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Nonprofit Organizations

Should Your Start-up Be For-Profit or Nonprofit?

by Cait Brumme and Brian Trelstad

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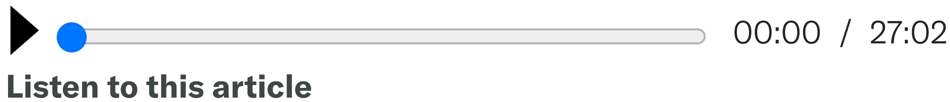
Mark Wagner

Summary. Years ago the line between nonprofit and for-profit enterprises was clear, but that has changed. Nonprofits now offer products that compete with those of the best for-profits, and for-profits can deliver as much social value as charities. Despite the blurred distinction,... more

There once was a time when "start-up" clearly referred to a new venture that sold a product, looked for investors, and aimed to turn a profit. A nonprofit was a completely different kind of enterprise—one that was funded through the largesse of donors, gave

away its offerings, and had relatively few similarities to a traditional business. In recent decades those lines have blurred. Many nonprofits now provide products or services that compete with those of the best for-profit companies. Meanwhile, for-profit start-ups, often backed by “impact investors” who care about more than financial returns, can do as much good as traditional charities. As a result, when a socially minded entrepreneur starts an enterprise today, it’s often unclear whether it will ultimately be for-profit or nonprofit.



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Despite the vanishing distinction, all mission-driven start-ups will eventually face a stark choice about which legal structure to adopt, and the crucial decision point often arrives before the founders are ready to deal with it. There are, of course, options in the middle—so-called hybrid organizations that use elaborate legal structures (involving, say, a parent and a subsidiary) to combine for-profit and nonprofit entities. But in our experience the best start-ups make an explicit, early choice. The decision is a difficult one made under a high degree of uncertainty and is very hard to reverse. Notwithstanding Patagonia’s remarkable transfer of its ownership to a nonprofit trust, it’s rare for a social enterprise to change legal form once its strategy crystallizes, its culture takes shape, and it starts to scale up.

In our work in impact investing and in research at Harvard Business School, we’ve studied and advised hundreds of start-ups that have stood at this crucial crossroads. Given the importance of the choice of structure and its long-term consequences, we’re surprised at how unsystematically people approach it and how

frequently they assume that some kind of hybrid organization is the best option or that they can easily switch legal forms when circumstances change.

This article looks at how to make this decision and is relevant not only for founders but also for board members, investors, and donors. While nonprofit law varies from country to country, the framework we offer applies in most geographies where social enterprises are active, even if the specific legal structures are different. We maintain that four factors should inform the choice between being for-profit or nonprofit: market readiness, customers' willingness to pay, capital availability, and access to talent and other resources. We also outline the time frame for making the decision and explain why it's better for start-ups to commit to one path rather than hedge or go hybrid.

A Foundational Dilemma

Historically, the choice of whether to create a for-profit or a nonprofit was straightforward. If you were starting a business that sold a good or a service and intended to make a profit, you made it a for-profit company. If you wanted to solve a pressing social or environmental problem, you created a nonprofit, which would allow you to accept tax-exempt donations but limit to some extent the organization's political activities and the nature of its earned revenue.

As the concept of social entrepreneurship gained traction in the 1970s and 1980s, the paradigm began to shift. In that era a cohort of businesslike nonprofits emerged, including the microfinancier Grameen Bank and the Delancey Street Foundation, which provides training and jobs to recovering addicts and ex-convicts. Mission-driven businesses like Greyston Bakery, which hires workers who've traditionally faced barriers to employment and funnels its earnings to a nonprofit foundation, and Stonyfield Farm, which sought to help small dairy farms in New England remain viable by selling organic yogurt made from their milk,

further muddied the distinction between for-profit and nonprofit. In recent years the options for entrepreneurs have increased in the United States, with legislation allowing "benefit corporations" in many states and the introduction of B-Corp certification, which a for-profit company can use to signal to shareholders that it will try to act in the best interests of society, the environment, and all stakeholders. Venture philanthropists and impact investors emerged to fund social entrepreneurs who sought both financial and social returns—that is, to do well by doing good.

Can market conditions support a for-profit approach, or does the cost to serve exceed potential revenue in the near term or midterm?

As the choices have gotten more complex, the favored path for founders has also shifted. In 2009, when MassChallenge, a nonprofit that aims to support high-impact, high-potential start-ups (and where Cait is the current CEO), was founded, all the social enterprises that participated in its accelerator program were registered as nonprofits. Today more than 70% of the social enterprises in the incubator have been formed as for-profit companies.

When to Make the Call

Before choosing a structure, you first must appreciate the best point in the life cycle of the enterprise to make the decision. Usually entrepreneurs begin by testing products and validating their approach, well before legally forming an organization and bringing in significant external resources. While using feedback from initial pilots to find product-market fit, the start-up team may also test for "capital-enterprise fit," determining what kind of funding would be best aligned with the enterprise's strategy. But

often founders take a shotgun approach, speaking to both investors and grant makers while being vague about the specific legal entity they're raising money for.

After months of hustling, the founders might hear, "Congratulations, you won the business plan competition and a $25,000 prize!" or "I heard you present at the demo day, and I'd love to make an angel investment." Either happy milestone will be accompanied by a request for legal documents and bank wiring instructions. Suddenly, the founders will have to make a potentially permanent decision: Should we incorporate as a for-profit or a nonprofit?

In our experience the time to make that decision is not after someone has offered to fund the enterprise but before. If a nonprofit raises a substantial amount of donations and then decides to become a for-profit, the donors might object; from their perspective, their charitable gifts will have been used to reduce the risk of investments that the founders and new backers can profit from. And if a for-profit raises venture capital and then decides to convert to a nonprofit, the VCs will likely lose all their investment, and new donors might not trust the founders' commitment to the mission. Though it's possible to raise both philanthropic and investment capital as a hybrid organization, doing so can more than double the fundraising workload in the venture's stressful early days. Hybrid organizations also often require two distinct teams with clearly separated duties, multiple governing boards, and strong legal oversight, all of which can increase complexity and administrative costs for a mission-driven venture.

To avoid mistakes, founders and their teams need to analyze four factors:

Is the Market Ready?

As part of their early strategy work, entrepreneurs must assess their market's size and rate of growth and the level of existing competition. But that task is more complicated for social entrepreneurs, who are more likely to operate in underdeveloped, complex, or emerging markets, where it's costly to create demand. Founders must answer questions such as: How much customer education is required for adoption? Does the market have a mature ecosystem—such as a reliable supply chain—to help deliver the product or service to end users? What barriers to entry, such as regulation, may be prohibitive? The central question here is: Can market conditions support a for-profit approach, or does the cost to serve—including entering the market and acquiring customers—exceed potential revenue in the near term or midterm?

The collage artist Mark Wagner uses deconstructed U.S. dollars to create intricate works of art.

Reboot Rx, for example, was founded with the insight that effective and affordable cancer treatments could be rapidly developed by repurposing generic drugs. However, finding new uses for low-cost off-patent drugs is commercially unattractive because the potential profits are too small to justify investments in expensive clinical trials. As a result, Reboot Rx's founder and CEO, Laura Kleiman, decided early on to establish the venture as a nonprofit that would use philanthropic funds to build an AI-powered technology platform to identify the most-promising opportunities. Once a drug candidate is identified, the

organization intends to use outcome-based contracts and program-related investments to finance the clinical trials for what will most likely be a below-market return.

Wellthy, by contrast, jumped into the new and rapidly growing market of caregiver coordination to help users navigate urgent family-care needs without having to stop working. While the market was fragmented, its large size and substantial labor supply, along with an ecosystem of providers and payers who were as interested in a new solution as the clients were, made it attractive enough to justify Wellthy's decision to become a for-profit.

Are Customers Willing to Pay?

Entrepreneurs must develop and test hypotheses about their target customers, the value proposition, and the customers' ability and willingness to pay. With social ventures, that process often prompts debates about intended impact as entrepreneurs grapple with tensions between customer access and affordability on one hand and profitability on the other. If the end users are unable to pay a price above costs, and a third-party payer, like the government or an insurance provider, is unlikely to become the customer at attractive margins, the organization should remain a nonprofit. That may seem obvious, but in our experience many early stage pilots, especially those launched in fragmented markets, sell to early adopters who are not representative of the full market.

Healthpoint Services Global was a for-profit company that raised a substantial amount of impact capital to fund its efforts to deliver integrated health services and potable water to more than 200,000 villages across rural India. While the carefully selected pilot sites delivered promising results, the company ended up selling its offerings at less than what it cost to deliver them. Had Healthpoint incorporated as a nonprofit, like the vision-screening and eyeglass-distribution organization VisionSpring (disclosure:

Brian serves on VisionSpring's board), it might have been able to raise philanthropic subsidies to cover the difference between the customers' willingness and ability to pay and the full cost. Because of the mismatch between its business model and its legal status, Healthpoint failed to grow and thrive.

Rocket Learning, in contrast, decided against a for-profit approach. It had developed an education platform using WhatsApp to connect teachers, students, and parents of elementary and preschool children in India. The hot education-technology market was attracting plenty of early stage venture capital, and the start-up had promising evidence of the effectiveness of the platform, but the schools couldn't afford to pay for it. Its potential for impact appealed to philanthropic donors, however, so the founders opted to incorporate as a nonprofit. Three years later, Rocket Learning has a partnership with India's Ministry of Education, is collaborating with MIT's J-PAL on a randomized control trial, and is serving more than a million students in over 70,000 classrooms across India.

Sometimes start-ups whose customers can't or won't pay can succeed by seeking out alternative sources of revenue. EatWell Meal Kits, for example, is a young start-up focused on healthful food. It targets low-income adults with conditions for which diet is an important component of treatment, such as diabetes or heart disease. The start-up understood early on that it would be unable to deliver food kits at a cost those customers could afford. But instead of soliciting donations to close the gap, it identified another option: subsidies from payers (such as integrated health-care systems and insurance companies) looking to improve the health and nutrition of their insured populations. So becoming a for-profit made sense for EatWell.

Where Is the Available Capital?

When social entrepreneurs are undecided about which structure to choose, we often hear them say, “I’ll just raise impact capital.” The thinking is that mission-aligned investors might provide more money than grant makers but have lower expectations for returns than traditional venture capitalists do. While some investors, notably foundations and family offices, are indeed patient, it’s unrealistic for founders to expect that they’ll provide all the funds needed to scale up a social enterprise. In fact, foundations often use their ability to make investments with their grant capital (known as “program-related investments”) to catalyze new ventures that can later attract investors seeking market-rate returns. And family offices often work with financial advisers who have an incentive to invest for market-rate returns.

Instead of hoping for a blank check from an infinitely patient (and capitalized) investor, social entrepreneurs need to do the same hard-nosed analyses that for-profit founders do, estimating how much money the venture will need and how much cash flow it can generate after reaching breakeven. They may even project when the venture might be sold, for what amount, and to whom. For some, the idea of selling a mission-driven enterprise in the capital markets might be anathema; for others, it might be the goal. But founders need to imagine what success may yield and how that will influence investors or donors.

The Line Between For-Profits and Nonprofits

While socially minded corporations and charities often do similar work, important distinctions between them remain. When choosing which kind of structure to adopt, founders should consider the nature of their potential market and customers, the kind of capital and exit options that are available, and the venture’s ability to attract talent and other resources.

	For-Profits	Nonprofits
MARKET	Large, growing, and competitive	Small, young, and fragmented
CUSTOMERS	Profitable to reach and serve at scale	Not profitable to reach and serve at scale; require subsidies
CAPITAL	Ample private capital and business banking services; liquid capital markets for exits; lack of interested donors	No venture capital but sufficient philanthropic capital to get started; few to no exit options
TALENT & PRIVILEGED RESOURCES	Team paid at market rates No privileged resources	Hires willing to accept below-market pay; high levels of intrinsic reward for mission alignment Access to privileged intellectual property, professional services, or customers

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Consider Iora Health, which was founded in 2011 as a for-profit. It aimed to transform the practice of primary care in the United States with a unique team-based approach targeting people with high medical needs, including those in low-income communities. The model evolved to focus on senior citizens covered by Medicare Advantage, a large and fragmented market. Over its first decade, Iora raised more than $300 million from venture capital investors. In 2021 it was sold to One Medical in a $2.1 billion transaction. Its investors were willing to commit that much capital for so long in part because they believed the potential financial returns justified the risk.

Founders also need to understand what capital is available in the near and medium term. Trying to raise charitable donations or secure government funding in a country or an industry where there is little of either doesn't make sense. That was the situation facing LifeBank, a health-care-logistics company that was launched to deliver clean blood in urban markets in Nigeria.

Despite the critical public-health benefits it provided, there was very little venture philanthropy in Nigeria to fund LifeBank's growth. Moreover, development financial institutions there were (and are still) often slow to invest in innovations. As a result the founders knew they needed to raise capital from investors who expected a market return, and they've worked hard to find revenues from new products, such as oxygen, and new markets, such as Kenya and Ethiopia.

Similarly, if a theme or a strategy has either become the flavor of the day or fallen out of favor with investors, founders will have to confront that reality. Both Khan Academy, the free online educational platform, and Rocket Learning decided to incorporate as nonprofits in part because of how frothy the education technology markets in the United States and India were at the time of their founding.

What Will Attract Talent and Other Resources?

The final consideration is the enterprise's ability to build the right team and obtain other nonfinancial resources, including intellectual property. Social entrepreneurs must assess the type of talent they need and whether the organization's mission is compelling enough to attract passionate and hardworking people at below-market salaries, or whether they'll be competing for talent that expects both market-based compensation and participation in a venture's financial upside through equity ownership or stock options. If a venture requires higher-paid talent and the gap between the compensation offered by for-profits and nonprofits is large (as it is with, say, tech enterprises), it will face challenges. For example, while Khan Academy is widely considered a success and pays its top talent very generously for a nonprofit of its size, it cannot offer employees stock the way for-profit tech firms can, and its founder, Sal Khan, has spoken about how difficult it has been to recruit, motivate, and align the employees needed to thrive in a competitive market.

Mark Wagner

Nevertheless, nonprofits can have a countervailing advantage over for-profits in their access to scarce or proprietary resources. These “privileged” resources include pro bono legal support, intellectual property licenses, commercial partnerships, favorable treatment from regulators, access to positive publicity, and invitations to prominent conferences, all of which are more frequently available to nonprofits. For example, many nonprofit

organizations license their intellectual property to other nonprofits through royalty-free licenses that can help start-ups scale up more cost effectively.

Kiva was one of several early crowdfunding platforms that enabled people to make microloans to (mostly) female entrepreneurs in the developing world. In 2010, after being featured on *Oprah*—an opportunity the cofounders believe they got because their organization was a nonprofit—Kiva went viral, and its net assets tripled within a year.

How One Start-up Did It

To understand how the structured process we've outlined works, let's look at how the founders of FoodCloud, a nonprofit social enterprise in Dublin, approached it. Founded in 2013 by Aoibheann O'Brien and Iseult Ward, a former investment banker and a student at Trinity College Dublin, the organization aims "to transform surplus food into opportunities to make the world a kinder place." To that end, it has developed a software platform, Foodiverse, that connects retailers such as Tesco with charities that will use food that might otherwise go to waste. It also operates a food bank, manages an EU food-security program, and connects surplus food from wholesalers with charities. FoodCloud competes with several successful for-profit start-ups focused on food waste, including Olio and Too Good to Go, which have each received tens of millions in venture capital funding.

In terms of *market readiness,* FoodCloud clearly targets an emerging market that is being rapidly shaped by regulation and corporate commitments to climate change. As food retailers seek to reduce their waste for both moral and environmental reasons, they're turning to outside providers for assistance. FoodCloud also anticipates that a growing number of laws will require that discarded food be composted rather than sent to landfills.

Founders and their advisers should anticipate that some of the decision factors may be in tension with others.

But because the market is still forming, there is *no established customer* and *little willingness to pay for the full cost of the service* at either the charity or the consumer end. So it was important for FoodCloud to partner with Tesco to understand ways to enable the distribution of surplus food without focusing on unit costs or on prices, which currently don't cover the cost of support and operations at FoodCloud.

In terms of *available capital,* FoodCloud also operated in a very different market for venture capital than Olio and Too Good to Go, which are both London based. According to Statista, in 2021 €34.9 billion of venture capital was invested in the UK, while only €1.6 billion was invested in Ireland. Though there are also far fewer venture philanthropists in Ireland relative to in the UK, O'Brien and Ward bet that a nonprofit social enterprise would be able to tap into enough philanthropic funding and corporate sponsorships to develop a proof of concept. Sure enough, Social Entrepreneurs Ireland, a venture philanthropy fund, and AIB, a leading bank in Ireland, provided critical grants in FoodCloud's early days.

Finally, FoodCloud's status as a nonprofit has allowed the founders to put mission first and *attract world-class talent* that is passionate about helping fight food waste and climate change. The operations director at FoodCloud previously worked in the supply chain at Tesco; the head of international partnerships was recruited from a large food retailer in Ireland after stints at Asda and Walmart; and the commercial and finance manager had spent more than two decades in finance and leadership positions at Thomas Cook Ireland. Each person on the senior team left a much larger organization with higher compensation to join FoodCloud.

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So far, FoodCloud is off to a flying start as a charity. In 2021 it redistributed more than 16,000 tons of surplus food in partnership with Tesco, converting it into 39 million meals and avoiding 52,000 tons of carbon dioxide emissions. Its status as a nonprofit was pivotal in persuading Tesco to try its nascent technology in a Dublin store in the early years. The opportunity to test a product with one of the world's largest food retailers was also a result of its strong technical capabilities, its focus on mission ahead of margin, and an ambitious vision of "a world where no good food goes to waste."

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As venture philanthropists and impact investors continue to seek both social and financial returns, it is up to entrepreneurs to make the crucial decision about whether to organize as a nonprofit or a for-profit and which kind of capital to raise. We think that a disciplined approach to making those choices as early as possible will serve founders well. But even with a framework, the decision may sometimes be murky. Founders and their advisers should anticipate that some of these factors may be in tension with others. For example, the team may be highly motivated by a social mission when the most readily available source of funding is from venture capitalists. So we encourage founders to anticipate where the market, the customers, the capital, and the talent will be in the next three to five years and carefully weigh their own motivations for having started the enterprise in the first place.

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Cait Brumme is the CEO of MassChallenge, a nonprofit accelerator that connects start-ups with experts, corporate partners, and communities.

BT

Brian Trelstad is the Joseph L. Rice III Faculty Fellow at Harvard Business School and a partner at Bridges Fund Management, an impact investing fund.

@trelstad