

# Exploring the Continuum of Social and Financial Returns:

When Does a Nonprofit Become a Social Enterprise?

*Kathy O. Brozek*

Goodwill Industries and the YMCA have something in common: by most definitions they each would be considered a “social enterprise,” a relatively new and increasingly popular term in the United States. Yet both these nonprofit organizations have a history dating back more than 100 years. For Goodwill Industries of San Francisco, which serves three counties in the San Francisco Bay Area, a whopping 89 percent of its \$28 million revenue for fiscal year ending June 2008 came from its business enterprises, not from government grants or foundations. By any standard, this is an enviable nonprofit revenue stream. Goodwill provides training, life coaching and jobs for those who possess a track record considered too risky for the private and public sector employment.<sup>1</sup>

In 2005, 54 percent of all U.S.-based nonprofit revenue, excluding that from hospitals and universities, was generated from the fees for goods and services. (Fees include government payments for services, but are not grants).<sup>2</sup> Yet even though fees account for more than one-half of the sector’s total revenue, nonprofits with social enterprise models like Goodwill Industries are not pervasive. Rather, the fee income of most nonprofits is not integral to its operational model and supplements other, more substantial, funding sources.

The differences between a nonprofit with earned income and a social enterprise nonprofit are core to this discussion and go beyond semantics and nuance. I posit that these distinctions lie in organizational structure, funding sources, formation, employees, founders, execution of tactics, and other parameters. I am not advocating one model over the other, but instead will focus on the challenges, opportunities, and trends facing nonprofits and the circumstances in which each model is a better fit. With insight, stakeholders can create the sustainable and innovative nonprofit organizations that this resource-strapped sector so desperately needs.

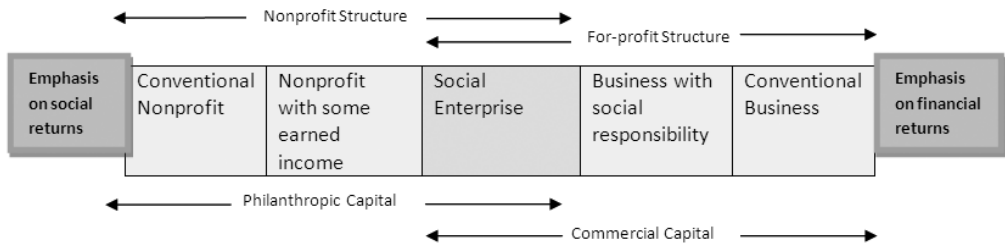
In general, all nonprofit and for-profit organizations fall along a continuum from social to financial returns. Effecting social change by combining in one organization social and financial returns, also referred to as blended value, is a key component of the evolving social capital market.<sup>3</sup> Figure 1 captures the essence, and the inherent ambiguity, of the social enterprise model.

<sup>1</sup> Goodwill Industries of San Francisco, San Mateo and Marin Counties 2007-2008 Annual Report (990 tax return) (San Francisco: Goodwill Industries, 2008).

<sup>2</sup> Urban Institute, Nonprofit Almanac 2008 (Washington, DC: Urban Institute Press, 2008), p. 145, figure 5.3.

<sup>3</sup> See Jed Emerson and Sheila Bonini, The Blended Value Map: Tracking the Intersects and Opportunities of Economic, Social and Environmental Value Creation (Blendedvalue.org website, February 24, 2004), available at [www.blendedvalue.org/publications/](http://www.blendedvalue.org/publications/).

*Figure 1. Spectrum of Social and Financial Returns*



*Source: Stanford Social Innovation Review, Spring 2008; Jed Emerson cited as a contributor*

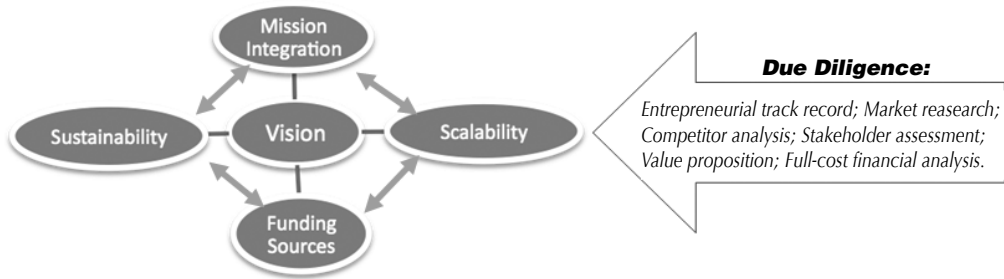
Presently there is no universally accepted definition of “social enterprise” for either a for-profit or nonprofit organization. The Social Enterprise Alliance defines social enterprise as “an organization or venture that achieves its primary social or environmental mission using business methods.” According to the Blended Value organization, a social enterprise is a “nonprofit organization that uses business solutions to accomplish social goals; the social objective is the primary driver.”<sup>4</sup> Here, I define social enterprise as a nonprofit organization with a sustainable, scalable revenue stream generated from activities related to its social mission; it has an entrepreneurial operating model and leadership team.

Another example of a social enterprise is the entrepreneurial and financially sustainable Delancey Street Foundation, a 501(c)(3) nonprofit. Despite many naysayers, in 1971 a few visionaries decided to help the unemployable—former drug addicts, people living on the street, and ex-felons—to turn their lives around through vocational training and entrepreneurial endeavors by “empowering the people with the problem to become the solution.” To this day, they continue to use this self-help model to run twelve social enterprises in five locations across the country, all without any government funding.

Where a nonprofit lands on the continuum of social and financial returns is determined by the vision of the leadership, its executive director and/or the board. However, this decision is, or should be, a dynamic process, as depicted in Figure 2. The vision is influenced by a core belief about how to address a social issue and a pragmatic assessment of how best to achieve the mission. For a nonprofit social enterprise, the question is whether the social mission can be integrated into a scalable, profitable, fee-based model with ongoing financial sustainability. The answers are not always clear-cut, and the risks often hard to quantify. Ideally, it would be an iterative decision process with a due diligence rigor similar to what a company would undertake in its early stages.

<sup>4</sup> Social Enterprise Alliance is at [www.se-alliance.org](http://www.se-alliance.org); E. Bibb, M. Fishberg, J. Harold, and E. Layburn, “Blended Value Glossary” (Blended Value, July 2004), available at [www.blendedvalue.org/publications/](http://www.blendedvalue.org/publications/).

Figure 2. Assessing the Nonprofit Models



The first question in locating an organization’s place on the continuum is whether a fee revenue model of any type is embedded in the operations; is it likely, in other words, to generate a timely, profitable cash flow? Questions to ask include: Is the infrastructure (staff, accounting, IT systems, building space, etc.) in place or does it need to be acquired? Will the revenue model detract from accomplishing the organization’s mission? Does staff have the necessary business acumen? Are the financial projections realistic?

If the answers point to relying strictly on outside funding, the organization lands far left on the continuum. Otherwise, whether it is a small, contained revenue stream or a full-fledged nonprofit social enterprise depends on the following criteria (see also Figure 2):

- A social mission integrated into a revenue model: Will this better serve the constituents? Does the operations model involve a workforce development strategy? If necessary, is the market willing to pay a price premium for a “socially responsible” service or product? What are the tax implications of not having the social mission integrated in the model?<sup>5</sup>
- Scalability: Is there capacity to increase revenues each year? Can the business model be easily replicated? Is growing the model feasible on the basis of funding, market-place, staff, systems, etc.?
- Sources of funding: Is it a multiyear funding commitment or series of one-year grants and ongoing fundraising? Do the funders provide a collaborative coaching process? Without a fee-generating revenue stream, are other sources of funding available?
- Sustainability: To what extent will the fee revenue add to the future sustainability of the nonprofit? What is the ongoing risk of losing money? Will it detract from the social mission over time?<sup>6</sup>

5 Anthony Mancuso, *How to Form a Nonprofit Corporation* (Berkeley, CA: Nolo, July 2007), pp. 80-81.

6 Alex Nichols, ed., *Social Entrepreneurship: New Models of Sustainable Change* (New York: Oxford University Press, 2008), pp. 205-206.

New Door Ventures, a nonprofit social enterprise based in San Francisco ([www.ggci.org](http://www.ggci.org)), is a good illustration of the concepts just described. Its revenue-generating model includes a social mission to provide assistance to at-risk youth aged 14 to 21. It offers hands-on training, internships, community support, and jobs programs at its small business ventures. In 2007, its business operations generated nearly 60 percent of its revenue. Its ventures include Pedal Revolution, a bicycle retail, repair, and custom-design shop, and Ashbury Images, a graphic arts production business. They continually seek new ventures. New Door Ventures was part of the REDF venture philanthropy portfolio from 1991 through 2005, receiving funding, coaching, and other benefits. The New Door Ventures social enterprise model works, not by accident, but because of its clear vision, operational efficiency, and innovation, which it has maintained throughout its lifecycle with the help of its initial funder, REDF.

Exploring the distinguishing characteristics between the two models—a nonprofit that generates some income and a social enterprise—highlights the influences that position nonprofits on the continuum and whether the revenue model evolved from an organic process or as a defensive reaction to a challenging environment. Certain features, by definition, describe a nonprofit social enterprise but appear less frequently in nonprofits with earned income. These features include an entrepreneurial vision of the executive director and/or board; a social mission integrated into the fee revenue model; a fee revenue model at the nonprofit's inception; a scalable operational model; and alliances and resources that are uniquely combined to create value. Additional features include close collaboration and coaching with major funders, a multiyear funding financial commitment, and a workforce development program embedded in the operational model.

Which model is best also depends on the situation. If the operational, financial, and human resources needed for a social enterprise are absent and raising the funds to acquire them is difficult, then a nonprofit with some earned income, even if not scalable, is the prudent choice. A fee revenue stream of any type can enhance the prospect of receiving funding. A Harvard Business Review article offered an example of a model that, in the end, was dysfunctional and stands in contrast to the New Door Ventures story. The author cites an unnamed nonprofit that built an industrial-sized kitchen to earn income through its catering and wholesale operations while providing job training to an underserved market. The kitchen was experiencing yearly losses exceeding \$250,000 and few were getting jobs, but the grant-making foundations were excited about the concept; it served as a reliable fundraising tool so the operations were maintained.<sup>7</sup>

This may be an extreme example of a funding system gone awry, but in the rush to generate more income, nonprofits are often pushed to eke out revenues however they can. It also underscores the question that arises in this process of how to assess the ability to raise

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7 William Foster and Jeffrey Bradach, "Should Nonprofits Seek Profits?" Harvard Business Review vol 83 (2) (February 2005): 92-100.

external funding. If a nonprofit possesses marketing savvy when seeking outside funding but bypasses the necessary due diligence to build a profitable model with good leadership, it could turn into an inefficient, money-losing venture. Or, it could mistakenly be perceived as successful because of incorrect accounting methods. The Harvard Business Review article mentioned above challenged the results of research studies conducted by two reputable organizations that indicated a fairly high rate of profitability among nonprofits with earned income. The authors substantiated their claim by sharing research findings from their own, presumably less biased, study. I will not attempt to refute the authors' analysis, but it is noteworthy as it highlights the complexities of defining and measuring success on the "blended value" continuum, which in turn, may muddle the decision process.

Moving right on the continuum in Figure 1, for-profit entrepreneurs that have incorporated a social mission into their model often face a trade-off between social and financial returns. Figure 2 still applies but the driver is the desire for a higher return which, at least in theory, means lower social returns. Increasingly, indications are that this gap may be shrinking, albeit slowly. Consider Revolution Foods ([www.revfoods.com](http://www.revfoods.com)), a start-up company that provides nutritionally healthy and mostly organic food for public schools in California and also sells its products retail. Their objective is to generate market returns while tackling the issues of childhood obesity and healthful food in public schools.

One of the changes that is helping to close the gap between the social and financial return are new investors such as DBL Investors, that invested in Revolution Foods. DBL is a venture capital firm with a mission to assist its portfolio companies in implementing a "double bottom line" strategy. The Community Reinvestment Act (CRA) is also influencing the funding on the for-profit end of the blended value continuum. Banks are able to fulfill their CRA requirements by providing loans to businesses in underserved markets, and more recently, by investing in social-mission-driven venture capital firms such as DBL Investors. Finally, other individual investors are starting to seek out social-mission-driven businesses with the expectation that they produce full market returns. The blended value continuum in Figure 1 will realign over time if public policy continues to incent private investment in social-mission-driven businesses.

## **Nonprofit Sector: Market Size and Funding Sources**

The efficacy of the nonprofit sector funding process has been a topic filled with some consternation. Bill Drayton, the founder of Ashoka, stated, "What a social entrepreneur needs and what a foundation provides is an almost perfect mismatch."<sup>8</sup> George Overholser, founder of NFF Capital Partners, has argued that the dearth of "builder" capital, which helps to sustain growth by investing in infrastructure, has a negative effect on the nonprofit sector. In contrast, "buyer" funding, which in effect purchases services for more recipients, is

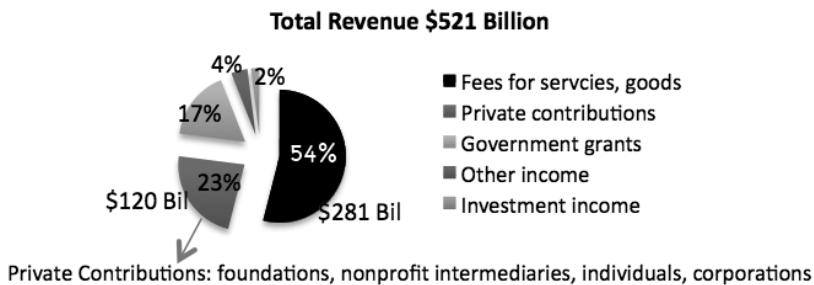
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8 Nichols, *Social Entrepreneurship*, p. 309.

easier to obtain but often includes restrictions.<sup>9</sup> A report from the William and Flora Hewlett Foundation describes how the information gap in philanthropy, both for foundations and individual donors, results in inefficient distribution of funding.<sup>10</sup> Other practitioners attribute the challenges that social enterprises face in raising funds to their unconventional place on the continuum.<sup>11</sup>

Of the 1.4 million nonprofit organizations registered with the IRS, the vast majority were 501(c)(3) public charities. The IRS requires only those with more than \$25,000 in gross receipts to file reports; religious congregations, foreign, and government-associated organizations are exempt. In 2005, approximately 303,500 reporting public charities (excluding hospitals and universities) generated \$521 billion in revenue.<sup>12</sup> As noted, the majority of revenue, 54 percent, comes from the exchange of goods and services (see Figure 3). Of this, about one-fifth of the total is government fees (not grants) for services.<sup>13</sup>

Figure 3. Sources of Revenue for the 303,500 IRS-Reporting Public Charities\* for 2005



Source: *The Nonprofit Almanac 2008*

\* excludes hospitals, universities

The next largest source of funding is private contributions, totaling about \$120 billion, or 23 percent. Private contributions are from individuals, foundations, corporations, and nonprofit intermediaries. Of the 23 percent, individuals contribute approximately 16 percent and foundations, 5 percent (see Table 1).<sup>14</sup> A significant portion of U.S. foundation giving is in the form of grants to hospitals, universities, and foreign-based recipients, which are

9 George Overholser, "Nonprofit Growth Capital, Part 1: Building is Not Buying" (New York: Nonprofit Finance Fund, n.d.), available at [www.nonprofitfinancefund.org/details.php?autoID=86](http://www.nonprofitfinancefund.org/details.php?autoID=86).

10 William and Flora Hewlett Foundation, "The Nonprofit Marketplace: Bridging the Information Gap in Philanthropy" (New York: McKinsey and Co., 2008).

11 Michael Chertok, Jeff Hamaoui, and Eliot Jamison, "The Funding Gap," *Stanford Social Innovation Review* (Spring 2008).

12 Urban Institute, *Nonprofit Almanac 2008* (Washington, DC: Urban Institute Press, 2008), p. 149, 153, Tables 5.6, 5.7.

13 "Preliminary Revisions for 2005 from the National Center for Charitable Statistics" (Washington DC: Urban Institute).

14 *Ibid.* Revenue from individuals is estimated from available data.

excluded in Figure 3. For example, only 30 percent, or \$467 million, of the ten largest U.S. foundation grants in 2005 were for nonprofits as defined in this analysis.<sup>15</sup>

*Table 1. Sources of Private Contributions for Public Charity Revenue\**

|  | Nonprofit Intermediaries                                  | Foundations               | Individuals | Corporations |
|--|---|---------------------------|-------------|--------------|
| Percentage of total public charity revenue | Less than 1%  | 5%                        | 16%         | Less than 2% |
| Who funds?                                 | Individuals, foundations, corporations, banks, government | Individuals, corporations | Self        | Self         |

*Sources: Urban Institute, Nonprofit Almanac 2008; For the Foundation estimate of 5% - Preliminary revision for 2005 from the National Center for Charitable Statistics at the Urban Institute; Other percentages based on author's calculations; Giving USA Foundation*

*\*Excludes hospitals and universities.*

Two of the groups comprising private contributions—intermediary investors and foundations—are detailed in the next section. Intermediary investors are nonprofit organizations that invest or donate money from other sources; they disburse funds using well-defined objectives and criteria.<sup>16</sup> (Foundations are essentially nonprofit intermediaries but are discussed separately for this analysis.)

## Nonprofit Intermediaries

There are three subgroups of nonprofit intermediaries. The first subgroup is “venture philanthropy,” often called high-engagement philanthropy (engagement between the recipient and the funder). The Blended Value glossary defines venture philanthropy as:

*A model for charitable giving that arose in the 1990's, based on the application of the venture capital investment principals. Funds “invest” not just money but energy and expertise in the organizations they support...nonprofits are asked to provide evidence of their results and impact on a regular basis...focuses on leadership, bold ideas, developing strong teams, active board involvement and long-term funding.*

The venture philanthropy model has stirred controversy in some circles owing to perceived clashes in cultures and objectives. It works best for nonprofits with a solid operational model, ambitious goals, a team open to collaboration, and a potential for scalability

<sup>15</sup> “Biggest Grants Announced in 2005,” Chronicle of Philanthropy, January 12, 2006.

<sup>16</sup> Chertok, Hamaoui, and Jamison, “The Funding Gap.”

and sustainability.<sup>17</sup> Venture philanthropists usually limit their focus to a specific issue(s) in a region. Venture Philanthropy Partners, for example, chooses nonprofits that serve disadvantaged children and youth in the Washington, DC area. Full Circle Fund and Tipping Point Community in San Francisco require individual donors to make a minimum contribution and to coach the nonprofits in the portfolio. Tipping Point board members cover the firm's operational expenses, ensuring that all donations go directly to the nonprofits. The model has gained some traction by refining the mix of engaged donors and willing nonprofit recipients. The portfolios run the gamut from conventional to social enterprise nonprofits.

The second subgroup, nonprofit loan funds, provides below-market-rate financing to nonprofits, often those with fee revenue streams but that are not necessarily social enterprises. Paul Carttar and Jed Emerson suggest that a nonprofit with earned income is more likely to use debt since lenders like to see a dependable revenue stream.<sup>18</sup> Most fall into the category of Community Development Financial Institutions (CDFI), which are entities established to provide credit and financial services to underserved markets or populations; they are certified by the CDFI Fund, and funded in part by the U.S. Treasury. According to the CDFI Fund website, development projects such as affordable housing are often the recipient of the funds; others target nonprofit organizations. Nonprofit Finance Fund (NFF) lends to nonprofits exclusively; to ensure debt repayment, it typically requires a three-year track record and \$500,000 in operating revenue, and earned income revenue is a plus. RSF Social Finance and Good Capital are two non-CDFIs that are providing a unique blend of financing instruments to both nonprofit and for-profit organizations. Because of the nature of providing debt and repayment, the risks associated with investing in social enterprise nonprofits, particularly in the early stage, do not seem to fit in with this model.

The final subgroup is social entrepreneur funds which focus on finding and financially supporting social entrepreneurs. Ashoka, for example, was founded in 1980 and has been at the forefront of social entrepreneurship in the United States since then. Although there are many definitions of "social entrepreneur," Ashoka uses the following:

*Individuals with innovative solutions to society's most pressing problems. [The social entrepreneur] solves problems by changing the system, spreading the solution, and persuading entire societies to take new leaps.*

The breadth and depth of the social impact that social entrepreneur funds impart distinguishes them from venture philanthropy funds, which focus on key issues within a defined metro area or region. In addition to multiyear grants, some of these funds provide loans for

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17 Mario Morino and Bill Shore, "High Engagement Philanthropy: A Bridge to a More Effective Social Sector" (Published jointly by Venture Philanthropy Partners and Community Wealth Ventures, June 2004).

18 Paul Carttar and Jed Emerson, "Money Matters: The Structure, Operations, and Challenges of Nonprofit Funding" (Boston: Bridgespan Group, 2003), p. 37.



market-based solutions to systemic social problems, such as the Acumen Fund. An example of an Ashoka-funded entrepreneur is a woman from South Africa's HIV/AIDS-plagued Gauteng province, who developed a home-based nursing service for chronically and terminally ill patients. This program has in turn positively influenced health care policies both in South Africa and globally. In this category, U.S. based nonprofit social enterprises typically are not the primary focus, although a few have been supported.

## Foundations

The second funding source that will be discussed is foundations; there were more than 72,000 U.S.-based foundations in 2006 and more than 71,000 in 2005.<sup>19</sup> Their grant-making activities have come under much scrutiny during the past decade because of their investment management practices and their grant-making processes. Recent research indicates that grants are often too restricted in use, time-consuming to obtain, and do not offer needed nonfinancial assistance.<sup>20</sup> (Anecdotally, some attribute the inefficiencies to the “inside circle” of well-connected nonprofits and foundations that can contribute to the increased odds of receiving funding via the grant-application process.) Others discuss an inherent aversion to risk-taking that is fueled, in part, by the foundation boards, staff, and legal and public relations concerns.<sup>21</sup> Consequently, nonprofit social enterprises, particularly start-ups, are at a disadvantage in receiving funding.

In an effort to be more proactive, foundations are increasingly using program related investments (PRIs), which are below-market investments, usually loans made to nonprofit organizations. Receiving a PRI is considered an important step in the nonprofit's financial sustainability, and other lenders perceive it as a sign of the organization's stability.<sup>22</sup> Many PRIs are made to nonprofit intermediaries, that is, CDFIs, which also count as part of the foundation's five percent payout IRS requirement. However, foundations awarded a relatively small number of PRIs in 2005 (428 PRIs totaling \$225 million) relative to the approximate \$26 billion in grants awarded to U.S.-based nonprofit recipients that year (excluding hospitals and universities). In 2007, there were 297 PRIs totaling \$304 million.<sup>23</sup>

Mission-related investing (MRI) “encompasses any investment activity which seeks to generate a positive social or environmental impact in addition to providing a financial

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19 The Foundation Center, *Highlights of Foundation Yearbook, 2008 Edition* (New York: Foundation Center, n.d.). Urban Institute, *Nonprofit Almanac 2008*, p. 106.

20 “Grant Makers Still Lag in Providing Essential Support, New Reports Find,” *Chronicle of Philanthropy*, December 11, 2008.

21 Nichols, *Social Entrepreneurship*, p. 311.

22 Rockefeller Philanthropy Advisors, “Mission-Related Investing: A Policy and Implementation Guide for Foundation Trustees” (New York: Rockefeller Philanthropy Advisors, 2008), p. 61.

23 The Foundation Center, *database of Program Related Investments for 2005, 2007* (New York: Foundation Center, n.d.).

return.”<sup>24</sup> Technically, PRIs are a component of the MRI portfolio; the purpose is to align the social mission of the organization with its investment policies. Examples of MRI products include Certificates of Deposit in CDFIs, Habitat for Humanity bonds, investments in the Calvert Social Investment Fund, and clean tech venture funds. The investments can fall on the blended value continuum as below-market to market-rate returns. The H.B Heron Foundation is a leader in this field; it justifies its below-market returns because its investments generally help the recipients to attain capital from other sources.<sup>25</sup>

Specialized foundations are slowly emerging as innovators in this arena, focusing on social enterprises and social entrepreneurship. Although few in number, they are garnering much attention as hybrid models of philanthropy. The Skoll Foundation, for example, offers three-year grants for global social entrepreneurs. Draper Richards Foundation provides ongoing coaching to recipients of its three-year awards of \$100,000 annually. The grants, according to their website, are “specifically and solely for entrepreneurs starting new nonprofit organizations.” The reach of the nonprofits must be national or global. The Calvert Foundation funds some social enterprise nonprofits and also, according to its website, offers a Calvert Community Investment (CCI) Note, “a flagship product and most popular offering” where investment is “pooled and placed in a portfolio of affordable loans to over 200 leading nonprofit organizations and social enterprises working in over 100 countries that focus on alleviating poverty.”<sup>26</sup>

## Emerging Trends

Unique combinations of existing models are appearing, such as an integrated franchise-nonprofit model to create a (hopefully) reliable and tested revenue stream. Some established organizations are tweaking their funding models. Ashoka, for example, has begun funding for-profit entrepreneurial organizations as part of their mix. Alliances, such as between Community Good Ventures and Maine Community Foundation, are promoting the efficacy of grants. Community Good Ventures is a consulting group that engages in multiyear coaching relationships with some of the grant recipients of the Maine Community Foundation. In addition, a new legal structure, an L3C, has been formalized in Vermont and Michigan. The L3C is a low-profit, limited liability corporation for social enterprises, providing them with more legal and financial flexibility. Lastly, the Edward M. Kennedy Serve America Act authorizes five-year matching grants to intermediary nonprofit organizations to provide small- and medium-sized nonprofits with organizational development assistance.

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24 Rockefeller Philanthropy Advisors, “Mission-Related Investing,” p. 11.

25 Ibid., pp. 50, 60.

26 Available at: [http://www.calvertfoundation.org/invest/community\\_investment\\_notes/index.html](http://www.calvertfoundation.org/invest/community_investment_notes/index.html).

## Conclusion

The rate of innovation in the nonprofit sector appears to have accelerated in recent years. Although the new efforts compose a relatively small portion of the sector, they are occurring with greater frequency and have the potential to realign the sector. The nonprofit social enterprise model has been around, amazingly, since the nineteenth century in the United States. As often happens when an industry experiences systemic difficulties, good things that work get repackaged. A system wants equilibrium and in this case, the nonprofit intermediaries and a handful of foundations are leading the way to help make nonprofits of any ilk more efficient and sustainable.

The nonprofit social enterprise warrants distinction from a nonprofit with earned income because of its many-faceted differences, including structure at inception, drivers of sustainability, leadership capabilities and vision, operations model scalability, funding sources, mission integration, and the need for collaboration. At its core, the availability of early-stage funding is the missing link that keeps a promising social enterprise business plan from being implemented. Given that the current funding system favors less risk, shorter time horizons, and labor-intensive practices, this social enterprise model could potentially be underused. Fortunately, the myriad new ideas and structures indicate that the innovative spirit is likely too strong to let the nonprofit social enterprise model fall by the wayside.

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