CASE STUDY

THE W.K. KELLOGG FOUNDATION MISSION DRIVEN INVESTMENTS (MDI)

April 2014

IMPACT INVESTING 2.0

ORGANIZATION HEADQUARTERS	Battle Creek, Michigan
YEAR FOUNDED / LAUNCHED	2007
LEADERSHIP	Joel Wittenberg, Vice President and Chief Investment Officer
DESCRIPTION OF PRIMARY ASSET CLASS	Direct and intermediated debt and equity investments. This case is focused on WKKF's direct MDIs
PRODUCT DETAILS	$500,000 - $5 million
FUND DETAILS	Size: $100 million in total MDI, including four direct investments
GEOGRAPHIC FOCUS	U.S. (75%, including all of the direct investments); Africa (25%)
SECTOR FOCUS	Education, health, food, community development
SUMMARY OF IMPACT AREAS	Core metrics aligned to WKKF programmatic priorities and focus areas: vulnerable families served, vulnerable kids supported, dollars directed to priority places, and dollars invested per vulnerable child reached.
FINANCIAL PERFORMANCE	Two realized exits out of six total direct investments, delivering IRRs of 46% & 65%.
SOCIAL PERFORMANCE	The MDI program's investments support WKKF's theory of change, which addresses social conditions such as improving the quality of, and equitable access to, food, education, and health for vulnerable families. 53,339 vulnerable kids were supported through direct investments, which accounts for 75% of the MDI total. WKKF also focuses on meeting diversity and place-based targets.

Ben Thornley and Brenna McCallick were the lead authors of this case. This case study is part of The Impact Investor, a research partnership between InSight at Pacific Community Ventures, CASE at Duke University and ImpactAssets from 2012-2014. The Impact Investor project team was co-led by Cathy Clark, Jed Emerson and Ben Thornley. More in-depth impact investing fund case studies, practitioner blogs, videos from expert convenings, as well as project reports, are available at: http://bit.ly/impinv and at the twitter hashtag #impinv2.

INTRODUCTION

In May 2007, the $8 billion W.K. Kellogg Foundation (WKKF), headquartered in Battle Creek, Michigan, launched a Mission Driven Investments (MDI) initiative that, with a commitment to investing directly in for-profit companies, stands as a successful and especially innovative example of a large institution aligning endowment preservation with programmatic objectives.

After celebrating the Foundation's 75-year anniversary in 2005, WKKF's 10 Trustees were eager to embrace fresh approaches to a unified objective of "whole child development." At the same time, the practice known as mission-related investment was gathering steam.[1]

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>
> – TOM REIS, FORMER DIRECTOR, MISSION DRIVEN INVESTMENTS, KELLOGG FOUNDATION

The Trustees authorized up to $100 million in the MDI program and made its first investments in June and September of 2008, first placing $18.3 million in an African private equity manager, Agri-Vie, and then making U.S. federally-insured deposits in Community Development Financial Institutions (CDFIs) or similar banks. The MDI Program made its first direct investment in January 2009, in Acelero, a company managing and providing technical assistance to Head Start programs, which are part of the largest U.S. government initiative supporting early education.

By August 2013, the MDI team had a total of $76 million committed to four direct investments (following two exits), one non-profit, and 17 funds and other intermediaries, with the goal of achieving mission alignment and returns of 4-6 percent in the U.S. and 8-10 percent in Africa, where 25 percent of MDI capital is invested.

This case focuses on the Kellogg Foundation's six direct MDIs from 2009 through mid-2013 both as a way to more readily compare WKKF to the other investors in our study, but, more importantly, because the direct investments were seen as central to WKKF's theory of change, as they are aligned with philanthropic notions of innovation, growth, and impact.

WKKF's performance during that period – six direct investments at August 2013 that had cleared rigorous screens for mission alignment, and two exits delivering internal rates of return (IRRs) of 46 percent and 64.64 percent – was driven by three key developments:

1. Buy-in from leadership and the development of a supportive governance structure;
2. The creation of a team combining internal, institutional credibility with external, specialist advice; and
3. A maturing, overarching strategy focused on later growth-stage investments that WKKF was ideally and uniquely positioned to make on the strength of its strategic alignment with enterprises.

[1] In January 2014, Sterling Speirn stepped down as president and CEO of the W.K. Kellogg Foundation after eight years as its leader. Speirn was succeeded by La June Montgomery Tabron, a 26-year veteran of the foundation and most recently its executive vice president and chief operating officer.

ORIGINS

Ten years ago, at the urging of pioneers like Luther Ragin, Jr., then Vice President of the F.B. Heron Foundation and now CEO of the Global Impact Investing Network, philanthropic foundations began to align their investing and philanthropic activities more intentionally, recognizing, in part, that investment could supplement traditional grant-making in solving problems on a global scale.[2]

The developments were timely for the Kellogg Foundation, one of the 10 largest philanthropic foundations in the U.S. The Foundation celebrated its 75-year anniversary in 2005 – a milestone that marked a turning point for the organization and sparked questions about its future and long-term goals. In January 2006, Sterling Speirn joined the foundation as CEO, bringing with him a fresh perspective. During his 15-year tenure at the Peninsula Community Foundation, he had launched the Center for Venture Philanthropy, an arm of the foundation that uses tools of venture capital to grow enterprising nonprofits and for-profit social businesses.

At that point, WKKF Trustees united themselves around a shared goal: holistic development for vulnerable children through initiatives that promote health, education, and family security, in congruence with the Foundation's pre-existing emphases on racial equity and civic engagement. These priorities informed the programming strategy that WKKF still follows as of March 2014, but also spurred conversations about how the Foundation could more effectively realize its goals. The question of how more of the Foundation's resources could be used to advance whole child development naturally followed.

Leading these considerations at the WKKF staff level were Tom Reis, the head of a new Design and Innovation unit, and Tony Berkley, who previously had been working on WKKF's Evaluation and Education & Learning teams.

Reis believed that mission-related investing (MRI) had the potential to be uniquely accountable and results-driven. He was excited by the prospect of unlocking more than the five percent of endowment assets that foundations are required to grant each year in the U.S. – a requirement that he argues was "supposed to be the floor, but had turned into the ceiling in most cases." Speirn embraced the idea, and instructed the Design and Innovation team to prepare a brief pitch on MRI for the Foundation's next Board meeting in December 2006.

Board members gave WKKF the green light to continue their research; in response, Reis hired John Goldstein, an external financial consultant with extensive experience in double-bottom line investing, to help develop the concept. In May 2007, a group of staff from both the Africa and U.S. program teams presented a formal proposal that recommended a "learning by doing" approach. Rather than spending additional time trying to design "surefire" ways to generate returns while meeting programmatic goals, the Foundation would try out various methods before arriving at an ideal strategy. The Design and Innovation team also made a strong case for the MRIs as a fundamental, strategic solution to challenges within philanthropy related to scale, organizational financial sustainability, and exit.

[2] Rockefeller Philanthropy Advisors, 2008. "Philanthropy's New Passing Gear: Mission-Related Investing." Accessed via http://rockpa.org/document.doc?id=16

Again the Trustees were supportive, but noted that the term "mission-related" seemed an inadequate descriptor; rather, this type of investing would be *driven* by mission, and its title ought to reflect that distinction. The Board approved the group once more to proceed, this time in collaboration with the Foundation's Investment and Finance units.

In an overview of the MDI program's creation, La June Montgomery Tabron, WKKF's former Executive Vice President of Operations and Treasurer and now President and CEO, describes her contributions to the development of the MDI program, saying, "My role in the design phase was to ask: Can we do this? How can it happen? Are we ready and do we have the capacity to make this happen? Our Board looked closely to see that the endorsement was there from the finance team, the investment team, as well as the program team."[3] (The MDI program overview is available online, an indication of the transparency with which WKKF has approached impact investing.)

"It made a good partnership for finance, investments and program to take mission-driven investing to the Board together and say, this is something that we want to do. Longer term, I will be an advisor, and my role as the advisor is making sure that we stay true to the purpose—to the Foundation's as well as our Board's requirement for accountability around recording and reporting financially on activities," Montgomery Tabron continues.

The final process of refining the MDI program focused on building staff capacity and developing a blueprint for operations. This included a three-tier management system to oversee governance of the portfolio, consisting of: a Portfolio Management Team (PMT) responsible for sourcing and overseeing investments; an Investment Committee responsible for final deal approval and monitoring; and high-level supervision by the Board Finance Committee.

The composition of the purpose-built investment committee was notable and provided credibility and independence to the effort. It included significant representation from the program side of the organization – including Speirn, who viewed himself as the program lead at WKKF; William Buster, a program officer and now director of Mississippi and New Orleans Programming; and Jim McHale, Vice President, Program Strategy. WKKF's Director of Investments, Reginald Sanders, represented the investment team, and there were two external participants– Elyse Cherry of Boston Community Capital and Dione Alexander of the Nonprofit Finance Fund's Detroit office. When Alexander left the committee, she was replaced by Cora Fernandez, the managing director for asset management at Sanlam, the second largest financial services company in South Africa.

The Board reconvened in August 2007 to consider and approve the PMT's plan of action, allocating $100 million of the endowment funds to the program. The MDI program would be implemented on two different platforms: one for investments in the U.S. (comprising 75 percent of assets) and another for investments in Africa (comprising 25 percent).

Appointed as the first director of the MDI program, Reis turned to Imprint Capital, the firm created by John Goldstein, to assist with implementation in late 2007. At the time, Imprint was working closely with Luther Ragin, who advised WKKF to invest initially in community development banks while mapping out a longer-term strategy. The MDI team followed this advice, and made its first investments in 2008.

[3] "Set: Mobilizing for Action," Mission Driven Investments: History and Approach. WKKF.org. Available at: http://www.wkkf.org/what-we-do/mission-driven-investments/history-and-approach

THE FUND

GOVERNANCE AND OBJECTIVES: PROVIDING PRIORITY AND FOCUS TO THE MDI PROGRAM

The $100 million MDI program exists within an endowment governance structure that, despite being created by the Kellogg Foundation in the 1930s, remains innovative to this day and has been replicated by other leading institutions, including the Gates Foundation. WKKF's endowment assets are managed in two pools. One, known as the trust, accounts for $8 billion of WKKF's total $8.3 billion in assets; the other, known as the foundation endowment, accounts for approximately $300 million. Grant monies are dispersed by the foundation endowment, which is governed by the Foundation's board of 10 Trustees. The foundation endowment receives transfers from the trust, which is governed by a separate group of directors, comprised of two Foundation Trustees, including the president and CEO, and two external members.

The MDI program was created within the foundation endowment through a one-time transfer from the trust, where it sits alongside a $100 million allocation for emerging fund intermediaries managed by women and racial minorities and invested primarily in public markets.

While the foundation endowment has the same financial objectives as the trust, to return a rate of inflation plus 5 percent, the arrangements have the practical effect of elevating the importance of the MDI portfolio. Rather than representing less than 1.5 percent of the endowment – and receiving a commensurate amount of attention – the MDI program accounts for one third of the assets of the foundation endowment over which the Foundation's board of Trustees has fiduciary responsibility. This gives Trustees ownership over the MDI program and provides a receptive venue at the Finance Committee for quarterly reporting.

Put another way, relatively unconventional investments in the foundation endowment that carry additional financial risks are being managed under a structure that allows for their potential *non-financial* benefits – their social impacts – to be better isolated and scrutinized, as one director in WKKF's mainline investment team explained it.

The MDI investment policy, approved by the board in December 2007, included the following elements:

- **MISSION IMPACT:** The goal is for investments to align with WKKF's mission to enable children, families and communities to strengthen and create conditions that propel vulnerable children to achieve success as individuals and as contributors to the larger community and society. There are particular interests in the issues of education and community wealth creation as approaches to achieving this goal and an additional priority in supporting these goals in priority areas for the foundation including Michigan, Mississippi, New Mexico, and New Orleans.
- **FINANCIAL RETURN:** The MDI program seeks to preserve principal and achieve a total return of four to six percent net of all costs and fees.
- **MISSION IMPACT:** WKKF seeks to gain experience in using a wide spectrum of tools. As a result, the portfolio will include investments across different asset classes, investment styles, asset managers, geographical regions, and sectors/industries. WKKF seeks internal learning through documentation of the process and involvement of the Investment Committee.[4]

[4] W.K.Kellogg Foundation MDI Investment Policy Statement, United States, December 10 2007

INTERNAL STRUCTURE: CLARIFYING FINANCIAL NON-NEGOTIABLES

The investment section of this case describes the evolution of WKKF's MDI portfolio from opportunistic origins in 2008 to a more commercial orientation for deal sourcing in 2013. WKKF's internal management of the program reflects a similar pattern of development.

In 2008, Reis was appointed as the first director of the MDI program, bringing 19 years of experience at the Kellogg Foundation, including eight as a program director. Berkley, who was also a member of the Design and Innovation unit at the time, became the MDI team's full-time program and portfolio officer, responsible for sourcing, reviewing, and structuring fund and direct deals.

The year 2011 was one of significant transition. In July, Reis retired from the Kellogg Foundation and was replaced as MDI program director by Berkley.[5] And John Duong was hired soon thereafter as a full-time program and portfolio officer, bringing experience as an investment banker with J.P. Morgan and a variety of financial and strategic advisory roles at Merrill Lynch, Citigroup, and Barclays Capital.

In early 2012, the MDI program became part of the investment division at the foundation, under the leadership of Joel Wittenberg, WKKF's Vice President and Chief Investment Officer. Reflecting on the transition, Wittenberg emphasizes the way in which the MDI program has become embedded within a more "multilingual" WKKF, and the opportunity this presented for building in investment disciplines:

"As MDI started up, the structure allowed the team to speak the language of the programming areas and to make the connection to investment opportunities in the same language that the program officers speak. Now it's evolved for the program side as well. Because they get it, the connection is made more easily and allows us to have a little bit more emphasis on the investment side than we've had in the past, while not downplaying the mission."

EXTERNAL SUPPORT: THE ROLE OF IMPRINT CAPITAL

Internal developments at the Kellogg Foundation have been essential in providing structure and direction to the MDI program. An equally important factor, particularly in the portfolio's deployment, has been external: WKKF's deep and enduring partnership with Imprint Capital, a registered investment advisor that consults on impact investing to foundations, families and financial institutions, based in San Francisco.

Imprint Capital, which was launched by John Goldstein and Taylor Jordan, then director of investments at the Rudolph Steiner Foundation (now RSF Social Finance), helped design the MDI program, thinking through parameters, objectives, constraints, and investment policy. According to Berkley, Imprint's key contributions have included financial acumen, broad insights on impact investing, sector-specific knowledge, and "time and open calendars" in order to provide the Foundation with considerable flexibility.

The relationship with Imprint is deeply collaborative. WKKF helped start Imprint by becoming its first client, and Imprint helped design and launch the WKKF MDI program and remains the core advisor. Imprint joins WKKF's weekly deal flow meetings and, for all intents and purposes,

[5] In November 2013, Tony Berkley transitioned from director of Mission Driven Investments to Planning, Evaluation and Research Officer at the Kellogg Foundation

is a fully-fledged member of the PMT. Thanks in part to WKKF's catalytic support, Imprint has gone on to work with nine of the 25 largest U.S. foundations and has more than $350 million in assets under advisement. Just as significantly, the core sector capabilities developed with the support of WKKF – food, health and well-being; education and learning; and family economic security – remain central to Imprint's work.

The emphasis on direct investments in the MDI program has been a particularly challenging, but rewarding, experience for both organizations. Like most investment consultants, Imprint typically focuses on funds and intermediaries, "but as you get tighter to mission, directs are the right way to play it," explains Jordan. "We had no resistance to that approach once we worked through the fact that there weren't funds or intermediaries to partner with," he continues.

DIRECT INVESTING: AT THE HEART OF IMPACT

Direct investments in companies, the focus of this case, represent one component of the foundation's total MDI portfolio, accounting for $14.9 million of total invested capital, or, as of August 2013, about 28 percent of the total committed in the U.S. The six companies receiving investment, of which two have been exited, include:

- **ACELERO:** A company that provides pre-K and childcare services to low-income children and caregivers who are eligible for federal government Head Start funding and state-funded childcare.
- **HAPPY FAMILY :** *(exited)* A "mother-owned, mother-run" organic food manufacturer targeting infants, toddlers and young children.
- **REVOLUTION FOODS:** A company that provides nutritious and affordable meals to vulnerable children with the help of the federally financed National School Lunch program.
- **SEECHANGE HEALTH :** An innovative health insurance company that financially incentivizes plan participants to engage in healthy behaviors.
- **SOUTHERN BANCORP:** The largest rural development bank in the U.S. with a focus in the Mississippi delta region.
- **WIRELESS GENERATION :** *(exited)* An education technology company that provides tools to analyze student data and provide curriculum customized to individual learning needs.

The remainder of the U.S. funds was invested in community bank deposits (15 percent); private equity funds (27 percent); and fixed income (30 percent). The portfolio details are shown in Figure 1.

FIGURE 1: MDI PORTFOLIO

MDI PORTFOLIO AT AUGUST 31, 2012		
TOTAL		$52,459,293
PRIVATE EQUITY – DIRECT		
	Date of Investment	Committed Capital
Acelero	January 2009	$500,000
Southern Bancorp	October 2009	$5,000,000
Revolution Foods	July 2010	$6,000,000
Happy Family	July 2011	$374,800
See Change	June 2013	$3,000,000
TOTAL		**$14,874,800**
PRIVATE EQUITY – FUND		
	Date of Investment	Committed Capital
Legacy Venture V	January 2009	$2,500,000
Legacy Venture VI	March 2011	$2,500,000
Core Opportunity Fund	May 2010	$1,000,000
Northwest Louisiana	April 2009	$2,000,000
Renaissance Ventures Fund I	September 2010	$1,000,000
Renaissance Ventures Fund II	March 2012	$3,000,000
Canyon Agassi Charter	November 2011	$2,000,000
TOTAL		**$14,000,000**
CASH		
	Date of Investment	Committed Capital
Hope Community CU	September 2008	$250,000
NCB	June 2009	$3,000,000
ProAmerica Bank	August 2009	$2,000,000
Latino Community CU	September 2008	$250,030
Self Help CU	September 2008	$250,025
Federation	August 2009	$300,000
Liberty Detroit	February 2011	$1,750,000
TOTAL		**$7,800,055**
FIXED INCOME		
	Date of Investment	Committed Capital
Habitat for Humanity International	April 2009	$249,305
Community Capital	August 2009	$7,757,475
Community Capital Food	August 2009	$4,777,658
NCB Capital Impact	March 2011	$3,000,000
TOTAL		**$15,784,438**

The percentage of total U.S. MDI program assets in direct investments has increased slowly over time, with some fluctuation, from 11 percent in 2009, to 30 percent in 2010, and 28 percent in 2013. This is consistent with the foundation's initial convictions, but also a response to evidence that direct investments are particularly impactful.

To this end, the Kellogg Foundation's preferred method for calculating social impact has had some influence. The Foundation examines how a company's product, delivery model, and customer/constituent approaches may have direct impact and/or influence on factors that matter most to vulnerable kids and their families (i.e., making the company's product affordable and accessible to these target beneficiaries). The Foundation also takes credit for the pro rata share of total company outputs and outcomes that its investment represents as a proportion of a company's enterprise value (e.g. the number of healthy lunches served daily to vulnerable children). Under this method, described in more detail in the next section, the MDI team estimates that its direct investments account for the majority of its core social impact indicator: number of vulnerable kids supported.

A second powerful influence is WKKF's focus on a 360-degree "learning return." WKKF believes companies are at the forefront of innovation in the impact verticals and industries that the Foundation focuses on. Because direct investments provide access to a company's board room, primarily as an observer, the Foundation gains tremendous insight into expertise and strategic thinking that may help WKKF develop innovative ways of creating social impact, including through its programs and grants. Similarly, insights from grantmaking have heavily influenced WKKF's investments, creating an enterprise-wide virtuous cycle. In short, an emphasis on learning has driven collaboration between grantees, grantmakers, investees and investors.

Writing recently in the Stanford Social Innovation Review, former President and CEO Speirn provides a number of concrete examples[6]:

"With decades of work and experience in food systems, and with long-term field-building efforts in farm-to-school, community food, and school food transformations, the foundation saw an opportunity to invest in a young company, Revolution Foods, that was dedicated to selling healthy, affordable, delicious food for schoolchildren. It has brought us wholly new perspectives on issues of public policy, school and community food systems, and family and child behaviors that we can use to inform our grantmaking and institutional efforts on the very same issues. Investing in a bank, Southern Bancorp, that does business in the Mississippi Delta region, one of the foundation's priority places, creates a partnership and provides a unique perspective on the challenges of economic and workforce development with which our program staff continually grapple. With our investment in Wireless Generation, our intense learning return on how to bring technology and big data to real-time assessments, coupled with customized instruction for K-3 early grade literacy, was matched by our 26 percent return with an early buyout. And today, as more funders seek to promote and invest in prevention and wellness as opposed to disease treatment, our investment in SeeChange Health tells the same story in the health arena."

Contrary to expectations that direct investing might limit deal flow, Reis argues that WKKF unearthed a tremendous, untapped source of investments in highly credible entrepreneurs. "There's all this entrepreneurial talent out there that traditional investors are overlooking… I continue to believe that we barely scratched the surface. If you are really into both financial and impact returns, then you need to find these people and fund them."

[6] http://www.ssireview.org/up_for_debate/impact_investing/sterling_speirn

FIGURE 2. MDI SOCIAL PERFORMANCE SAMPLE

Investment	Acelero	Southern Bancorp	Revolution Foods
Key Indicator	Kids Served	Low income People Banked	Easy, equitable access to healthy food via daily meals served
Investee (Total)	3,886	64,000	64,000
WKKF (Share)	92	7,234	6,764
Second Indicator	Jobs	Loans to low income areas	Jobs for parents of the kids who are served
Investee (Total)	970	$233,250,000	940
WKKF (Share)	23	$26,364.977	45

TRACKING MISSION ALIGNMENT: FOCUSING NARROWLY ON WHAT MATTERS MOST

The highest priority for the MDI program is finding investee organizations that produce an outcome that advances WKKF's mission. In keeping with this objective, the Foundation makes an effort to identify just one or two metrics that speak directly to its rationale for investing in the first place. It then takes credit for a portion of a company's social outcomes, equal to the percentage of a company's enterprise value that its equity and debt represents.

By way of example, Figure 2 below is a sample of data reported internally by the MDI team in December 2012 to track social performance.

At the aggregate level, WKKF utilizes a standardized set of metrics across all investments to track performance against particularly critical priorities. These include:

- Vulnerable kids supported;
- Vulnerable families served;
- Dollars invested per vulnerable child reached;
- Target geography served; and
- Vulnerability conditions addressed (directly and/or indirectly)

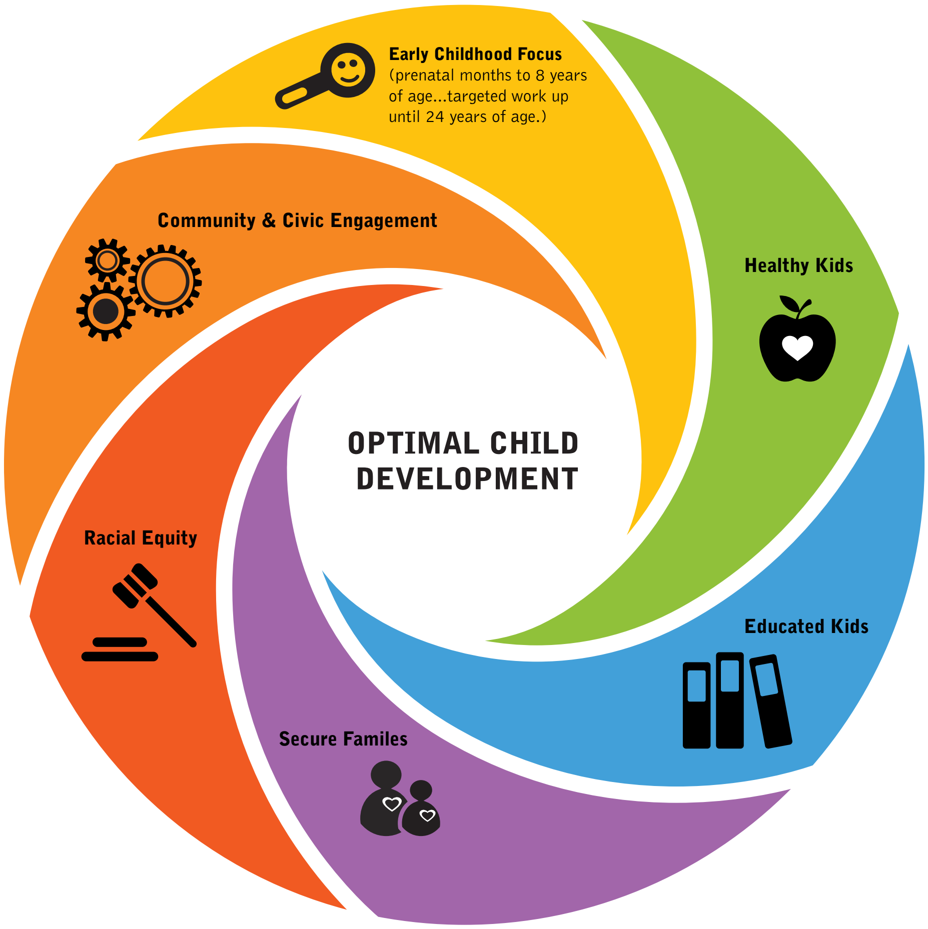
Finally, the MDI team also evaluates the portfolio against two overarching screens for geography and diversity. WKKF has a target of investing more than 50 percent of its MDI program dollars in the states of Michigan, New Mexico, and Mississippi, and in the city of New Orleans. These areas are identified as priority places for the Foundation due to entrenched issues of poverty that were prioritized decades ago; long-standing relationships and initiatives remain. A concerted effort to invest in companies and intermediaries led by racial minorities and women is also ongoing, but not benchmarked in the same manner.

INVESTMENTS

OVERVIEW: MISSION ALIGNMENT THROUGH GROWTH CAPITAL

The Kellogg Foundation's direct investing is anchored firmly in its singular goal of supporting "whole child development" of vulnerable children and its key program areas and mission priorities: education and learning; food, health and well-being; family economic security; community and civic engagement; and racial equity, as illustrated in Figure 3 below:

FIGURE 3. WKKF STRATEGIC FRAMEWORK



Through a focus on entities with the strongest potential to meet key mission and financial criteria, WKKF's early research determined that the Foundation would better achieve its objectives through "growth capital" investments in enterprises that were beyond the start-up stage.[7]

To be sure, while the Foundation has considered early-stage deals as part of its market scans, there is a widely held view that the overall upside actually is more attractive in growth-stage investments. This is due to the relationships and knowledge that are embedded in a company and which can be leveraged organization-wide, and the company's ability to "influence policy as a more established market player," explains Imprint's Jordan.

[7] Reference WKKF's own overview of the MDI program.

There are internal guidelines that the MDI team adheres to concerning both mission and investability when considering an investment:

Mission

- Fits with program priorities of a WKKF grant-making team.
- Reaches vulnerable children, where vulnerability is defined as "poverty +." The proxy for poverty is living below twice the Federal poverty rate (approximately $46,000 for a family of four in 2012). The "+" refers to other vulnerabilities such as race or a single-parent-headed household.
- Evidence of efficacy. This is often demonstrated by one or more of the following: a third-party study, research literature, compliance with high standards, or a survey of beneficiaries.

Investability

- Market traction as indicated by a minimum of $5 million in annual recurring revenue and a stable customer base
- Experienced management team with a track record of successful scaling
- Institutional co-investors

WKKF has made investments between $500,000 and $6 million directly, in more established businesses with $20 million-$99 million in revenue, using a mix of debt and equity. This has provided the Foundation with an ownership stake ranging from 1.3 – 2.6 percent and usually an observer board position. The Foundation generally likes to be part of an investing group, with an institutional lead investor.

IMPLEMENTATION: FROM OPPORTUNITY TO INTENTIONALITY

Phase One: Start-up

The MDI team's first two investments, in Acelero and Southern Bancorp, were sourced from the Foundation's grantee networks. Acelero also had a connection with an MDI investment committee member. More generally, as the only for-profit operator of Head Start programs in the country, and with prominent investors like Chris Gabrieli, the former Bessemer Ventures general partner and education reformer, Acelero was a known entity. The mission fit was unmistakable and a good place for the MDI program to get started with direct investing, using a preferred share with a redeemable eight percent coupon to help manage liquidity risk.

Southern Bancorp was more formative still. The bank had been a long-term WKKF grantee and, despite market turmoil driven by the default of Shorebank, the largest and oldest community development bank in the U.S., the MDI program team was convinced it could make a good investee. When WKKF invested in Southern Bancorp in October 2009, the deal included $1 million in common equity and $4 million in preferred equity with an option to buy $2.5 million more.

While Southern and Acelero shared a clear mission fit with WKKF as former grantees, both were understood to be operating in challenging markets with fewer potential liquidity events compared to traditional private equity investees.

Phase Two: A Commercial Approach Emerges

While tapping the Kellogg Foundation's established relationships had been (and remains) an essential source of deal flow, one of the most important learnings in the early years for WKKF was that you could not just opportunistically source deals through foundation networks. The MDI team discovered that it needed to proactively find appropriate investments, a strategy that required a more assertive and systematic market analysis.

Based on the research typically done by private equity firms, Imprint initiated a process of undertaking detailed market scans for prospective MDI opportunities.

The first scan was of the education sector in 2008. It included a review of more than 580 education and learning enterprises, 100 potential investment partners and intermediary lenders, and seven broad venture subsectors of interest. Three target segments at the intersection of investability and programmatic impact emerged from the scan. From there, the team focused on finding the best amongst 31 short-listed enterprises. This process provided the backdrop against which Wireless Generation was identified as the best player in a priority segment, and the impetus to reach out to the company, engage in due diligence, and structure and consummate a transaction that would, in relatively short order, become the program's first successful exit.

This scanning process has since become central to the MDI program (and Imprint's broader work). One of the latest scans, in September 2012, was again in the education and learning sector and provided by Imprint to WKKF in September 2012. It illustrates the growing sophistication of the approach. The scan highlights key market trends and conditions – growth in total venture capital investments into education technology from $88 million in 2008 to $334 million in 2012 – and describes more than 30, dedicated high-impact sub-sectors within three core themes – digital media and learning, data-driven education, and new school models. From more than 1,200 funds, intermediaries, and companies screened by Imprint, WKKF's pipeline includes nine investments, of which eight were direct and one was a fund.

WKKF's MDI direct investment portfolio has always targeted a market rate of return. However the change in approach over time – illustrated by Imprint's market scans – represented a more intentional effort to identify a clear pathway to exit. Says Imprint's Goldstein: "We started to be more proactive in finding companies that are attracting top-tier investment capital, with more sophisticated investors at the table."

THE STRATEGIC INVESTOR: A COMPETITIVE ADVANTAGE

WKKF's process of investment is the same as that of most traditional private equity funds. Each deal is thoroughly vetted, by MDI and Imprint staff, carefully structured through a process of negotiation, and ultimately presented to the investment committee for final approval.

Where WKKF diverges, however, is in its role as a strategic investor. The Foundation is not hamstrung by the need for quick exits, even while it seeks a clear line of sight on how to receive its capital back. For investees, there are benefits to be gained by working with a large, well connected, and mission aligned foundation.

As a result, WKKF has secured excellent terms, as in the case of Happy Family (see breakout), Wireless Generation (which declined many offers of commercial private equity, but recognized value in having WKKF as an investor), and Revolution Foods. It also negotiated observer board seats, something unique for a relatively small investor.

Two deals are illustrative of WKKF's privileged position in some of its investments. WKKF invested in Happy Family in July 2012, but on terms from a financing round started in November 2011, thereby benefiting from an additional six months of visibility while revenues were surging. And in SeeChange Health, WKKF built a partnership with the lead investor, Psilos, and was able to enter the deal again on the same terms of a completed round.

WKKF describes its MDIs as a vehicle for offering more flexible (but not softer) terms to companies that would ordinarily attract commercial capital, but for the lack of knowledge or enthusiasm among traditional investors in sectors like food, healthcare and education. "We have been willing to be on a path that's not paved," Berkley says.

Berkley's comments hint at a resource intensive process of due diligence and deal making. However the costs have been tightly managed. The operating budget for WKKF's MDI portfolio totals around $900,000 annually. Spread out over the $100 million allocation, that is a more modest percentage than most private equity funds. However it remains significantly higher than the operating costs of managing the other assets in the foundation's endowment, where managers are paid a management fee to perform many of the tasks the MDI team performs internally and through Imprint on its portfolio.

RESULTS

With a diversified investment strategy and long-term perspective on the MDI program, WKKF emphasizes the financial performance of the program in its totality. The program's returns have been reflective of the ups and downs of a newer portfolio, combined with "J curve" headwinds, according to WKKF, although it remains too early to make definitive conclusions.

Direct investments are a small sub-set within the overall MDI program and, with just six investments in total (including two exits), it would not be appropriate to present these deals as a "portfolio" to be benchmarked directly against the other funds in our study, most of which are soliciting external capital.

Instead we examine the financial performance of WKKF's direct investments by focusing on realized returns. As of August 2013, these consisted of two exits through trade sales, of Wireless Generation, which was acquired by News Corp, and Happy Family, which was acquired by Danone.

Wireless Generation, which entered the portfolio in May 2010 and exited in December 2010, returned a multiple of 1.26, representing an IRR of 46 percent. Happy Family, which entered the portfolio in July 2012 and exited in June 2013, returned a multiple of 1.63 and IRR of 64.64 percent.

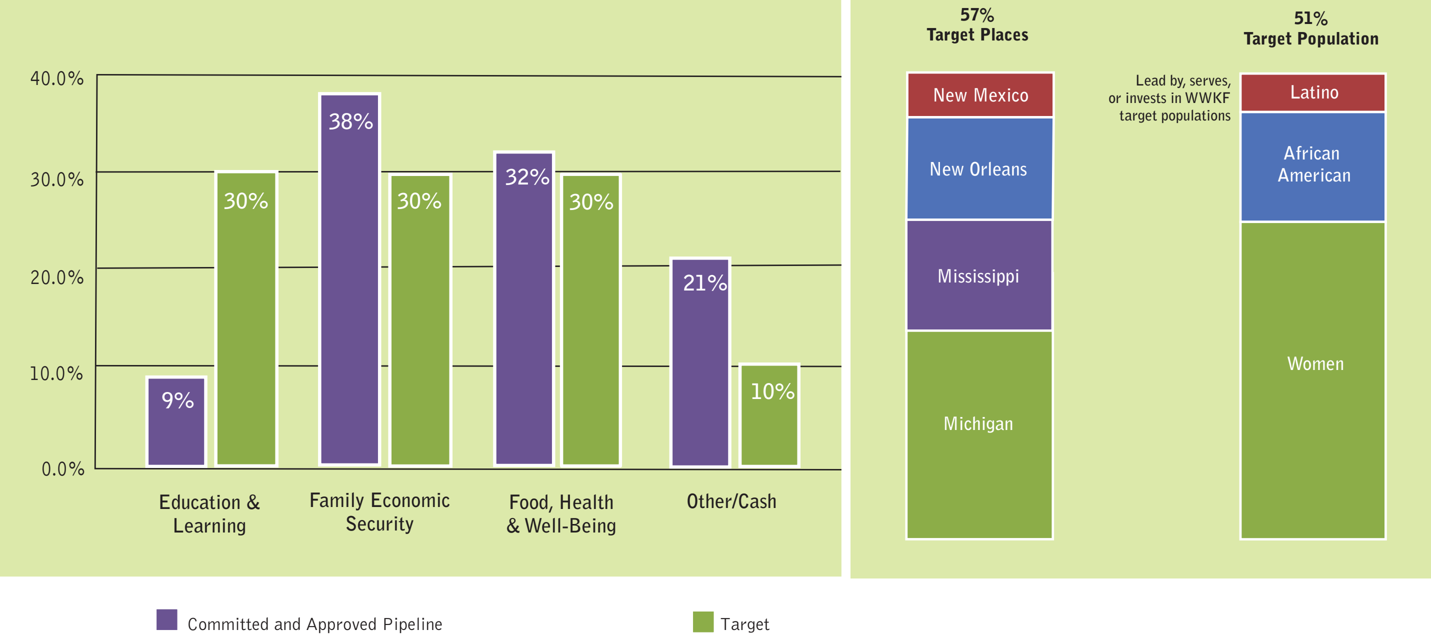
SOCIAL PERFORMANCE: DELIVERING ON INSTITUTIONAL PRIORITIES

As discussed earlier, WKKF's tracking of social performance directly reflects its institutional priorities: a number of indicators tailored to each enterprise and an aggregated assessment of performance across all MDI investments focused on a few key metrics, including vulnerable kids supported.

In December 2012, the latest period for which social impact data is available, WKKF's MDI program supported around 71,000 vulnerable kids, of which about 75 percent were attributed to the direct investments (totaling 53,339 kids). All four investees at the time made key contributions: Acelero, Southern Bancorp, Revolution Foods, and Happy Family.

At the total MDI portfolio level, WKKF has achieved a balanced allocation to the places, mission areas and target populations it prioritizes, including women and ethnic minorities, as the 2012 data below from a presentation to the MDI investment committee indicates. Specifically, WKKF has so far achieved its goal of investing over 50 percent of MDI assets in the states of Michigan, New Mexico, and Mississippi, and in the city of New Orleans.

FIGURE 4. COMMITTED INVESTMENTS



The achievement of balance is particularly noteworthy given a shift away from Certificate of Deposit Account Registry Service (CDARS) deposits in community banks over time, which provided a useful instrument for achieving place-based and diversity impacts. According to WKKF, it has been more difficult to find investment intermediaries with racially diverse managers.

INVESTMENT PROFILE: HAPPY FAMILY

Happy Family, a New York-based, "mother-owned, mother-run" organic food manufacturer targeting young children, first came to WKKF's attention in 2010 through an introduction from RSF Social Finance, which had provided working capital and a mezzanine line of credit to the company prior to WKKF's involvement.

For WKKF, there were two particularly interesting elements about the potential deal. First, Happy Family had secured approval in California for its products to be purchased under the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC), which provides federal government grants for low-income mothers and children. Second, Happy Family's Founder and CEO Shazi Visram and COO and Founding Partner Jessica Rolph, were big proponents of breast feeding, a WKKF programmatic priority.

The centrality of Happy Family's mission to broaden the customer base for organics and transform the larger baby food industry was underscored by the company's decision to become a B Corporation in 2011. It had also prompted Visram to steer clear of commercial capital since she founded the company in 2003.

WKKF, on the other hand, was welcomed to the table by Happy Family because of its alignment with the company's mission. "It has always been of paramount importance to do what is right for the children of our country. Working with Kellogg Foundation was a perfect match as the relationship allowed us to also have financing solely earmarked to support that very same goal," says Visram.

WKKF first looked at Happy Family in 2011, but could not find agreement on how to price the transaction. However, time worked in WKKF's favor. When a deal was finally consummated in July 2012, price was no longer a factor, as it was clear Happy Family's growth trajectory would continue. WKKF invested on terms from a financing round started in November 2011, at a $109 million valuation based on prior year sales of $30.3 million, thereby benefiting from an additional six months of visibility while revenues for Happy Family were surging and expected to reach $60 million annually.

Visram was happy to bring WKKF in for the additional working capital and to provide partial exits to existing shareholders. She says, "I never wanted to have a stakeholder who didn't support the original and still very pure mission. I'm happy it was able to work out for us to have the additional working capital at a time we needed it to grow, and that WKKF was able to participate at very favorable terms. I love it when socially responsible investors make great returns because that means more and more social investments will follow."

WKKF's $4.6 million investment included a $3 million loan made alongside RSF Social Finance, and $1.6 million in common equity, which secured WKKF an observer board position and ownership stake. In April 2013, at the request of Happy Family, WKKF increased its debt facility from $3 million to $3.75 million, with RSF providing the same adjustment. And in May, 2013, Happy Family was acquired by French company Group Danone.

Joel Wittenberg, Kellogg Foundation's Vice President and Chief Investment Officer, comments: "Danone has a good reputation as a socially responsible acquirer and nothing builds credibility like a profitable exit."

CONCLUSION

The Kellogg Foundation's internal reflections on the establishment and early years of the MDI program, available online as a model of transparency, provide an invaluable perspective and important complement to our own findings. They include:

- **ORGANIZATIONAL READINESS IS A MUST.** The MDI program originated out of a process of internal deliberation focused on the need to define a clear framework of program priorities centered on vulnerable children.

- **CHAMPIONS ARE CRITICAL.** Sterling Speirn, Tom Reis, La June Montgomery Tabron, and other WKKF leaders and board members present at the MDI program's creation played crucial roles, together with the MDI Investment Committee.

- **A PRAGMATIC FOCUS ON NAVIGATING POLITICS AND PROCESS HELPS.** This emphasizes the balance for staff, in setting the program, between leveraging internal credibility and relationships, and thinking strategically, rather than about the minutiae of issues and investments.
- **UNDERSTANDING THE ENVIRONMENT MAKES A DIFFERENCE.** The Foundation was systematic in doing its homework, scanning past efforts and the potential deal flow.
- **INTERNAL AND EXTERNAL DIVISIONS OF LABOR ARE BENEFICIAL.** The successful integration of internal and external team members (i.e. Imprint) made a big difference.
- **FOCUSING ON THE "WHAT" AND "HOW," NOT THE "WHY," IS CRITICAL.** Taking the "why" off the table – the existential rationales and goals of mission investing – meant WKKF could focus on the set of issues that were mission consistent and investable for the foundation, and learn by doing when it came to execution.
- **PROGRAM INTEGRATION IS DESIRABLE, BUT IT DOESN'T JUST HAPPEN.** It takes time to determine and demonstrate that mission-driven investing can be a complement to, and extend, programmatic thinking.
- **THE RIGHT TALENT AND TEAM ARE ESSENTIAL.** WKKF benefited from the involvement of deeply experienced staff with institutional knowledge and strong ties to key program and finance areas.

Focusing specifically on WKKF's portfolio of direct investments, these and other experiences point to three essential elements that have driven the foundation's strategy and success in the MDI program.

First, buy-in from leadership (at the CEO and board level) and a governance structure that ensured the MDI team had significant discretion and sufficient operational resources provided sustainability and strategic clarity to the effort.

Second, the relentless efforts of an experienced team of professionals internally, combined with the long-standing and deeply embedded relationship with Imprint Capital. In particular, the method of scanning target sectors for investment opportunities, driven by Imprint, has emerged as central to WKKF's approach.

And finally, WKKF's "growth capital" strategy, which neatly aligns impact and learning objectives. While direct investments are inherently concentrated and carry significant risks, WKKF has been able to negotiate and structure deals on attractive terms, even when compared to its co-investors, made possible by the unique access to opportunities that the foundation's brand and resources provide.

POSTSCRIPT:

THE NEXT STEPS IN INSTITUTIONALIZING THE MDI PROGRAM

As of March 2014, the MDI program has been part of the larger WKKF investment department for almost two years, during which time the benefits of this more institutional approach and the future of the program have come into sharper focus.

According to Wittenberg, a style and pattern for investing have emerged, as has a better understanding of the roadblocks and opportunities that exist. WKKF remains strongly committed to the MDI program, which continues to create a real buzz in the Foundation, and believes that the market inefficiencies that the MDI program has surfaced continue to present an exciting pipeline of deals. "We're very busy," affirms Wittenberg. The focus now is ensuring that the best practices associated with investing WKKF's entire $8 billion endowment flow through to the MDI program. "Tom started it with a great vision. Tony took it from Tom's beginning, and developed it even further, filling out the portfolio now to a full commitment of $76 million. And now we've got the portfolio in maintenance and are getting into a bit more of the operations of the MDI program rather than the start-up," says Wittenberg.

The size of the MDI program is not expected to change in the near term – although this decision will ultimately be determined from the bottom up. "We are going to see some cash flow coming back, which will give us some reinvestment opportunities," says Wittenberg. "If these are so significant, we will absolutely go back to our board to seek a larger allocation." And the make-up of the portfolio across strategies, including the direct investments, is not expected to change moving forward either. While grant making remains the primary activity of the foundation, WKKF believes it can have greater impact if it can pick from, and combine, a variety of approaches including mission driven investing, program related investments (PRIs) and grant making.

The MDI program still requires a significantly larger allocation of time from the investment team than the other $8 billion they deploy for WKKF. Like all start-ups, initial costs will always be higher. Reflecting on his personal experience leading the effort, however, Wittenberg says the team is passionate about contributing to the foundation's mission in this way. "Mission investing is an important part of the fabric of this foundation, so it's an important part of my job. My group is in the building. We are part of the staff meetings. We know the mission as well as the people who are driving that mission on the program side. This makes it important for us to invest money well, but when we can do mission investing to add to that, it's a really big deal."