THE LENDING OPPORTUNITY
of a GENERATION

FAQs and Case Studies for Investing in Businesses
Converting to Worker Ownership
The Lending Opportunity of a Generation: Worker Coop Conversion Financing FAQs and Case Studies

ABOUT COOPERATIVE FUND OF NEW ENGLAND
The Cooperative Fund of New England (CFNE) is a Community Development Financial Institution founded in 1975. Its mission is to advance community based, cooperative and democratically owned or managed enterprises with preference to those that serve low income communities through the provision of prompt financial assistance at reasonable rates; provision of an investment opportunity that promotes socially conscious enterprise; and development of a regional reservoir of business skills with which to assist these groups. For more information please visit www.cooperativefund.org.

ABOUT PROJECT EQUITY
Project Equity’s mission is to foster economic resiliency in low-income communities by demonstrating and replicating strategies that increase worker ownership. We envision a future where communities (re)gain economic self-determination and today’s working poor have good jobs that keep them out of poverty and enhance their lives. We see cooperatives and employee ownership as key elements of this future. For more information please visit www.project-equity.org.

ABOUT DEMOCRACY AT WORK INSTITUTE
The Democracy at Work Institute advances worker ownership as a strategy to create a fairer economy and better jobs, build local wealth, and retain businesses in communities. Created by the US Federation of Worker Cooperatives, the Institute brings both a national birds-eye view and an experiential on-the-ground understanding of cooperative business. Through strategic research, organizing and capacity-building training, we are working to bring the worker cooperative movement to scale to effect transformative change for individuals and communities throughout the country. http://institute.coop.

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PHOTO CREDITS

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DISCLAIMER
This information is not intended to constitute legal or accounting advice and should not be relied upon in lieu of consultation with appropriate legal or accounting advisors in your own jurisdiction.
Worker-owned cooperatives bring tremendous benefits to workers, to businesses, and to society more broadly, but are highly underrepresented and misunderstood in the U.S. today. This paper is designed to prepare lenders to take advantage of the convergence of two opportunities. The first is a forecasted $10 trillion business lending opportunity from baby boomer business owner retirements over the next 5-20 years. The second is the opportunity to scale the community impact of worker cooperatives by “converting” successful existing businesses to worker ownership.

In the Lender FAQs and Conversion Financing Case Studies that follow, we aim to provide a basic overview of worker coops, call out the key differences in their financial statements and tax treatment, outline what it takes to transition (“convert”) a traditionally-structured business to a worker-owned coop, explain how financing these transactions works (both conceptually and through five recent case studies), and walk through the 5 C’s of Credit for these types of deals.

A worker cooperative conversion is similar to a management buy-out, but instead of just a few key managers purchasing the business, most or all employees are offered an equal ownership stake. A conversion has three basic components: (1) The creation of a worker-owned cooperative business entity; (2) A transaction to sell the existing business (or its shares or assets) to the worker coop, typically financed by a group of lenders that includes the selling owner; and (3) A transition of roles and culture among the new worker-owners to run it under democratic governance.

A coop conversion is an ownership transition, a time of change for the business. As with any significant transition, it needs to be effectively implemented. Lenders can partner with technical assistance providers to both help prepare the business for the transition, and provide ongoing training and support after the transaction.

Like financing any small business, financing options for worker coop conversions include a combination of debt and equity—coming from worker-owners or outside investors. Most worker coop conversions have been primarily debt-financed from a variety of sources, including banks, CDFIs, vendors, the selling owner, members, and individuals from the community. However, equity financing is increasingly being utilized through issuing non-voting equity shares, including Direct Public Offerings (DPO). Existing lenders with coop financing track records bring experience both with coop lending and with coordinating various lenders in a deal, so they can be a great option to coordinate deals requiring multiple lenders. The five enclosed Case Studies demonstrate specific examples of how financing has been structured.
With respect to coop accounting, there are two main areas that differ from that of a typical business:

- **The balance sheet**: Each worker-owner “buys in” to the coop at the time of conversion and receives a single voting equity share. The value of the combined buy-ins becomes equity, tracked in the individual capital account of each worker-owner. The cooperative’s bylaws provide for how members can redeem the equity in their Capital Accounts. When a worker-owner leaves the cooperative, typically their Individual Capital Account (equity) is paid out over a period of years. Equity redemptions are often subordinated to lenders’ rights.

- **How profits are taxed**: A worker coop can qualify to receive single tax treatment (also called pass through treatment) for profits generated by and allocated to worker-members based on hours worked or some other measure of their labor contribution. Coops can retain this allocated surplus in the business through member (worker-owner) equity accounts instead of paying it all out in cash to worker-owners. This retained patronage is tracked as equity.

Underwriting coop conversions follows the same principles as underwriting other small businesses, with a focus on the 5 C’s of Credit framework:

- **Capacity**: Is the applicant able to repay the loan through operations? Very similar to other small business underwriting, this involves reviewing past and projected financial statements, assessing whether projections are in line with historic trends and business plans, and whether projections demonstrate enough post-expense cash flow to service all of the debt. Conversion financing is different from a typical working capital loan, however, because the business is typically financing 80% - 100% of its market value. Despite the large leverage amount, we have data from other comparable transactions in the Employee Stock Ownership Plan (ESOP) field showing that ESOP companies have a very low default rate (0.5% according to the National Center for Employee Ownership). Subordinate financing, including from the seller, can be restructured if needed in the future.

- **Capital**: Is the applicant taking on sufficient risk of failure? Consider not only member equity and loans, but also other sources that may come into play given the community-oriented nature of coops, including outside equity, contributions and grants, and subordinated debt. In coops with many worker-owners, pay attention to how member equity enters and leaves the coop and confirm that redemption of equity to exiting worker-owners is subordinate to all lenders’ rights. Bylaws can clarify that equity can be redeemed over a period of years, rather than immediately, to help alleviate cash stresses.
• Collateral: If things don’t go as planned, how will the lender be repaid? The main difference is the availability of personal guarantees, an often standard requirement even if collateral fully covers the debt amount. This can be a challenge to enforce and collect in a worker coop, since many individuals each own a small part of the business. If unable to collateralize the loan using only business assets, limited loan guarantees can play an important role, for example from the selling owner or top management, or from other stakeholders that recognize the community benefit of worker coops.

• Character: If the applicant is able to repay, will they? Traditional lenders use credit scores to assess the character of loan applicants, harder in a coop with many owners. Instead, consider: the commitment of the worker-owners to developing an ownership culture; the attractiveness of ownership to the workers based on the percentage of workers who will become owners; the skill and experience in governance and management within the coop (or long-term commitments by external advisors to develop this capacity); and the strength and depth of leadership within the organization.

• Conditions: What broader economic context might impact the borrower? This involves looking at trends in the economic sector and the geography of the applicant, and is largely the same for coops as for traditional businesses.

To get involved in financing these deals, lenders can partner with one of the dozens of organizations across the U.S. that is working to identify candidates for conversions to worker ownership. By doing so, lenders can participate in pre-vetted deals that have a built-in business support network. These same organizations can support lenders’ current banking clients in assessing fit with their succession goals, and whether a conversion is feasible. Then, if the owner decides to pursue a conversion, the lender’s existing relationship with the owner may make the financing process easier.

To participate without being the primary lender, the most hands-off approach with the most diversified risk portfolio is to invest in existing cooperative banks or loan funds. The Cooperative Fund of New England, Local Enterprise Assistance Fund, Shared Capital Cooperative, The Working World, and other cooperative-specific lenders offer this type of investment option. Alternatively, an investor could co-lend with an experienced coop lender, drawing up their own loan documents with the borrower, and signing an inter-creditor agreement with the coop lender to clarify the rights of each lender.

We hope that this resource serves to 1) “demystify” lending to worker coop conversions, 2) help lenders tap the dual opportunity of baby boomer business owner retirees and 3) expand worker ownership as a strategy for strengthening our local economies.
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The organizations that authored this resource are members of Workers to Owners, a national collaborative of finance institutions, cooperative developers, employee ownership advocates, legal professionals, and other organizations committed to bringing worker ownership to scale through conversions of existing businesses. Learn more at http://www.becomingEO.org.