



Additionality in theory and practice

Background

Prime Coalition is a nonprofit that partners with philanthropists to catalyze, deepen, or accelerate solutions that we believe will massively reduce greenhouse gas emissions and that might struggle to progress toward meaningful climate impact without us.

This report is dedicated to describing how Prime has approached the concept of “additionality” since our founding in 2014. Honoring the uniqueness of philanthropic capital and putting it toward its highest and best use is central to our doing and being. At Prime, additionality serves as one of five core organizational values, a gating question about the macroeconomic moment on the path to launching any new catalytic investment program, and a contemporaneous gating criterion we use to make each catalytic investment once a program has launched. Our view around additionality is rooted in the program-related investment language from the US Tax Code, and we view our practice as both an ongoing process of internal iteration as well as a contemporaneous monitoring of external factors.

In this report, we discuss additionality in theory, additionality in practice at Prime, and our lessons learned to date. Our hope is that others might benefit from lessons that have been hard won on the ground at Prime so that you can leapfrog in your own work.

Additionality in Theory

The concept of additionality at Prime is rooted in our founder’s discovery of the program-related investment language in the US Tax Code during her graduate research in 2011. Since 1969, program-related investments have allowed the infusion of private foundation capital into for-profit entities but count toward minimum grant distribution requirements. Defined in Section 4944(c) of the Internal Revenue Code enacted 50 years ago, “through program-related investments, a private foundation can invest money – equity, loan, loan guarantee, etc. – in ventures that aim to achieve the foundation’s charitable purposes but do not otherwise meet the criteria to be a permissible business investment.

To qualify as a program-related investment, an endeavor must meet three requirements:

- (1) the primary purpose of the investment is to accomplish one or more of the charitable, religious, scientific, literary, educational and other exempt purposes described in section 170(c)(2)(B)¹ of the Internal Revenue Code;
- (2) No significant purpose of the investment is the production of income or the appreciation of property;
- (3) No purpose of the investment is to lobby, support, or oppose candidates for public office or to accomplish any of the other political purposes forbidden to private foundations by section 170(c)(2)(D)² of the Internal Revenue Code.³

The first prong – primary exempt purpose – requires a two-part test: 1) investment must **significantly further** the accomplishment of the foundation's exempt activities and 2) it would not have been made **but for** the relationship between the investment and the accomplishment of exempt purposes.⁴ "But for" in the tax language here is synonymous with additionality as Prime imagines it today.

While the notion of additionality at Prime is inspired by the program-related investment language written for private foundations in 1969, in practice today we try to take the concept much further than we need to as a public charity across three motivating thresholds:

1. *Conviction threshold*: Prime's board, staff and close advisors must feel proud of the work that we're doing and convince ourselves that Prime is living its value of additionality in both the what and the how of our work. We view our own conviction as the highest bar among all our motivating factors, as well as the threshold most important to forging and stewarding trusting relationships with our philanthropic partners.
2. *Public image threshold*: Prime strives to achieve the highest and best use of every philanthropic dollar we raise and deploy toward our mission of mitigating climate change. We're highly sensitive to reputational risk in many directions. It is critical that Prime leads by doing and sets a strong precedent for the field of catalytic capital. To do so, Prime must publicly demonstrate that we prioritize mission over profit and be known as a champion for the public good through our stewardship of charitable and mission-driven capital. Prime's reputation as a public charity underpins our relationships with philanthropic partners and strengthens the field of catalytic investing broadly.

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² "For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of a corporation, trust, or community chest, fund, or foundation which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

³ IRC Section 53.4944(a)(1)(i-iii)

⁴ IRC Section 53.4944-3(a)(2)(i)

3. *Section 501(c)(3) tax-status compliance threshold:* As a public charity, Prime must advance our nonprofit mission. While public charities have a less stringent “but for” threshold on making investments to advance their nonprofit mission, Prime chooses to hold ourselves to the highest standard of the “but for” test both in order to achieve alignment with our philanthropic partners and to go above and beyond the compliance threshold required of Prime itself.

Additionality in Practice at Prime

1. Additionality as a core organizational value

During Prime’s first ten years, we spoke about additionality in the context of Prime’s catalytic investment practice alone. As we grew our team and programs, we came to realize that the value of additionality has always extended beyond an investment criterion to be one of our core organizational values.

We call in the spirit of additionality when we contemplate new projects. Not only does this help us focus our limited time, but it forces us to take the extra step to think how our work fits into the broader landscape. This is an important consideration for a highly altruistic and enthusiastic team, typical of so many nonprofits! Here are a few of the ways the value of additionality at our organization shows up:

1. What projects we say yes to as an organization and as individual employees. We seek spaces and gaps where Prime can add unique value, whether it be via catalytic capital or beyond.
2. How we understand our role. We aren’t everything to everyone and don’t need to be. There are many talented organizations doing their jobs well that we can partner with or be complementary to. We ask ourselves who we’re crowding out, and who we’re crowding in at all important decision points.
3. Where our efforts lead. Addressing gaps and uncovering hidden value is at the core of additionality. Our work is inherently connected and relative to others. In order to be successful, we seek to bring others with us, and if we’re building bridges, we make sure they lead to somewhere.
4. How we approach problem solving. Additionality requires curiosity and reflection. As go through our work, we are compelled to check in with the field, with our partners and with our supported projects to understand how our work fits into an ever-evolving field.

Is additionality as it was originally intended meant to fill gaps — or change behaviors? By making additionality an organizational value that is always top of mind for everyone on our team, we can actively consider where and how filling gaps differs from changing systems.

2. Substantiating phase: convincing ourselves there is a capital gap that no one else will fill

Catalytic capital absorbs specific, well defined financial risks to encourage conventional investment in high-impact projects. Often unusually patient, risk-tolerant, concessionary, and/or flexible, catalytic capital provides a missing piece of financing that prompts conventional investors to shift from “no” to “yes” in supporting impactful projects, either immediately or over time as risks have been retired. Catalytic capital may also include the practices of designing capital to incentivize conventional investors to change the quality of their participation or incentivize the solution to deepen its impact goals.

Before moving into a design phase for any catalytic capital intervention, it is critically important to systematically collect information on who needs capital, who has capital, and what their respective conditions of capital are. This may include deep interviews with representative samples of solutions, among both potential investees and capital providers.

In designing an intervention – nonprofit program, fund, investment product, etc - for a group of solutions, answering these questions can help set parameters for which solution types are eligible and what kinds and amounts of resources they need. It also helps check assumptions about how well we know our audience and their available resources in a rapidly changing world.

3. Building the case for additionality within specific investments

While Prime runs three nonprofit programs today that take an ecosystem approach to supporting solutions to climate change, our earliest work focused exclusively on mobilizing capital to support climate solutions that demonstrate they 1) have potential for significant impact; 2) are unlikely to receive sufficient or well-aligned support from investors applying “conventional investment” terms; and 3) have a business model that best serves the solution's impact goals. By “conventional investment,” we mean investment exhibiting terms that are representative of their asset class — such as amount, rate of return, or expected exit.

To date, additionality encompasses the second investment criteria for our catalytic investment program. Additionality at Prime is defined as the characteristic of providing a type or amount of funding that conventional investors are not likely to provide. Prime green-lights investments that meet criteria for climate impact and additionality. Separate team members are responsible for each criterion. Investment managers in the Prime family — which may be on Prime's nonprofit team or independent partners bound by contract — green-light investments that meet the third criteria.

Investing Criteria	Description
1 Impact	Investing in solutions with potential for significant impact We only invest in companies when there is a strong case that their solution can lead to a large-scale impact. For Prime’s venture investment vehicles to-date, this means solutions that could lead to emissions reductions or removal of <u>at least 0.5 GT CO2e cumulatively through 2050</u> .
2 Additionality	Investing in solutions that are unlikely to receive sufficient or well-aligned funding from “conventional investors” We only invest in companies when there is a strong case that they’re very unlikely to raise enough or well-aligned financial support from conventional investors. The types of financial support needed depends on the company’s business model and impact goals. By “conventional investors,” we mean investors providing capital under terms that are representative of their asset class — such as amount, rate of return, or expected exit.
3 Commercial potential	Investing in solutions with business models to back impact potential We only invest in companies when there is a strong case that the team will be able to <u>advance a business model</u> that meets the impact goals after our investment. The kind of business model depends on the company’s impact goals. For example, if the company must scale quickly to reach impact goals, then our investment should position the company to raise more capital.

To understand and build community with investors who have their pulse on the norms and terms of conventional investing, Prime creates and facilitates an investment advisory committee (“IAC”) that reviews all potential investments from the point of view of additionality. We convene this group on a regular basis to answer where and how a potential investment is unlikely to raise sufficient or well-aligned financial support. Together with this criterion, the investment advisory committee also weighs in on a third criteria regarding business model by providing their input on what the solution needs to overcome in order for it to be attractive to follow on conventional investment.

The IAC represents the predefined conventional investor group and includes investors who, as part of their day job:

1. Approve investments, such as a Managing Partner or Partner
2. Manage assets owned by others, such as institutional investors
3. Have a track record of making investments in the solution’s sector
4. Invest in companies that are at later, closely adjacent stages than Prime
5. Reflect and center diversity, such as establishing funds owned by women or people of color
6. Are influential in the asset class, such as having brand recognition
7. Are available to meet our expectations for participation
8. Understand the nonprofit mission of our work and the value it has in the field.
9. Have expertise in relevant sectors to the fund

During IAC meetings, Prime asks conventional investors where and why resource gaps exist and why they can't or won't fill them. Assessing **sufficiency** invites us to consider why conventional investors won't invest at all. Assessing **alignment** invites us to consider where investors might be willing to contribute, but in a way that may not best serve impact. Each solution will encounter unique circumstances in the fundraising process that may affect how investors ultimately assess the sufficiency or suitability of capital. Responses on **context** inform discussion and help us determine whether our investment is likely to catalyze conventional investment.

A. Sufficiency

Conventional investors say they *won't invest at all*, because they:

1. Think the solution type/sector is too unknown or unfamiliar
2. Think the solution is in a category that has seen too many failures
3. Think the solution type/sector is of little interest
4. Seek a return that is higher than they believe the solution will generate
5. Believe the timeline to see a return on their investment is too long
6. Believe the exit potential of the solution is not certain enough
7. Perceive the team to be too inexperienced or without the necessary skills to deliver on the solution's financial promise
8. Think the solution is too early and faces a binary go/no-go step that they're unwilling to pay for
9. Believe the solution carries too much market or financial risk
10. Believe the solution is dependent on and will not be supported by policy or regulation (e.g., proliferation of offset market)
11. Believe the solution will be in an industry subject to high regulation or frequent regulatory changes that put their investment at risk

B. Alignment

Conventional investors say they'll invest. *But their investments could be harmful or unhelpful to impact by:*

1. Setting a low valuation that can harm the solutions agency and hinder future financing
2. Leading the solution to de-prioritize impact, as projected in Prime's impact assessment (eg, by pressuring the solution to prioritize production/sales over maximizing emission reduction potential of a unit)
3. Pressuring the solution to progress on a timeline that is too short
4. Setting terms that could exacerbate the solution's potential negative impact described by Prime's impact assessment
5. Preventing the solution from addressing negative impact (Eg, by ignoring or deprioritizing management of unforeseen negative impacts)
6. Preventing the solution from further deepening positive impact (Eg, by setting impact goals that never strive further)

C. Significance/Magnitude

- **How significant or severe is the misalignment?** Where does the assessment fall on a scale from strongly agree, to strongly disagree — or not significant at all to very significant?
- **How entrenched are conventional investment norms?** Are conventional investors likely to adjust their terms **without** catalytic intervention in the next 2, 5, or 10 years?
- **How significant an impact could catalytic capital have on conventional investing practices? (And under what potential conditions?)** Will catalytic capital attract conventional capital to a small group of solutions; a whole subsector of solutions, or multiple subsectors? (If so, what subsectors?)
- **What potential increases or decreases in catalytic capital dollars in this space do we anticipate?** Are the number of catalytic capital providers or amount of catalytic capital dollars likely to go up or down in 2, 5, or 10 years? (If so, why?)

D. Context

- How long has the solution been fundraising, and approximately how many investors have they spoken with?
- What feedback has the solution received from other investors?
- Is the solution **unlikely** to raise 20% or more of capital in the planned round without Prime's support?
- Is the solution **unlikely** to hit internal deadlines for the round closing without Prime's support? And what are the consequences for not meeting the deadline?
- Will Prime's presence crowd-in conventional investment in the same round?
- Will Prime's presence crowd-in catalytic investment in the same round?
- Would the company be sufficiently de-risked on the investment amount in the round without Prime's participation?
- Is no other investor willing to lead the round (ie, price and set terms)?

Lessons Learned

Prime's approach to assessing additionality has evolved over the years as we reflect on our own processes and our role in the context of our actual investment transactions. Below are a few of our lessons learned to date:

Conventional investors aren't always easy to define or characterize

Additionality, by our definition, relies wholly on doing what most investors are not doing. But a catalytic investor's ability to understand the norms of capital will vary widely, according to how standardized the terms of capital are and how transparent investors can or will be in sharing their investment criteria, as well as their perceptions of specific companies. Catalytic investors do the best they can to benchmark their actions against these norms by building trusting relationships with conventional investors and creating space to observe their behavior and reactions to prompts that test their thinking when it comes to investment decisions.

Additionality assessments change with the ebb and flow of conventional investment

Even if Prime has high confidence that we've understood the nature of conventional investing at a given moment in time, that investment landscape is always changing. While a shift in the landscape may not have an effect on the outcomes of one solution, it might affect the quality of a fund if the additionality criteria are too narrowly defined. On the other hand, it is possible for additionality criteria to be so inclusive and flexible that it dilutes its purpose. Collecting information on significance and magnitude is one way to try to find balance even though our interpretation of this information means the assessments will always include a dose of subjectivity.

In addition to setting flexible criteria, we try to account for change by paying attention to broader investment trends, including from government, and reassessing who is represented on additionality committees on a regular basis. We are also transparent about the limitations of our point-in-time assessment.

Building strong, trusting relationships must be a priority

Additionality is relative to what others are doing and how others are interpreting what is profitable, risky, and needed. Prime must be constantly aware of how our peers — including catalytic investors, conventional investors, and more — are thinking, evolving, and operating in a changing world. Investors can center relationships at every step, by building workflows that look at each stage of the investing process with a relationship lens.

Additionality, impact, and business model dynamics are not always met equally or simultaneously.

The three investment criteria gating Prime investments are managed by separate teams to ensure that each criteria receives equal focus. But the investment workflow prioritizes impact and business model by screening earlier for these criteria. For example, interviews may surface that a particular solution, such as off-grid solar, may suggest that it falls into several categories

of additionality. But if it doesn't align with our gigaton-scale impact goals, we would conduct no formal additionality assessment on this solution.

Not all solutions are representative of their sector or category.

All investors group and organize information from portfolios to assess patterns in quantifiable and structured ways. But tensions arise when individual projects diverge from the representative group. For example:

- The solution category may be unlikely to raise sufficient or well-aligned financial support, even though an individual company may not. For example, a project in an underfunded solution space may have well connected founders. Do we not fund it, because they're not characteristic of their group?
- An impactful and innovative solution within a popular sector, such as electric vehicles, may not get funded because of structural business norms within that sector that prevent new economic or manufacturing models from being adopted. Do we not fund it, even though it passes certain additionality criteria?
- The individual solution may also be unlikely to raise sufficient or well aligned financial support, even though the solution may be widely accepted. For example, a high-impact solar project led by an entrepreneur of color may meet certain additionality criteria. Do we deny funding to under-funded founders because their solution space is more common?

Recognizing that the answers aren't simple, we rely on processes to reduce bad biases, hold ourselves accountable to our commitments, and constantly verify our research.

Additionality inverts the orientation of success, and this can be counter-intuitive for conventional investors

When additionality is not met, but the impact and commercial potential are, it's good news at Prime. While we will not invest ourselves, it means that someone else most likely will, and we happily invite our co-investor partners to step in. For some, this can seem counterintuitive; why would an investor choose not to fund a high-impact project right in front of them that could generate great returns?

As a nonprofit, Prime's responsibility is to focus on the projects and sectors that others will not tackle. Over the years, we've monitored the ability of our IAC to accurately assess whether or not ventures would or would not be able to raise capital without a catalytic intervention. Of the 103 companies brought before the IAC to date, 85% passed the additionality criteria, and Prime ended up investing in 25% of those. Of the 68 ventures Prime did not invest in, 54 passed the additionality criterion (were not expected to raise capital without us). 83% of those companies failed to raise capital within 6 months, validating the IAC's assessment, while 17% turned out to be "wonderful surprises" by completing a funding round within the same period. Of the 14

ventures that did not pass our additionality criterion (were expected to be successful in their fundraising) only 5 failed to do so, while 9 were successful as predicted. Taken together, the predictive power of the IAC proved to be 78% accurate within the time constraint of 6 months post assessment. Although our data is limited and is influenced by variables outside our control, these results do indicate the process we have in place is on the right track.