

GLOBAL HEALTH

Innovation Insight Series

Embrace, a Mulago investment, was founded as a nonprofit but then transitioned to a hybrid structure as the needs of the organization changed



Photo courtesy of the Mulago Foundation

MULAGO FOUNDATION III: Choosing a Legal (and Capital) Structure

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THE PROBLEM/SOLUTION SPACE

In 2012, global health financing totaled \$28.1 billion (just shy of the \$28.2 billion peak achieved two years earlier).¹ Governments provide the majority of this funding, but each year private philanthropists play an increasingly prominent role. Private contributions through foundations, nongovernmental organizations (NGOs), and corporate giving accounted for nearly 15 percent of global health funding in 2010.² Private sector participants can manage their own global health programs or use their donations to fund other organizations performing work in the sector.³

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ABOUT THE MULAGO FOUNDATION

The Mulago Foundation is a private foundation focused on the prospect of creating a better life for the world's poor. Concentrated in rural settings in developing countries, the Foundation's work is in four areas that contribute to this overarching goal—livelihoods, health, education, and conservation.⁴ The Mulago team looks for investment opportunities in promising products and services that address these high-priority problems. When it comes to health, the organization is particularly committed to improvements affecting the lives of mothers and children.

In seeking investments, Mulago looks for the best solutions to the biggest problems in the poorest countries. The team describes itself as “unabashedly obsessed with impact: measuring it, funding it, and scaling it up,” and considers its job “to find those [organizations] most able to create change and get them what they need to do it.”⁵



Photo courtesy of the Mulago Foundation

Microclinic International, which taps into the power of social networks to spread healthy behaviors, has chosen a nonprofit model to support its activities

venture capitalists, and even impact investors) in exchange for equity in the organization. These investors expect a more traditional return on their money in the form of an eventual “exit” through which they will recoup many multiples over the original investment amount.⁷

Because many mission-driven global health innovators are creating social businesses that will have a revenue stream, deciding between these options can be a difficult choice with no “right” answer. But in order to ensure the sustainability of the organization, innovators must think carefully about their organization's legal structure and capital strategy. This is critical in order to most efficiently identify and pitch to potential investors and will be a key question that credible investors will ask before they will commit funds to the effort, especially as the investments become significant. As Laura Hattendorf, the Portfolio Director for the Mulago Foundation, described, “There's a valley of death in this space. When somebody gets \$500,000 of funding, they think they're on their way. But there's this huge gap between \$500,000 and the \$3 million that they need a year or two from now. And that's when problems start to occur.”⁸ Accordingly, innovators must assess the pros and cons of their alternatives, make a decision, and position themselves to bridge this gap.

THE CHALLENGE: CHOOSING A LEGAL (AND CAPITAL) STRUCTURE

At some point, many global health innovators will grapple with a choice between establishing their organizations as nonprofit or for-profit entities. Importantly, one of the key implications of this decision is that it determines what sources of capital their organizations can tap into to fund their work. Nonprofits typically rely on donations from individuals, foundations, or corporations, often in the form of grants, which are generally given in anticipation of some “social return on capital.”⁶ In contrast, for-profit organizations commonly raise money from commercial investors (angels,

THE SOLUTION: USING THE ORGANIZATION'S MISSION, STAGE, AND SCALE AS A GUIDE

In her role at Mulago, Hattendorf interfaces with hundreds of mission-driven innovators and social entrepreneurs each year, many of whom are working in the global health sector. Through these interactions, she has gleaned valuable insights that can help innovators as they wrestle with this important issue.

For nonprofits, being dependent on donor subsidies can be frustrating and challenging. “Relative to private investment capital, the dollars available are tiny and the process to secure them is riddled with inefficiencies,” Hattendorf contended. In order to qualify for grant funding, the innovator’s work must align with the focus of the donor and align with their theory of change. Additionally, funding agendas among foundations, corporations, NGOs, and even governments can be fickle, changing with shifts in leadership, politics, and public perception. The uncertain nature of donor priorities compounds the funding risks faced by nonprofit entities. Another source of risk is the timing of grant cycles, which may or may not match the strategic needs of the nonprofit organization. Grants are also frequently linked to specific projects or activities, restricting the organization’s ability to decide how those funds can be used and preventing them from supporting general management needs. (Unlike most foundations, Mulago provides unrestricted funding with the view that the leaders of the organization know better than anyone else how those dollars are best used and leveraged.)

We find remarkably few for-profit ventures that both reach [the bottom-of-the-pyramid] target population and have the potential to become viable business enterprises.

Despite the known challenges of working with grant-making entities, if an organization’s mission is to positively affect users at the base of the socioeconomic pyramid, a for-profit model can make this difficult to

achieve. According to Hattendorf, “We find remarkably few for-profit ventures that both reach [this] target population and have the potential to become viable business enterprises. Cash flow projections are wildly unrealistic, management teams untested, and market failures unacknowledged. There’s 10 times the risk profile of a standard U.S. venture deal without the same potential upside.”⁹ Kevin Starr, Mulago’s director, elaborated on a few key points in a blog post on the subject.¹⁰

- “Few solutions that meet the fundamental needs of the poor will get you your money back,” he wrote. It’s rare for an organization seeking to address basic health needs to create a business with realistic profit potential serving customers in the target geography, primarily because these opportunities represent profound market and/or government failures that must be overcome. For the few that do, it will take years, if not decades, to reach profitability.
- “When overcoming market failure to reach the poor, it takes subsidy to do the R&D, launch the business, build the market, and sometimes even to deliver the product or service over time,” said Starr. “Delivering at a price point the poor can afford almost always translates into very small margins.”

- His next point is that revenue does not equal profit. “There seems to be this idea that if a revenue stream exists, it could be turbocharged to make a profit,” Starr wrote. “That’s simply not so.” His belief is that the best organizations currently in the field are already operating on an incredibly lean and efficient basis and there are limits to how much revenue can be squeezed out of low-income markets while still serving them well.
- Finally, Starr is concerned with the idea that the imperative to achieve a financial return can drive organizations off mission. “There really is only one bottom line,” he stated. “It’s either impact or profit—and the demands of investors can pull an organization away from the target population toward those able to pay more. We’ve seen it happen, and we’ve seen more than a few organizations start in more affluent markets with the intention to move down-market to the real target population when the numbers are right (they almost never do).”

In combination, these factors make it difficult for for-profit organizations to realize their goals in base of the pyramid markets and also for them to attract commercial investors who expect a financial return on their money. As a result, in its efforts to meet the basic needs of people in some of the world’s poorest countries, Mulago’s portfolio consists of 95 percent nonprofits.¹¹



Photo courtesy of the Mulago Foundation

Hattendorf in Zambia, where Mulago supports an organization called Comaco that improves food security and livelihoods for smallholder farmers

the right time.”¹² She offered Embrace, maker of a low-cost infant warmer as an example: “Embrace ... started as a nonprofit, only to emerge four years later as a for-profit company that will have an ongoing royalty relationship to the start-up nonprofit. In 2008, moving their first product through research and development and clinical trials was simply not a good fit for debt or equity funding. There were too many unknowns and a relatively inexperienced management team, both of which would have limited their ability to attract investors. But now that they have a viable product, along with a more mature management team, debt and equity are the right forms of capital to fuel manufac-

Cautioning would be for-profit organizations against additional pitfalls, Hattendorf noted that, “Entrepreneurs like to think that raising money from investors is somehow easier than raising money for a nonprofit. But meeting the expectations of debt and equity investors can be quite difficult. Most business startups don’t end up raising outside funding. And just compare how many businesses shut down—lots—to how many nonprofits shut down—not that many.”

Regarding its own investing philosophy, Mulago is open to supporting both for-profit and nonprofit entities. However, as Hattendorf summarized, “The right capital structure needs to be applied to the right organization at

turing, distribution, and future product development. Early-stage, exclusive grant capital allowed the company to get past research and development and make private financing a realistic option.¹³ ♦

NOTES

- 1 “Financing Global Health 2012: The End of the Golden Age?” Institute for Health Metrics and Evaluation, 2012, <http://www.healthmetricsandevaluation.org/publications/policy-report/financing-global-health-2012-end-golden-age> (May 21, 2012).
- 2 Ibid.
- 3 David McCoy, Sundeep Chand, and Devi Sridhar, “Global Health Funding: How Much, Where It Comes From, and Where It Goes,” *Health Policy and Planning*, April 20, 2009, <http://heapol.oxfordjournals.org/content/24/6/407.full> (May 21, 2013).
- 4 “Scalable Solutions Portfolio,” The Mulago Foundation, <http://www.mulagofoundation.org/who-we-fund> (May 21, 2013).
- 5 Home page, The Mulago Foundation, <http://www.mulagofoundation.org/> (May 21, 2013).
- 6 Jane Chen, “Should Your Business Be Nonprofit or For-Profit?” *Harvard Business Review Blog*, February 1, 2013, http://blogs.hbr.org/cs/2013/02/should_your_business_be_nonpro.html (May 23, 2013).
- 7 Ibid.
- 8 All quotations are from interviews conducted by the authors, unless otherwise cited.
- 9 Laura Hattendorf, “The Trouble with Impact Investing: P2” *Stanford Social Innovation Review Blog*, April 18, 2012, http://www.ssireview.org/blog/entry/the_trouble_with_impact_investing_part_2 (May 23, 2013).
- 10 Kevin Starr, “The Trouble with Impact Investing: P1,” *Stanford Social Innovation Review Blog*, January 24, 2012, http://www.ssireview.org/blog/entry/the_trouble_with_impact_investing_part_1 (May 23, 2013).
- 11 Ibid.
- 12 Hattendorf, “The Trouble with Impact Investing: P2” op. cit.
- 13 Ibid.