner "owns the deal" and is inclined to help the company.
Nancy Floyd—Nth Power Technologies

Have a clear internal champion amongst the partners but create automatic checks and balances within the team to ensure objectivity. At least two partners should meet the management team and the lead partner must meet the board members before investing. The dynamics of these two key groups will have lasting impact on the future of the business. Alignment is crucial.
Gina Domanig—Sustainable Asset Management

Always meet the entire management team in person before you invest in a company.
Nancy Floyd—Nth Power Technologies

Be open-minded about the background of the entrepreneur, as very successful business leaders can come from backgrounds as unlikely as communes, organic farms or political movements.
Nancy Floyd—Nth Power Technologies

Valuation Best Practices

Strong Theme: **Establish Realistic Valuation and Control Expectations**

Make sure you lay out the long-term story of pricings and valuations and dilutions so the entrepreneur has a firm grasp of typical financings stories from present to post-IPO.
Sona Wang—Inroads Capital Partners

Entrepreneurs understandably are concerned with "control" issues. It is often the case that the entrepreneur does not optimize (his/her) economic interest because they focus on control. Where this would be true, help the entrepreneur understand this.
Harry George, Henry Newman, Fred Bamber—Solstice Capital

Discuss valuation (at least ranges) early in the process to avoid an unbalanced negotiation at the 11th hour.
Gina Domanig—Sustainable Asset Management

Strong Theme: **Start with Low Valuations**

One important social best practice is to set valuations low but higher in each round. Having the company succeed is more important than getting a high price in the next round, and growing companies are so vulnerable to big bumps in the road that down rounds can come about too often. Then you have introduced distrust between rounds of investors and between investors and the company. Distrust is one of the most expensive costs in venture investing. If you've 'tricked' incoming investors with too-high valuations, the interpersonal dynamics of getting over that are going to be much more destructive of return than taking a low price at the beginning. When you finance a company, you're redistributing its ownership and so you have a natural human tendency to want more for yourself than for others. I try to get the competitive piece out of that this way. I remind everyone that the company succeeds based on how well we work together. That's going to happen more when we've treated each other in a trustworthy way. The downside is really too big so let's not do it this way. I say, as the entrepreneur, you want to look for the investor you can work with and trust. Coming from that place, let's choose the right valuation and let's lowball it. The truth is that, after the financing, the team has an 80% chance of making the numbers if the environment is positive. If the environment isn't positive, with all the challenges of growth, you have almost no chance. Most companies are going on preposterous numbers anyway, so most have a 10% chance of making their targets. Meanwhile, the trusting new investor thinks the incentive system should be based on the projections based on which he invested. In contrast, the entrepreneurial team knows the numbers are almost unreachable. So approaching financings in this way sets it up for distrust to get rooted early on. I advocate setting a valuation low enough that you dramatically increase the probability of sustaining trust among the parties. We counsel our entrepreneurs to focus on getting trustworthy investors and enough money for their growth rather than on getting the highest price.
Barbara Santry—Capstone Ventures

Start with low valuations and undervalue each round to lessen the risk that future rounds will require write-downs, thus avoiding cram-downs and other negative features that can dramatically demotivate all concerned. Make sure that at each round, everyone's happy.
Bob Shaw—Arete Corporation

And then a different view…
Early stage returns are less correlated with entry price than with more qualitative factors such as good will, trust and loyalty. Thus it is important not to lowball the valuation particularly in the beginning. **Sona Wang—Inroads Capital Partners**

Valuation Best Practices (cont.)

Valuation is one of most difficult challenges for all of us and I address that by having valuation be an ongoing discussion. Use fact finding and the due diligence process to hone the valuation by checking very specifically into the soundness of the projections, testing out assumptions and interviewing key people crucial for the success of the company's business plan. Over time, a pattern emerges about the validity of the information surrounding the valuation that the entrepreneurs have given you. That then gives you solid ground to negotiate a fair valuation.
Willy Osborn—Commons Capital Management LLC

Term Sheet Provisions

Demand and give active board membership. Accept the responsibility as a board member to address critical issue in a timely manner - be vocal, stand for your principles. Be strict on monthly reporting (content and timeliness)- the discipline is good for all concerned. Ensure that other key employees have face time with the board as well - if there is an internal problem with the CEO it is critical that they feel they can contact the board.
Gina Domanig—Sustainable Asset Management

Don't be greedy. Demonstrate flexibility in designing term sheets with agreements that make it possible for the entrepreneurs to win bigger if their numbers and targets prove to be more accurate than yours.
Liz Harris—UNC Partners, Inc.
When tying trenches to milestones, it is best to clearly spell out the consequences for failure to meet the milestone plan. If the milestones are then not met, the consequences seem more fair to both parties.
Gina Domanig—Sustainable Asset Management

Employees with stock options get common stock but all investors of cash should get preferred.
Harry George, Henry Newman, Fred Bamber—Solstice Capital

Develop a risk management strategy regarding exits and stick to it. Communicate early on to the company what your policy is regarding exiting after the lock up.
Gina Domanig—Sustainable Asset Management

Strong Theme: **Establish "Democracy of Interest" on Board**

> Achieve a "democracy of interest" on the board. For example, have two inside directors, two investors and one from a relevant domain.
> **Harry George, Henry Newman, Fred Bamber—Solstice Capital**

Instilling Socially-Responsible Practices in Portfolio Companies

Strong Theme: **Give Everyone Stock Options**

Encourage wide equity participation.
Harry George, Henry Newman, Fred Bamber—Solstice Capital

Every employee should get stock options.
Sona Wang—Inroads Capital Partners

Advocate 100% employee stock ownership,
Mark Donohue—Social Capital Partners, Inc.

Stock options to all employees are very important, although there may need to be flexibility for hourly folks to whom cash may be much more desirable.
Willy Osborn—Commons Capital Management LLC

The stock option thing can get overdone if taken too far among support staff, who often just want cash. If the company wants this, fine, but I wouldn't fight for it.
Wayne Silby—Calvert Social Investment Fund

Offer stock options to all employees and make adequate provisions for day care, training and formation of social capital. Look for diversity in a management team.
Nick Parker—Parker Venture Management

Things a company should implement include a mission statement, a code of ethics, a policy for disclosure and information sharing, fair investment terms, employee incentives and formal modes of participation in the direction of a company. A statement of values would also include, hopefully, regard to community involvement, diversity, and environmental considerations AND the recognition that all these are integral to the company's success. There should be a process set up for reviewing, even if only periodically and informally, how well a company is performing on these different levels.
Steve Moody, Calvert Group

Strongly encourage the management team to exemplify diversity at all levels.
Harry George, Henry Newman, Fred Bamber—Solstice Capital

The board can be helpful in encouraging management to round out the skills represented on the management team. Don't expect one manager to embody all the qualities needed in the leadership group.
Ann Partlow—Rockefeller & Co., Inc.

We look at the company's commitment to the sustainable energy industry, including the company's interest and willingness to partner and support small innovative companies and technologies that need support to enter the market.
Peter Heller—PerEnergy Funds

Open book management may not be appropriate at every level, but entrepreneurs owe employees complete information. If you are running out of money, it shouldn't be covered up but used as a motivation to keep everyone focused. Create an open environment where employees feel free to ask questions. Fear and paranoia and disloyalty breed where there is a lack of information and that will scuttle your company quickly. Open communications have to start from the top.
Sona Wang—Inroads Capital Partners

It is crucial to fire people who are not doing the job; it is an act of kindness, not an act of cruelty.
Peg Wyant—Isabella Capital

As a social venture investor, you must walk a fine line between inspiring the entrepreneur to implement environmental and social best practices and requiring compliance reporting that is too onerous, as the latter could be the straw that breaks the camel's back for overworked entrepreneurs.
Willy Osborn—Commons Capital Management LLC

Help management professionalize by inspiring the management team to set and meet objectives and milestones. (For example, have important board and other meetings scheduled a year ahead so busy people can plan to be there.) Once you've professionalized the board, you can insert social initiatives in an orderly fashion, such as giving responsibility for board diversity to the nominations committee.
Willy Osborn—Commons Capital Management LLC

Another important example of professionalizing is to get materials to board members a week early so they can prepare their contributions. I think of the analogy of how New York City dramatically reduced crime by ending graffiti on the subways - it can be the little things that serve as the "trim tab" of important improvement.
Willy Osborn—Commons Capital Management LLC

When you're a private company, it's what you do that's important - the product, technology, whatever. However, when you go public, it's how you do it that people look at more. So it's crucial to get enlightened practices instilled in companies while they're start-ups. Reputational capital and attracting employees is hugely important and the basis for this is laid in a company's early years. Public markets are rewarding corporate social responsibility so you better equip yourselves.
Nick Parker—Parker Venture Management

As you build the company, it's imperative that you are consciously creating a corporate culture that encourages risk taking. My advice is to instill a sense of open communications in the company, which will enable the company to move much faster. I encourage entrepreneurs to make it OK to identify problems, even before there is an identified solution. This is extremely important in high-tech start-ups where time to market is key, and engineers have a natural reluctance to identify problems that they have not yet found a solution to. In one company I ran, we even had a "lurking alligator award" for merely identifying an unsolved problem in the company. The recipient received a giant blow up alligator to display on their cubicle and dinner for two. However you do it, it's important to build a culture that's nurturing and tolerates failure. The message needs to be "the only way to fail is not to have tried."

The thing about being a high-tech entrepreneur that everyone needs to know going in to it, is that it's an Xtreme Sport. You need an extremely high level of energy and passion as well as intelligence and expertise to pull it off. There are always a million reasons why it won't work, and you and your team need to be the reason why it will.
Audrey MacLean—Challenger Venture Consulting

My advice to start-up teams is that, ultimately - reality will make itself known. The trick is to always have an intellectually honest assessment of reality combined with a larger than life view of your potential to succeed.
Audrey MacLean—Challenger Venture Consulting

Monitoring the Deal

Make reasonable reporting demands, including demographic and gender data on the portfolio company's management and non-management employees.
Liz Harris—UNC Partners, Inc.

Maintain a trusting, collaborative and transparent relationship with the (potential) portfolio companies.
Gina Domanig—Sustainable Asset Management

Treating Different Rounds of Investors Fairly

Get to know the other investors likely to invest early on and ensure equality amongst the investors (e.g. equal terms).
Gina Domanig—Sustainable Asset Management

If the first round investors try to be punitive in their term sheet with the entrepreneur, they cut their nose to spite their face because the next round of investors will use the same terms on them and they'll lose a lot more than they gained.
Barbara Santry—Capstone Ventures

How do you stop taking advantage of others in your pricing? There is sufficient latitude in pricing that one could fairly easily lean towards the generous end of that range and favor management and seed investors. I've found that the payoff of trust and good will has been well worth the price!
Sona Wang—Inroads Capital Partners

Achieving Social Dividends

Our guidelines for corporate conduct are the principles of the Earth Charter (www.earthcharter.org) which reflect better than anything else we know a set of contemporary values related to human rights, gender issues, environment, poverty, corruption and - the rights of future generations. Thus we ascertain the degree to which a portfolio company acts on these guidelines.
Peter Heller—PerEnergy/Canopus Foundation

We educate all our portfolio companies on the long-term profitability of adopting progressive environmental policies. As a condition of investing, we often require the board to pass a set of standards for 'best environmental practices.' In countries where best practices don't exist, we retain a consulting firm to help the company. For example, we have health care companies adopt U.S. standards for medical waste disposal or water treatment companies adopt World Bank or U. S. standards. If companies are multinationals, we ask them to adopt ISO14000 environmental standards….This all drops to the bottom line because management believes our expertise helps them find optimal technology which gives them an edge over their competition.
Jeff Leonard—Global Environment Fund, LP

Achieving Social Dividends (cont.)

Having our companies ISO14000 certified increases business because many multinationals cannot use unregulated or substandard landfills and must use our company's facilities to meet their corporate standards.
Jeff Leonard—Global Environment Fund, LP

In the beginning, decide if there's an international market of need for the service or product and if there's a small marginal cost of production that could benefit the developing world. If yes, when you are negotiating with the entrepreneur, require that they distribute internationally in this way to achieve the social dividend. They usually want the money and are open to this request. The resistance can be strong however. As a related example, I wanted to give our GroupServe software away to not-for-profits but my board didn't agree, so I've had to say I'll pay for it. So make sure investors and management are aligned with your values if you're operating in the social venture arena.
Wayne Silby—Calvert Social Investment Fund

Encourage your companies to do ESOPs (Employee Stock Ownership Plans).
Jeff Leonard—Global Environment Fund, LP

Adopt formal policies toward social responsibility / corporate citizenship which are distributed to all team members,
Mark Donohue—Social Capital Partners, Inc.

There's no distinction between running a good social venture fund and running a good venture fund. Each venture capitalist comes into the industry with a set of values and standards. I thought I could make a difference and kill two birds with one stone by choosing socially responsible companies, but my values and standards would have led me to operate the same whether I had done social investing or not.
Noel Perry—Baccharis Capital

Special Viewpoints

An Unusual Strategy…

We only do business with friends or those who could be.
We stay out of control position and support people we want to back.
We stay in long term.
Our expectations for returns include far more than money.
Our financial returns expectation is proportionate to the potential of the business. Long, slow, steady growth is the goal.
We have low documentation requirements and low hoops, once we are clear on the values; competence and trustworthiness of the entrepreneurs.
We focus on a geographic region and build an interdependent relational field of projects and businesses.
We stay consistent on mission and values.
We steer clear of offensive terms like "ethical" or "socially responsible."
Joel Solomon—Renewal Partners/Endswell Foundation

A Network for Your Investors and Entrepreneurs…

By design, Nth Power brought in strategic investors to its funds. Nth hired a professional to create synergy between the corporate investors and portfolio companies. Twice a year. Nth's investors and portfolio companies meet for several days. The result has been a win/win situation for Nth's portfolio and its LPs. **Nancy Floyd—Nth Power Technologies**

Special Viewpoints (cont.)

A Ten-Year Track Record…

My goal was to show that you could invest in socially-responsible companies and make money and I have demonstrated that. The story is an unexpected one though, because I invested in consumer products and retail areas that have returns from the bottom to the lower-middle of overall industry returns. The fund was launched in October of 1991 and, for the first seven years, I invested in three areas: organic food, educational toys and medical devices. I had several successful deals in each area and was earning respectable returns. In the last three years, I made internet investments in health and, like many, had quite a few failures. However, I had made a very substantial investment in a company in the functional genomics area and this made up for these losses and more. My expectations now are that the last three years will substantially improve the overall profitability of the fund. So I believe I'm achieving my goal of demonstrating that you can invest in social ventures and make money.

Noel Perry—Baccharis Capital

Thoughts From an Industry Founder…

Triple bottom line experiences in situations where professional investors are involved with entrepreneurs have been mixed and informative. Adding Venture Capitalists, or professional business angels (active angels) to an early stage company provides great opportunity and great complexity to achievement of financial, stakeholder, and community/environmental goals.

The greatest enhancement of performance in these areas comes when there is initial clarity of purpose, identification of specific benchmarks and quantifiable targets for success, and establishment of communication procedures among all parties. Because triple bottom line is not the norm in our economic system, extreme care must be given to lay out goals, strategies, and reporting mechanisms on each arena. Financial backers thus must not just bring standard financial criteria for success but must buy into the multiple objectives inherent in a social venture.

However, entrepreneurs oftentimes dwell in the product/service success area without sufficient consideration that the stakeholders need to make a reasonable return on investment - otherwise we wouldn't call the activity investing - so clear up front communication and agreement on goals, targets, "what is success" in a bottom lines – is essential.

These are the critical success variables in this evolving space - very few companies can juggle a couple of these goals, much less three. It is in the honest trying that we may advance the art—and this type of investing is still an art!

John May—New Vantage Partners

A New European Player…

We analyze the social and environmental practices of companies worldwide and are responsible for the UBS Eco Performance Fund (see http://www.ubs.com/e/investmentfunds/ecoperformance.html.)

We are also involved in the build up of a label for socially advanced small and medium-sized companies in Switzerland. The criteria in development for this is that we will integrate all stakeholders in our survey. The companies must be good in communications and in integrating the interests of employees, customers and society. They must demonstrate that sustainable earnings are created by improving the health and motivation of employees and by creating customer loyalty.

Markus Schmid—Ecos.ch

Special Viewpoints (cont.)

Develop the Personal Relationship First…

Our principle strategy is to invest in people we can have a dialogue with and we're constantly engaging in that dialogue. I'll give you a typical example. The CEO of a company called Happy Planet Foods came to see me some time ago, introduced by Joel Solomon, with whom I sit on a board. Happy Planet Foods is an Odwalla-type company producing almost-all-organic juices and smoothies.

We started talking about the SRI aspect of Happy Planet because they wanted to operate with a strong relation to community, both through contributions and volunteer activities. They had reasonable and progressive employee practices and we explored their opportunities in the SRI realm. We stayed in regular contact, with 85% of our talk about the company's production and distribution channels and about 15% of our conversation about SRI. The longer we continued exploring the possibilities of SRI, the more he could see that it was possible to carry out the social mission.

Eventually I went on the board and made an investment in their first formal round and then in the next round too. However, the CEO didn't ask for an investment until we'd been talking for almost a year. He understood the importance of establishing a trusting dialogue first. That's the gist of it.

I use the same strategy with our money managers. Their basic orientation is not to have any social mission at all. We tell them we have basic negative screens like no tobacco, weapons or gambling before we later start talking to them about their other SRI possibilities. But it's when you have a good relationship with the manager that they not only see they can do it, but they see that other customers will want it too. They also learn that customers like me can send them other clients that want the same SRI product so they wind up getting more customers.
Alan Broadbent—Avana Capital Corporation

Profile of a Mentor Capitalist…

I call myself a Mentor Capitalist because I work so closely with the entrepreneurs I back. I invest my own funds and don't have limited partners. While I don't define my investments as social, I have ended up backing several female entrepreneurs. My area of expertise is networking and software, so I focus primarily in those market areas.

First, I make sure I'm passionate about the area the company is targeting. Second, I have to feel aligned in a powerful way with the integrity and intentions of the entrepreneur. Third, the entrepreneur must very much want what I contribute, which is to do the early stage seed work preparing the company for the venture capitalists. I don't work with the entrepreneur if they don’t intend to take the company public. I'm very selective and work with only a couple of companies a year. Of my 20 investments, 6 went public, 12 were acquired and 2 failed.

I don't invest unless I have an intuitive feel for the market.

I don't invest unless I think I could make the deal work if I was running it.

I don't invest in a "me-too" deal that doesn't have real product differentiation.

I don't invest unless my values are strongly aligned with the entrepreneur's.
Audrey MacLean—Challenger Venture Consulting

Special Viewpoints (cont.)

As a Private Investor Sees It…

I look first and foremost at the management. Anything else may be an indicator but is certainly not going to assure me that the company will really operate as a socially-conscious business. But how do I determine that management has the right character and highest integrity? This is an art, not a science. I believe that social consciousness is grounded in spiritual roots. I never ask management what their spiritual beliefs are, but if I spend enough time with them and ask enough questions about their operating philosophies, I can tell. Understanding their motivation, talking to their employees and knowing what they do in their spare time (family and community activities) is also important to this understanding.

Once I'm satisfied that management has the right character and integrity and that these qualities are founded upon deeper-than-humanistic values, then I know that their social practices will be best practices. That's my first "screen". After that, I can begin more traditional evaluation of the business.

Of course, it's important that social businesses be sustainable—more important than my being rewarded as an investor because without sustainability we will never be able to attract enough capital to social investing to have the kind of impact I think is possible. Thus, the rest of my evaluation focuses upon sustainability. The expected ROI for investors is less important. If the business is focused on both social issues and sustainability, I believe my return as an investor will be satisfying in more ways than one. My pamphlet outlining my investment philosophy is available to those interested.
Dick Grafer, Private Investor, Investors' Circle Member

Industry Challenges and Opportunities

Strong Theme: **Don't Perpetuate the Practice of Exaggerated Projections**

Many venture funds require projections that are almost preposterous before they consider the investment, but I encourage my entrepreneurs to create projections that represent 'if everything went well' rather than the preposterous.   It creates distrust for everyone to have actuals be wildly off projections, which is often the case.

During the internet boom, it was easy to 'trick' gullible investors into investing based on preposterous valuations.   Many funds did do the 'tricking.'   The results of this speak for themselves, with devastating losses to all parties.
Barbara Santry—Capstone Ventures

Venture capitalists now require entrepreneurs to create almost-preposterous projections. Then they peg the milestones to it and the management winds up disincented. This is a lose-lose proposition. The present practice of patently unrealistic projections in venture capital brings the integrity of both the entrepreneur and the investor into question but it's unfortunately become the norm. The industry as a whole needs to find a new win-win option.
Wayne Silby—Calvert Social Investment Fund

I think the industry would be served by having a fund that works at all stages of financing. Otherwise we have the situation we have now, where different funds focus on financing different stages and each round of investor can be somewhat ruthless with the investors coming before, if the company hasn't had stellar performance.
Barbara Santry—Capstone Ventures

Industry Challenges and Opportunities (cont.)

The worst existing practice among venture firms is to "inventory a deal" by stringing an entrepreneur along and then not investing. Don't issue a term sheet until due diligence is done.
Harry George, Henry Newman, Fred Bamber—Solstice Capital

Venture investors have so many companies seeking money that you can fall into playing god, when actually the business works best when the investors are deeply respectful of the entrepreneurial team and realize that it is only they who manifest the results.
Barbara Santry—Capstone Ventures

It may be very tempting because of typical early-stage uncertainties to extract the best economic deal possible when you have the leverage. You have the maximum leverage just before the investment is made. However, if you maximize your leverage when you can, it may be very subtle but it creates a sense of inequity on the part of the entrepreneur that doesn't go away. The recent book, *The New New Thing* describes how Jim Clark felt Mayfield Partners extracted too rich a deal when he formed Silicon Graphics and how he got even with them later when forming Netscape. So maximizing your leverage short-term at the expense of the relationship with the entrepreneur is a stupid thing to do. The same principle actually applies at each level of financing. It's the seed investors that take the greatest risk and in some ways they are the goose that lays the golden eggs. Don't kill that goose!
Sona Wang—Inroads Capital Partners

We are intrigued by some funds' practice of having the management team of a deal being proposed present at the investment committee meetings. We do not do this as common practice (although it has happened) and we are interested to hear the pro's and con's from the other funds.
Gina Domanig—Sustainable Asset Management

You can never overstress the quality of the people. The venture person should see his role as trying to find top talent for his deals. The people are as good as the capital. There ought to be a social venture talent network.
Wayne Silby—Calvert Social Investment Fund

Survey Participants

Alan Broadbent—Avana Capital Corporation
Gina Domanig—Sustainable Asset Management
Mark Donohue—Social Capital Partners, Inc.
Nancy Floyd—Nth Power Technologies
Harry George, Henry Newman, Fred Bamber—Solstice Capital
Dick Grafer—Private Investor, Investors' Circle Member
Liz Harris—UNC Partners, Inc.
Peter Heller—PerEnergy/Canopus Foundation
Alan Kay—Technology Investor, Investors'Circle Member
Jeff Leonard—Global Environment Fund, LP
Audrey MacLean—Challenger Venture Consulting
John May—New Vantage Partners
Steve Moody—Calvert Group
Willy Osborn—Commons Capital Management LLC
Nick Parker—Parker Venture Management
Ann Partlow—Rockefeller & Co., Inc.
Noel Perry—Baccharis Capital
Vin Ryan—Schooner Capital Corporation
Barbara Santry—Capstone Ventures
Markus Schmid—Ecos.ch
Bob Shaw—Arete Corporation
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