# ADDRESSING THE RISK CAPITAL GAP FOR WORKER COOP CONVERSIONS

## Strategies for the Field to Increase Patient, Risk Capital

project {EQUITY}

# ABOUT

## ADDRESSING THE RISK CAPITAL GAP FOR WORKER COOP CONVERSIONS
STRATEGIES FOR THE FIELD TO INCREASE PATIENT, RISK CAPITAL

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**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. For more information please visit www.project-equity.org.

**ABOUT THE SERIES**
This paper is the second in a two-part series about patient, risk capital for worker cooperative conversions. Read our companion paper, "The Original Community Investment: A guide to worker coop conversion investments."

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# EXECUTIVE SUMMARY

While the impact investing field has taken off in recent years and has influenced mainstream banking priorities, worker cooperatives are not yet a viable option for a typical impact investor interested in 'investing with purpose.'[1] Given the positive impacts that worker coops create—including improved company performance and employee wellbeing, what would it take for an investor to be able to easily target part of their investment portfolio to worker-owned cooperatives?

Worker coops are businesses that are owned and governed by—and for the benefit of—their workers. They are different from traditional corporations, whose fiduciary responsibility is focused on maximizing financial benefit to their shareholders. Cooperatives exist in all industries, in every country of the world, and range in size from a handful of members to multinational multi-billion dollar business groups.

However, in the U.S. today, there are only a very small number of worker cooperatives (estimated at 3-400). But with a growing interest and focus on building the field of worker cooperatives, we expect this number to grow significantly in the years ahead. The strategy with the biggest potential for growth is 'converting' existing businesses to worker coops—with the support of appropriate capital—through leveraged employee buy-outs. This is particularly timely given the 'Silver Tsunami' baby boomer retirement wave, as retiring boomers own between half and two-thirds of privately held companies with employees.[2,3]

Ensuring available and appropriate investment capital to support the growing pipeline of investment-ready conversion deals will be critical. Today, the collective pool of lending and equity capital specifically earmarked to support cooperatives of all types is estimated at just shy of $50M; the portion of this targeted to worker-owned cooperatives is likely $25M or less.[4] Though capital of all types is needed, the **biggest capital gap is in patient, risk capital** (regardless of whether it is equity or debt).

There are four main ways that worker cooperatives raise patient capital, and all but the first are available to outside investors (more detail in Appendix C).

1) Member Equity Voting Shares
2) Private offering of Class B Preferred Stock
3) Investment Crowdfunding
    - Direct Public Offering
    - Title III Federal Crowdfunding
    - Investor-Member shares available in some states
4) Indirect Investments through cooperative loan funds

We captured perspectives from investors, loan funds and worker cooperatives about the challenges of raising patient risk capital for worker cooperatives through more than 40 interviews.

## PERSPECTIVES

### The Investor Perspective

*An issue of deal flow and size; low returns, and limited control*

From the investor's perspective, investing either directly or indirectly in coops can prove inefficient or cumbersome compared with other investment options,

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THE ORIGINAL COMMUNITY INVESTMENT
A guide to worker coop conversion investments
A primer for investors

# EXECUTIVE SUMMARY

due to the structure of the cooperative business (along with a lack of understanding of that structure), its modified due diligence needs and the general inability to allocate investments through online investment platforms. Investments in worker cooperatives are low-return investments, and when investing equity, the stock is preferred shares (common voting stock is only available to worker-owners), which typically have no appreciation of the underlying stock value, little-to-no voting rights, and a target dividend rate. For some investors, weighing these challenges against the small size of cooperative investment deals and the capped returns on investment make it less appealing even given the positive social benefits of the model.

### The Loan Fund Perspective

*The need to expand patient capital*

Cooperative loan funds experience a challenge in meeting investors' minimum deal and fund size thresholds given today's pipeline of deals. Their other common challenges are the need to educate investors about the unique aspects of cooperative investments given low awareness and understanding of the model, and the ability to bring in capital that is patient, flexible, and with equity-like terms. Capital is also needed for collateral pools or loan / investment loss reserves to secure investments the funds make in cooperative conversions.

### The Worker Coop Perspective

*The need for coop-specific TA, the cost of issuing equity, and undercapitalization*

It is harder for worker cooperatives to receive technical assistance from TA providers that understand the coop structure (worker coops have not yet been mainstreamed into most small business TA providers) and that can provide the specific supports needed for raising patient investment capital. It can require more time and cost for worker coops to figure out how to issue equity shares than for a traditionally-structured business, and more effort to find a match with investors. These factors help lead to a capitalization gap in equity or equity-like capital, which often means that worker coops are undercapitalized, limiting their growth model to bootstrapping. Depending only on loans requires demonstrating strong cash flow; getting to strong cash flow can often require a capital infusion.

## FIVE KEY CHALLENGES AND RECOMMENDATIONS

Through our research, we identified a gap between the supply of investment-ready worker coop deals and the demand for those deals. We outline the following challenges and associated recommendations, and discuss each of them in detail in the full paper:

1) Low and fragmented supply
2) Unconventional business model with unfamiliar risks, customized underwriting and high transaction costs
3) Fragmented demand
4) Constrained returns
5) Need for impact data

Our recommendations highlight the many challenges—and opportunities—that exist in sourcing appropriate patient, risk capital to support the expansion of worker coop conversions. This marketplace first needs an increased supply of investor-ready deals (larger, profitable companies), which we expect will attract more capital on its own.

Additionally, being able to effectively tap larger sources of capital requires loan or investment funds to already be big (for example, the set up costs to be traded on electronic platforms are prohibitively high for small funds). One key question is about how to approach this conundrum. Is forward investment viable by the smaller CDFI funds to get registered on the standard investor platforms (perhaps supported by philanthropy)? Or could dedicated impact investors help grow the funds to the size where this investment makes financial sense on its own? Or, is the growth in supply of investment-ready coop deals enough on its own to attract the increased investment?

Another major question is about the need for an equity fund. Today, there is only an estimated $25M for worker coop investment in existing coop loan funds (with projections of growth in the coming years as the funds hit their capital raising goals). And, most of this capital is placed as debt. Could we come together as a field and launch an equity fund (utilizing existing infrastructure)—or networked local equity funds—to

# EXECUTIVE SUMMARY

| CHALLENGE | RECOMMENDATIONS |
|---|---|
| **1. Low and fragmented supply** | ✓ **Grow pipeline** of increasingly larger deals<br>✓ Focus efforts on **target sectors**<br>✓ Increase **Technical Assistance** to improve deal quality |
| **2. Unconventional business model with unfamiliar risks, customized underwriting and high transaction costs** | ✓ Existing coop-focused CDFIs play **market-making role**, including education and awareness raising<br>✓ Leverage **first loss capital**<br>✓ Streamline the **syndication and underwriting processes** |
| **3. Fragmented demand** | ✓ **Raise more** patient capital funds<br>✓ Aggregate demand through **existing funds**<br>✓ Create a **national equity fund**<br>✓ Create networked **local community equity funds** |
| **4. Constrained returns** | ✓ Augment with **social return reporting**<br>✓ Create **first loss** pools<br>✓ Consider **royalty financing** when it's a fit<br>✓ Consider **hybrid models** with limited voting for equity holders |
| **5. Need for impact data** | ✓ Develop standardized **social impact metrics**<br>✓ **Track** social and financial performance |

invest in companies pre-conversion to set them up for an exit to employee owners?

Expanding this marketplace also requires a continued, ongoing effort to raise the profile of worker coop conversion investments. Increasing familiarity increases comfort, which in turn reduces perceived risk. By standardizing impact metrics, then tracking them to demonstrate the impact, we can strengthen the ability to raise patient capital. And finally, we must stress the importance of quality technical assistance, both to identify investment-ready deals, and to move these transactions from 'each one is unique' to a more standard approach with predictable deal costs and timelines. Quality post-transaction TA also provides investors a level of assurance that the transition to effective cooperative governance and ownership culture results in solid business outcomes.

Communities the world over have utilized broad-based employee ownership to strengthen their local economies, given the many benefits of this business model. Appropriate capital is key to the growth of the worker coop sector, and to worker coop conversions in particular. We hope that the analysis and recommendations in this paper are helpful for moving the field forward, and that capital providers and practitioners alike can continue their coordination with an explicit focus on growing the marketplace for patient, risk capital.

[1]According to a recent report on impact investing by B-Lab, "Increased demand in impact investing has Wall Street taking note: Financial giants including BlackRock and Goldman Sachs recently established impact-investing units". Murray, Sarah. "Investing for Good", B Magazine, Winter 2016/2017 Edition.
[2]Rosenberg, Joyce M. (15 May 2013). Retiring boomers driving sales of small businesses. CNSNews.com. http://www.cnsnews.com/news/article/retiring-boomers-driving-sales-small-businesses
[3]Fink, Billy. (25 June 2013). Will Private Equity Inherit Baby Boomer Businesses? Axial. http://www.axial.net/forum/baby-boomers-deal-flow/
[4]The $50M figure represents capital for the purpose of lending to cooperatives of all types; the authors estimate that the capital specifically available for worker cooperatives is $25M or less. Data on size of cooperative loan fund pool is estimated by author based on original research surveying and interviewing the five CDFI Cooperative loan funds, 2015-2016. For a more complete picture, please refer to the chart in the appendix, "Current and Potential Sources of Capital for Worker Coops."