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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INTRODUCTION

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] In other words, while assets under management in the United States' impact investment space have grown to $15.2B, only a tiny portion of those investments are going into worker-owned cooperative businesses.[2] What would it take for an investor to be able to easily target part of their investment portfolio to worker-owned cooperatives, to 'mainstream' the practice of investing in worker cooperatives?

Worker cooperatives provide a myriad of benefits. For worker-owners, benefits include better paying jobs, asset and skill building, and enhanced control over their work lives. For businesses, benefits include reduced employee turnover and increased profitability and longevity. For society more broadly, worker cooperatives foster social innovation, expand access to business ownership, and train people in democratic practices. Worker coops are also positively correlated with many health and other social benefits.[3] However, in the U.S. today, there are only an estimated 3-400 worker coops.[4]

Converting existing business to worker coops through a leveraged employee buy-out—**with the support of appropriate capital**—has the biggest potential to significantly grow the worker coop sector in the U.S., especially by tapping the baby boomer retirement wave, dubbed the 'Silver Tsunami.' There will be a dramatic shift in the landscape of local business ownership as baby boomers retire. It is estimated that boomers own between nearly half and two-thirds of privately held businesses with employees—or four million companies, leading to forecasts that "trillions of dollars of value are going to change hands in the next 10 to 20 years." [5,6]

Cooperative developers the world over agree that a successful cooperative ecosystem—like Spain's Mondragón cooperative network, Italy's Emilia Romagna region, or Quebec's cooperative financing ecosystem (wielding nearly $200B in assets across five institutions)—has a large-scale source of capital to support it. Yet in the U.S., the estimated 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.[7]

As the pipeline of investment-ready deals for these 'conversions' grows in the coming years, available capital will also need to grow. A range of capital sources is needed, with a concerted effort needed to grow patient, risk capital, regardless of whether it is equity or debt:

- Junior/subordinated debt with a longer loan horizon (7-10+ years) and the ability to go for a time period without making principal payments
- Mezzanine financing
- Equity financing (preferred stock*)

In traditionally-structured businesses, patient risk capital is most often in the form of equity, though debt and hybrid debt-equity vehicles are also used. This type of capital provides flexibility and ensures that the business isn't over-burdened by debt servicing. And, having equity on the balance sheet can help bring lenders in to the deal. Preferred stock (the only type of stock that can be sold to outside investors in a worker coop) can be seen by sophisticated lenders as a form of mezzanine financing, freeing up hard assets and cash flow as collateral.[8]

There will be a dramatic shift in the landscape of local business ownership as baby boomers retire... Trillions of dollars of value are going to change hands in the next 10 to 20 years.

* In a worker coop, voting stock is issued only to worker-owners. Outside investors can hold preferred, non-voting stock.

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Worker coop conversion buy-outs vs. traditional leveraged buy-outs

As this table shows, worker coop conversions rely almost exclusively on debt financing, whereas traditional leveraged buy-outs have a much richer mix of equity or mezzanine financing.

		Worker coop conversion leveraged buy-outs		Traditional leveraged buy-outs
		Who provides	**% of financing[9]**	**% of financing**
Highest Risk / Return	**Common equity**	• Voting shares are restricted to worker-owners • Often financed by the business through payroll deductions	0-10%	20-35%
	Preferred equity	• Non-voting shares • Private investors (individuals, CDFIs, others)	Historically low usage	6-12%
	Mezzanine financing[10] (debt / equity hybrid)	• Very infrequently utilized	Historically low usage	0-15%
	Subordinated / junior debt	• Selling owner • CDFI • Friends & family • Vendors • Employees	TOTAL: 25-50% Selling owner: 10-20% Other junior debt: 15-30%	15-30%
Lowest Risk / Return (first in line for payback if defaults)	**Senior debt**	• CDFI • Bank	50-70%	30-50%

INTRODUCTION

A recent study focused on place-based impact investment also identified patient, risk capital as a major gap for financing impact deals. The study highlighted the challenges from the perspective of impact investors, finding that,

> "[a] significant gap still remains to connect these impact-oriented investors to the capital needs…. The variety of capital users and needs, as well as the complexity of underwriting, make it operationally difficult for any single investor to tackle the transaction costs required to connect with a specific capital user. Mobilizing new capital will require an efficient marketplace that helps aggregate supply and demand, vet readiness for investment, and deploy capital in various forms."[11]

Through our research, we identified a similar supply-demand gap and set of challenges in the worker coop investment space:

- Low and fragmented supply
- Fragmented demand
- Unconventional business model with unfamiliar risks, customized underwriting and high transaction costs
- Constrained returns
- Need for impact data

This paper, the second in our series of companion publications focused on patient risk capital for worker coop conversions, is targeted at the field of worker coop practitioners, investors, lenders and advocates. In the pages that follow, we will first share some of the challenges to placing investments in worker coop conversions from different perspectives: investors, existing loan funds and worker cooperatives themselves. Then, we will discuss each of the five key challenges we've identified and their associated recommendations, and close with a snapshot of current funds available in the context of impact investing dollars more broadly.

READ OUR COMPANION PAPER

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

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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 worker coops can sometimes prove inefficient and cumbersome compared with other investment options, due to the structure of the cooperative business (along with a lack of understanding of that structure) and its modified due diligence needs. For some, weighing these challenges against the small size of cooperative investment deals and the capped returns on investment make it less appealing, even given the benefits of the model.

Investments in worker cooperatives are low-return investments, and when investing equity, it is in the form of preferred shares (common voting stock is only available to worker-owners), with no appreciation of the underlying stock value, little-to-no voting rights, and a target dividend rate. For example, CERO (a start-up coop), has a 4% targeted dividend for investors.[12] Real Pickles, a pickling business which converted to worker-ownership, also offered non-cumulative 4% returns through their Direct Public Offering. The converted cooperative Namaste Solar offers five-year terms with slightly higher returns, at a 6.5% annual target dividend rate. And Equal Exchange, a well-established worker cooperative with over $64 million in sales, offers investors a target return rate of 5%. Equal Exchange's average return also comes with increased stability—Equal Exchange outperformed the stock market during the great recession from 2008-2010, but 5% is still lower than many investors' target returns.

Family impact investment funds find worker coops very aligned from an impact perspective, but some are challenged by the lack of governance rights that restrict their ability to control their long-term investment in the company (this is less of an issue for short-term investments). Family investment funds we interviewed with spoke of the need to protect their capital, suggesting either through some legal structure that mandates buy-down or refinancing to a loan-like structure.

Working with an intermediary that plays a diligence role could help reduce transaction costs with this unfamiliar model, as would a sector focus that aligns with sector experience of the investor(s), especially if it is a sector that enhances the impact (environmental, etc.). Funds' 'minimum check size' (often $5 or $10M) can also be an issue given the small deal size of most coop investment opportunities today.

When investing in coops indirectly, through loan and equity funds which service coops, investors again run up against a number of barriers. Social impact funds such as Calvert Foundation and ImpactAssets will pool investors' and donors' resources and invest them in cooperatives if the transaction makes sense for them and for the donor. (ImpactAssets manages a donor advised fund, so the process looks a bit different for them). However, after interviewing a number of social impact fund managers, it became clear that even they are not investing in worker cooperatives (with few exceptions) because of the cooperative sector's small size, generally a lack of pipeline / deals in which to invest, and lack of proven return on investment. We forecast that this equation will change as cooperative conversion projects offer investors larger deal sizes.

Justin Conway, Vice President of Investment Partnerships at Calvert Foundation, explained that there aren't many opportunities to invest in cooperatives through the Calvert Foundation's note portfolio unless those coops or coop funds meet or exceed a certain size. At Calvert Foundation, that threshold is generally $10 million in total assets unless other credit enhancements are involved; at other investment funds the minimum can be much larger. Some investment entities do not have a minimum

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investment size—like at Pi Investments, which invests on behalf of a single family, co-led by Morgan Simon and Aner Ben-Ami. While their process is more flexible, Simon still identified a number of reasons why they tend to invest in funds rather than investing directly in coops—taking advantage of the potential for scale, local or regional knowledge, and specific coop development expertise that funds tend to offer. Pi has made commitments to a few cooperative CDFI loan funds, including The Working World and Shared Capital Cooperative, and intends to continue doing so in the future.[13]

Investors are more likely to place their money into CDFI loan funds that meet the following conditions:

- Tradable on the electronic retail market (requires having a CUSIP #)
- Insured by the FDIC
- AERIS-rated (a CDFI impact rating service for investors)

Many of the existing CDFI cooperative loan funds do not meet all of these conditions, which leaves many traditional investors deciding to put their money into easier or 'safer' investment vehicles that fit the low risk, low return asset class.

For example, Rosalie Sheehy Cates of Philanthropy Northwest describes one challenge from the investor's perspective of investing in CDFIs in an article in Shelterforce. Note that this is a generic comment about CDFIs, not specific to any of the coop loan funds listed in this paper.

> Community development investments are often offered through esoteric, non-standard loan documents that are not electronically handled. Most modern investments are accomplished with a few keystrokes online. In contrast, CDFIs use the mail and fax machine to offer and execute loan documents that are completely unfamiliar to most investors. Further, if the investor works through a professional advisor, the advisor must manually track the status of the investment and add it to their client's overall portfolio. This kind of labor of love has very low acceptability in the conventional investor market.[14]

David Henry, Community Investment Portfolio Associate for Trillium Asset Management, emphasized the need for those funds to "find ways to make it easy for larger investors to purchase their notes" by registering as a security through the Depository Trust Company (DTC). Registering with the DTC is discussed in further detail later in this paper.

In 2016, the Foundation for Enterprise Development (FED/ fed.org) initiated a landscape study to explore the potential of investing its financial assets in such a way that furthered its mission–promoting broad-based employee ownership. Their research shows that employee or worker ownership is not an explicit criterion used commonly in the impact investing community; however, they found that there are some real opportunities in mutual funds with 'Best Place to Work' and/or other employee-based criteria, and with Community Development Financial Institutions (CDFI) Investment Notes with a strong consideration for worker cooperatives. Future opportunities may become evident with investing frameworks that consider good jobs, domestic job growth, and financial inclusiveness with workers. As of this paper's publication, FED is preparing a white paper summarizing its findings, which will be available in May of 2017. The paper, titled "Impact Investing: It's Time that Employee-Owned Enterprises are Considered Part of the Income Inequality Solution," is authored by Mary Ann Beyster, president of The Foundation for Enterprise Development.

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THE LOAN FUND PERSPECTIVE

The need to expand patient capital

The most prominent direct lenders to coops—CDFI cooperative loan funds—expressed a number of challenges in recruiting investors. In addition to the constraint of deal / fund size that meets the minimum threshold for investors, their most common challenges seem to be in both (1) educating investors and (2) bringing in capital that is patient, flexible, and with equity-like terms.

> "It's not a choice to seek to grow our funds—it's a need."
>
> Gerardo Espinoza
> Executive Director
> Local Enterprise Assistance Fund

Leaders of cooperative loan funds articulated that more and better communication and education between coop developers and impact investors could create new opportunities for investments. Ideas to foster better education include marketing CDFI notes as the "original community investments"[15] and getting better at measuring, reporting and communicating impact to investors.

There is a clear need for both coops and coop loan funds to receive more patient, flexible investments with longer terms to provide the flexibility that equity capital typically provides. Such monies could be used in a collateral pool or loan loss reserve to secure loans that such funds seek to make in cooperative conversions. Micha Josephy of the Cooperative Fund of New England reflected on CFNE's collateral pool (the Cooperative Capital Impact Fund), set up to offset possible shortfalls and risks of their larger conversion deals: "If there's a way to communicate to the investment world the need for this pool, along with the risks and potential rewards of investing in it, that would be game-changing."[16]

A collateral or loan loss reserve pool can serve to supplement worker-owner equity and seller junior loan financing (other forms of patient capital), but these deals still need additional patient capital. Christina Jennings of Shared Capital Cooperative shared these sentiments, asserting that in order to close large conversion deals, Shared Capital needs larger investments with longer time frames to provide the level of liquidity required for such deals. Jennings' goal is to grow Shared Capital's fund to $20 million over the next three to four years, and she sees conversions being a large part of their upcoming portfolio.[17]

Brendan Martin of The Working World also aims to grow their fund to $20 million over the next several years, and he confirmed that there are more than enough conversion deals in the pipeline to meet that demand.[18] Finally, Gerardo Espinoza, Executive Director of the LEAF Fund, highlighted the need in many deals for mezzanine debt—financing that is subordinate to senior debt and acts like equity—in order to close on the types of larger ($5M and up) deals that he's seeing in the conversion deal pipeline.[19]

Fortunately, some investors are already aware of this increased need for mezzanine capital and subordinated debt for large conversion deals, are taking steps to provide that capital. According to Alison Powers at Capital Impact Partners, "We're hearing from partners that there's a capital gap for larger conversion deals, and we'd like to see how we can help fill that gap."[20]

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THE WORKER COOP PERSPECTIVE

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

The challenge of the cost and time needed to issue equity shares—whether Class B or direct investments via crowdfunding—was a concern raised by a handful of worker-owners who have used these instruments. These challenges are not unique to worker cooperatives; they apply to all businesses raising equity capital.

Daniel Fireside, Equal Exchange's Capital Coordinator, explains that in order to sell shares to even a single non-accredited investor, a company must produce a comprehensive disclosure document similar to a stock prospectus. The company is prohibited from advertising the stock or any other form of publicity that could be considered 'public solicitation,' including discussing the offering on social media, newsletters, or packaging. Further, the company is limited to accepting investments from a maximum of 35 unaccredited investors per offering, and cannot have more than 500 such investors in total. According to Fireside, it can cost tens of thousands of dollars to prepare the required documents for each private placement offerings, although Equal Exchange has managed to reduce those costs substantially after conducting so many offerings during its nearly 30 years of operation. It is worth noting that in large part because of the challenges in selling Class B preferred shares, Equal Exchange freely shares its offering document templates with other worker cooperatives interested in making similar offerings. For example, Equal Exchange consulted Namaste Solar and shared tips and learnings prior to Namaste's first Class B Shares Offering.

Cooperatives nonetheless offer Class B preferred shares to investors for the compelling reason of raising millions in liquidity and still being able to maintain full control and rights of the company. This was reason enough for Namaste Solar. After converting to a worker coop in 2011, Namaste decided to offer Class B preferred shares using the Equal Exchange model starting around 2013. Namaste financed the conversion transaction through loans, but the company had a hard time obtaining loans with favorable rates. Blake Jones, Namaste's President & CEO at the time of their conversion, cited that the ability to later bring in Class B Shares as a major benefit to converting to worker ownership, "[Becoming a cooperative] enabled us to accept external investors without sacrificing internal control."[21]

Stacey Cordeiro, of the Boston Center for Community Ownership and a key organizer assisting the CERO Cooperative, noted the challenges of their Direct Public Offering (DPO): it took nine months to get CERO on a platform to start receiving investments, legal fees were $20,000, and it required a big time investment by the members to file paperwork with the secretary of the Commonwealth of Massachusetts.[22]

Nonetheless, Cordeiro does recommend the DPO model, in her words, "for people who don't have other options for equity investment. Additionally, while CERO is considered a high-risk investment, spreading that risk among many small investors is a strategy for CERO to raise capital that, in one lump sum, may have been denied by most individual investors."[23] Others have had big success raising investment dollars through a DPO—Real Pickles was able to raise $500,000 through their DPO in just two months from 77 investors, in large part due to their extensive network of customers and supporters gained over their 11 years in business.[24]

The challenge of investment readiness is one that many coops and cooperative developers can relate to. According to Margaret Lund, a consultant and cooperative developer with over twenty years' experience in financing and underwriting for cooperative businesses,

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"A lot of thinking needs to go into better financial modeling and better business planning for cooperative businesses. Particularly when a coop has no industry-specific benchmarks to look to for guidance, no examples of other successful coops in the same sector to look to for guidance on successful business practices, it will be just that much more difficult for that coop to convince potential investors and lenders that their plans are realistic. A one-off project here and there is a risky strategy, for members as well as investors."[25]

As is the case with all start-ups, many start-up worker cooperatives fail after their first two to three years. However, because coops struggle to attract equity-like capital, their growth models are restricted by being undercapitalized, limiting them to bootstrapping. Getting loans requires demonstrating strong cash flow; getting to strong cash flow can often require a capital infusion. Micha Josephy of the Cooperative Fund of New England stated,

"The biggest problem I see in scaling up the worker cooperative sector is that of pipeline development—that there aren't enough cooperatives that are ready to take in significant investments because the process to get to that point takes years—and, in the absence of significant support from a coop developer, requires workers to be ready to sacrifice years of their life. They need to be dedicated to strong business planning, and make serious investments (time and money) into marketing and feasibility research. We need philanthropic or other high risk money going into providing these expert services for worker coops."[26]

The importance of investment readiness holds true for any business. Until worker cooperatives are more broadly integrated into mainstream business assistance services, and can access capital that addresses their undercapitalization, coop-specific technical assistance (discussed further below) is needed to bridge this gap.

RECOMMENDATIONS

FIVE KEY CHALLENGES AND RECOMMENDATIONS	
CHALLENGE	**RECOMMENDATIONS**
1. Low and fragmented supply	✓ **Grow pipeline** of increasingly larger deals ✓ Focus efforts on **target sectors** ✓ 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 ✓ Leverage **first loss capital** ✓ Streamline the **syndication and underwriting processes**
3. Fragmented demand	✓ **Raise more** patient capital funds ✓ Aggregate demand through **existing funds** ✓ Create a **national equity fund** ✓ Create networked **local community equity funds**
4. Constrained returns	✓ Augment with **social return reporting** ✓ Create **first loss** pools ✓ Consider **royalty financing** when it's a fit ✓ Consider **hybrid models** with limited voting for equity holders
5. Need for impact data	✓ Develop standardized **social impact metrics** ✓ **Track** social and financial performance

CHALLENGE #1: Low and fragmented supply

Recommendations

- ✓ **Grow pipeline** of increasingly larger deals
- ✓ Focus efforts on **target sectors**
- ✓ Increase **Technical Assistance** to improve deal quality

GROW PIPELINE OF INCREASINGLY LARGER DEALS

It's hard to attract more investors when there aren't many deals (and certainly not many large, quality deals) to invest in. Over and over in our interviews, we were told that a strong pipeline of worker coop conversions made up of profitable, stable and larger companies (ideally alongside proof points of the financial success of these investments, see the Impact Data section below) is the most critical effort. Gerardo Espinoza, Executive Director of Local Enterprise Assistance Fund (LEAF) based on Boston summed it up by saying, "If the quality deals are there, the capital will follow."[27]

At the time of this paper's publication, we are seeing growth in the pipeline as more conversion deals come to the financing stage, but supply has not yet outstripped current demand (even though some funds

> "If the quality deals are there, the capital will follow."
>
> Gerardo Espinoza
> Executive Director, LEAF

RECOMMENDATIONS

do have more deals than they can finance). We're seeing at least a doubling or tripling of the top of the pipeline this year compared to years prior through the Workers to Owners collaborative of organizations focused on conversions, and that doubling will likely happen again next year. As practitioners continue their efforts to grow the pipeline, these numbers will continue to increase.

We advise practitioners to focus their pipeline development effort on converting companies larger than 'micro' size (upwards of at least 20 but ideally 50 or more employees). Larger companies with proven track record of revenue generation and profits are more attractive to investors of all types. Their conversions also create a greater number of new worker-owners, thereby increasing the social impact, especially when focusing in low-wage sectors. We also recommend a focus in a small number of targeted sectors (increasing over time). Sector expertise is important to make more informed due diligence and therefore investment decisions. Plus, some investors have their own sector focus, which can help match investor interest.

FOCUS EFFORTS ON TARGET SECTORS

Coop funds and coop developers should partner more explicitly to hone in on specific geographies and sectors, and increase the joint capacity and expertise to develop pipeline, structure deals and support effective conversions. This tighter communication and collaboration could take place through the Workers to Owners collaborative, a collaboration of leading organizations across the country that are focused on worker coop conversions (Project Equity, this paper's author, is an active member and a part of the collaborative's steering committee).

Honing in on target sectors shouldn't exclude expanding the numbers of conversions outside of these target sectors, but instead has a goal of more systematically helping to build out the field's expertise. Additionally, we believe that a focus within sectors will help spread awareness and interest more effectively by creating reference companies that selling owners can look to ('companies like mine') and by spreading through word of mouth. The growth of interest among solar companies (see call out box on next page) is one example of how this has been effectively done, in large part through the leadership of key individuals like Blake Jones at Namaste Solar (a worker-owned cooperative).

INCREASE TECHNICAL ASSISTANCE TO IMPROVE DEAL QUALITY

Finally, ensuring quality technical assistance is critical for deal quality. Practitioners focused on pipeline development and deal support must continue to get better at identifying quality conversion candidates, as well as streamlining the processes, timeline and cost of the transaction support. Quality TA can attract investment capital by the reducing perceived risk of deals and creating a more predictable cost and length of time to transaction. And when the TA provider stays on to support the company post-transaction, this can serve as insurance for investors, knowing that there is outside support to help the company with the employee ownership transition. Philanthropic or government funding for TA providers to complete feasibility studies and provide technical assistance can mobilize greater investment capital.

According to Chris Cooper of the Ohio Employee Ownership Center, the OEOC has tapped different government funding sources for pre-feasibility studies over the years. From 1998-2010 (with minor interruptions), the state of Ohio had a Pre-Feasibility Study Grant Program that provided matching funds to business owners interested in exploring viability of a sale to their employees, either through an ESOP or a worker-owned coop. The program was initially funded under the Ohio Bureau of Employment Services (OBES), then the federal Job Training Partnership Act (JTPA), and then finally through Workforce Investment Act (WIA) funds in its final years. The program funded on average 4-5 studies per year, and helped the OEOC to transfer some or all of the ownership stakes in 19 privately held companies to some form of employee ownership (primarily ESOPs). During the Great Recession, at least in Ohio, JTPA / WIA / DJFS funds that may have otherwise gone for a pre-feasibility study grant program were redirected towards support, retraining, and re-education programs for displaced workers, which at the time was considered a higher budgetary priority.

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In addition, from 2000-2001, with extensions for 2002-2003 a small congressional budget initiative (sponsored by Ohio Congressman Tom Sawyer and funded via the Department of Labor) created a national counterpart to this program called the National Steel and Aluminum Retention Initiative (NSARI). Over the course of four years, the Program provided similar funds for studies for companies in the Steel and Aluminum industries that were suffering from systemic economic conditions that made US companies less competitive. The OEOC administered this program in partnership with the Steel Valley Authority (Pittsburgh Pennsylvania), the Center for Labor & Community Research (Chicago Illinois), the Business Retention & Expansion Program (Washington State), and the ICA Group (Boston Massachusetts).[28]

SOLAR AMICUS COOPERATIVE

STRONGER TOGETHER.

SOLAR: A CASE STUDY OF HOW SECTOR FOCUS SPREADS INTEREST

Amicus Solar Cooperative is a purchasing cooperative with 40 member businesses, all of which are solar PV development and installation companies. Amicus has made an explicit effort to educate its member businesses about worker cooperatives. With four worker coops already among their membership, they currently have two additional businesses that are in process of transitioning to a form of employee ownership.

CHALLENGE #2: Unconventional business model with unfamiliar risks, customized underwriting and high transaction costs

Recommendations

- ✓ Existing coop-focused CDFIs play **market-making role**, including **education** and awareness raising
- ✓ Leverage **first loss capital**
- ✓ Streamline the **syndication and underwriting processes**

EXISTING COOP-FOCUSED CDFIs PLAY MARKET-MAKING ROLE

We are in a fortunate position in the U.S. to have five well-established and experienced loan funds that are explicitly or exclusively dedicated to worker coops, and have deep expertise in worker coop conversion financing. They are all Community Development Financial Institutions, or CDFIs, lenders granted this status by the U.S. Treasury that qualifies them for some types of federal support, and with a mission to help historically disinvested communities join the economic mainstream. Opportunity Finance Network (the membership organization for CDFIs) has an easy-to-use searchable database of CDFIs nation-wide.[29] More detail on each of the cooperative loan funds is in the Appendix.

National

- Local Enterprise Assistance Fund
- Shared Capital Cooperative
- The Working World

Regional

- Common Wealth Revolving Loan Fund (CWRLF)
- Cooperative Fund of New England

These loan funds have played (some for 40+ years) and continue to play incredibly important leadership roles. Their leadership can and should continue, and their growth should mirror that of the sector as a whole. These funds can exercise their leadership to expand the market by:

RECOMMENDATIONS

1) Raising awareness and educating peers and other investors
2) Leveraging first loss capital to help other investors gain familiarity and experience with coop investments and reduce their sense of perceived risk
3) Leading an effort to streamline the syndication and underwriting processes for these investments

Education and awareness-raising
A more systematic approach to awareness-raising is needed to help investors better understand coop conversions. The impact investing community, by and large, is not talking about the cooperative model in their investment criteria. Impact investors who want to see jobs stay in their community, income inequality addressed, and the many other benefits of worker cooperatives take hold, may not today know how to put their money to work to achieve these impacts. What if that changed? What if cooperative leaders were more visible and vocal in these networks?

Some of the most needed education is to dispel myths about the cooperative model. Margaret Lund, a consultant and cooperative developer with twenty years' experience, sees peer-to-peer education as the most effective path. "When a socially-minded investor can tell his/her colleague about investing in cooperatives, that education goes a lot further than when unknown cooperative developers walk into a room and say the same thing."[30] One way that peer-to-peer education could take place is through sessions at investment conferences paired with personal invitations and outreach. Also, targeting local, nationally networked mission-aligned investment clubs (like Slow Money and others) could be channels for reaching engaged, mission-aligned investors.

Ben Selden from LEAF identifies the need for increasing general awareness among investment managers of local investment allocations as a substitute for fixed income or some small allocation of alternative investments. "This way the lower return, higher risk, and poor liquidity are somewhat neutralized on the basis of scale (i.e. if only 0.5% of a portfolio is in local investments, liquidity does not seem as critically important)."[31]

Our companion paper, The Original Community Investment, is targeted for investors and includes a set of FAQs and sample term sheets. We hope this can be useful to coop advocates—especially current lenders and investors—to distribute along with other resources through impact investing and CDFI networks and conferences, and other channels. A formalized awareness raising campaign including trainings and workshops targeted at investors could be developed and executed, if funding were available.

FIRST LOSS CAPITAL TO REDUCE UNFAMILIAR RISK

First loss capital serves a number of purposes, and it can be an important tool to help investors gain comfort with unfamiliar risk. In its 2013 publication "Catalytic First Loss Capital,"[32] the Global Impact Investing Network discusses the role of first loss capital:

> There are some markets about which certain sets of investors have far greater knowledge than do others. …Investors unfamiliar with these markets may believe investment risks to be greater than they actually are, and may thus be unwilling to invest. …[Providers of first loss capital] may believe these markets to be commercially viable (or at least very close to being so), and that other investors are misperceiving risk.
>
> The Provider [of first loss capital] is counting on this demonstration effect: if the investment performance is sound, it can lead investors to alter their risk-return expectations and to subsequently re-invest with reduced credit enhancement.

We recommend that coop investors that have first loss capital incorporate an explicit goal of that capital to attract investors who otherwise might not participate in coop investing in order to help them gain familiarity and reduce their sense of perceived risk. Limited loan guarantees can also play an important role, for example:

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- Limited guarantees from the selling owner or top management. These guarantees might expire after a set period of time or cover a fixed amount of the debt.
- Loan guarantee through the USDA Business & Industry Loan Guarantee program:[33] Available for cooperatives in rural locations (as defined by the USDA) and with some exceptions, food-related businesses outside of rural areas. In 2016, the USDA expanded its loan guarantee program to cooperatives, explicitly stating applicability for worker coop conversions. The loan must be done through an eligible lender (most experienced business lenders will be eligible), and the guarantee can be 80% of the loan amount, up to $25M loan value. The ownership transfer must be 100% completed with equal governance rights for the worker-owners (including selling owner if staying on) by Year 5, but the loan can be for a longer term.[34]

Coop-focused lenders have used limited guarantees and have also used a vehicle similar to a CD-backed guarantee, where a guarantor provides a cash investment with a promissory note clarifying that the investment is at risk if the coop defaults. Structuring a guarantee this way provides interest income to the guarantor while assuring the lender that the cash will be available if needed. CDFIs generally provide a higher rate of return on these guarantees than a bank's CD or money market fund rate. Furthermore, if the CDFI is a nonprofit and the guarantee is called upon, the amount is a tax-deductible donation, giving the guarantor favorable tax treatment. This option is not available to all CDFIs, depending on their policies and source of funds.[35]

Small Business Administration (SBA) loans are another potential source of financing that require loan guarantees. The SBA 7(a) loan may be used to "establish a new business or to assist in the acquisition, operation, or expansion of an existing business."[36] Currently, for all SBA loans (including to cooperatives), personal guaranties are required from every owner of 20 percent or more of the business, as well as from other individuals who hold key management positions. As of the time of this paper's publication, there is an effort underway to work with the SBA to find an alternative to the guarantee requirement for cooperatives, to enable the cooperative entity to provide the guarantee.[37]

LEVERAGE AND STREAMLINE SYNDICATION ROLE

Existing coop funds are experienced lead underwriters for coordinating syndicate deals for cooperative conversion financing. They can leverage this role to bring in lenders or investors with less experience in worker coops. As the pipeline and deal volume increases over time, streamlining the syndicate process can make it less costly to all parties. We offer some ideas for consideration by the coop loan funds around standardizing and streamlining in the next section, Challenge #3 under "Aggregate demand through existing funds." By cementing their role as lead underwriters, existing coop funds can continue their leadership role in the sector and protect themselves from competitive pressures by new entrants to the coop investment space.

Tied to the need for investor education, continuing to share best practices about due diligence for worker cooperative deals[38] will help unfamiliar investors who can then gain experience through investing in loan funds or participating in deals syndicated by the more experienced investors. With the long-term goal of mainstreaming, these are steps along the path to mainstreaming coop conversion investment. Philanthropy could play an important role in providing resources for these efforts.

As progress towards mainstreaming coop and coop conversions financing is made (as we hope it will over the coming decade), the field of worker coop financing will go through some shifts that are hard to predict. The CDFI loan funds who have blazed the way as pioneers and long-standing, committed backers of worker cooperatives will grow along with the field and will need to carefully manage their own growth strategies. We recommend a concerted strategic planning process by these funds to cement their roles over the long term given their deep mission commitment to the model, and to ensuring the growth of this model within underrepresented communities.

RECOMMENDATIONS

CHALLENGE #3: Fragmented demand

Recommendations

- ✓ **Raise more** patient capital funds
- ✓ Aggregate demand through **existing funds**
- ✓ Create a **national equity fund**
- ✓ Create networked local **community equity funds**

RAISE MORE PATIENT CAPITAL FUNDS

Having more patient, risk capital can help bring in more capital overall, because it enables less risk tolerant capital to come into deals. For example, there are lenders that very much want to invest in worker coop conversions, but can only come in to the larger deals in the most senior position (for example, Capital Impact Partners or National Cooperative Bank). Existing loan funds have a strong track record of successfully bringing in lenders with lower risk capacity (perceived and real) through their syndicate role.

Increase existing funds' capacity to provide patient, risk capital

Unless they can attract either equity or equity-like capital, funds must lend money out with terms that enable them to cover their own debt service. Existing loan funds can only lend out patient, equity-like capital if (1) they can accept equity investments or (2) they can attract lender investors willing to provide very patient terms.

Increase equity investments in funds that can take them

Of the existing loan funds dedicated to cooperatives, only one is able to accept equity investments. The other loan funds are all nonprofits (which can't accept equity). Shared Capital Cooperative, which is organized as a cooperative association under Minnesota statute, is owned by about 200 cooperatives of all types (not just worker coops) who borrow from and invest in the fund. A little more than half of their total $12.5M in assets comes from the cooperative sector, with $3.5M in equity (cooperatives' member common stock is about $2M; preferred shares is about $1.5M) alongside about $10M in investment notes (loans).[39] Preferred shares have an estimated dividend rate of 2-6%, capped at 8%, and can be redeemed by request and at the discretion of the Board of Directors. Shared Capital allows and encourages coops to convert some of their principal to preferred shares as they pay back a loan.

Shared Capital's structure and approach builds on what is known as 'Principle 6' of the Cooperative Principles, known by its shorthand of "coops helping coops:"

Principle 6. Cooperation among Cooperatives

> "Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional and international structures."[40]

Christina Jennings, Executive Director of Shared Capital shared, "We have strategic vision for growth of our fund in order to achieve greater self-sufficiency and operating efficiencies and to increase our impact. Equity capital is essential for us to reach our targets for growth since equity allows us to leverage other investments." Shared Capital has plans to initiate new equity offerings in 2017 then again in 2018, with the goal of raising $1.5-2 million in each offering.[41]

Attract non-equity patient capital

Nonprofit loan funds are restricted to bringing in capital as debt (there isn't any equity investment possible into a nonprofit), but there are mechanisms for structuring patient debt capital. For example, The Working World has some flexibility in its ability to provide what they call 'non extractive' equity-like loans due to having a first loss cushion.[42] And Cooperative Fund of New England (CFNE) has successfully used a specific fund to provide long-term, patient, equity-like capital in a pilot they ran from 2007-2017. Though this specific fund is closing down (terms of the funds created in 2007 when interest rates were higher are hard to continue in today's low interest rate environment), they are considering other pilot loan products to focus specifically on filling collateral shortfalls and potentially also loan loss reserves following this successful pilot.[43] With less than $500,000 in capital from their Coop Capital Fund, CFNE was able to leverage $18 million of debt, both from CFNE and other lenders.

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Ben Selden from LEAF suggests a targeted effort to raise collateral funds for worker coop loans from cooperatives, leveraging Principle 6. He noted that, "one of our food coop borrowers pooled other food coop's investments in LEAF's fund as collateral, which could potentially also work in the worker coop space, especially if larger worker coops got involved."[44]

Leverage credit union capital
While credit unions have historically had restrictions that make it hard for them to loan to—much less invest in—worker-owned cooperatives, there are some emerging opportunities to increase the ability of credit unions, themselves a form of cooperative, to invest in other coops, including worker-owned coops. At the federal level, legislation to exclude the purchase of residential properties from credit unions' business lending caps has been drafted and recently introduced to our current (115th) Congress. At the state level, there has been a recent (re)discovery of a statute for state chartered credit unions that allows equity investments in cooperatives that has potential to be expanded beyond the eight states in which it currently exists.

Federal legislation
To expand credit unions' capital available to loan to coops, we need to increase the highly restrictive cap on commercial lending under which that the vast majority of credit unions operate. CUNA (Credit Union National Association) and NAFCU (National Association of Federal Credit Unions) developed and introduced bills to Congress in 2015 to change the lending cap from 12.25% to 27.5% of credit union assets. Unfortunately, both of those bills (H.R. 1133 and H.R. 1188) died in the 114th Congress. In January 2017, a new bill was introduced (H.R. 389) by a bipartisan group of representatives that would exclude residential properties from the calculation of the 12.25% member business lending cap currently imposed on credit unions, thus freeing up an additional $11 Billion for small business lending.[45] That legislation is pending at the time of this publication.[46]

State legislation
Matthew Cropp from the Vermont Employee Ownership Center recently rediscovered a little-known credit union statute applicable to state-chartered credit unions in eight states (Arkansas, Illinois, Kentucky, Montana, Nevada, New Jersey, New Mexico and Vermont) that allows credit unions to make equity investments into cooperatives, including worker cooperatives.[47]

> "CFNE successfully piloted our Co-op Capital Fund from 2007-2017 to put long term patient equity like capital into cooperatives. Now our collateral support fund serves a similar function within CFNE."
>
> Rebecca Dunn
> Executive Director
> Cooperative Fund of New England

As a result of this discovery, one of the largest credit unions in Vermont (VSECU) has begun to offer equity to cooperatives in its region—an unprecedented move as most credit unions, if they offer any financing for coops, offer debt financing. The Vermont statue language specifies that state-chartered credit unions are authorized to invest equity of up to 10% of the shares, deposits, and surplus of the credit union into cooperatives.[48] These investments would not count against the 12.25% member business lending cap that most credit unions are currently subject to. VSECU has decided to make 10% of their total equity available for equity investment in coops, roughly equal to $5.5M in 2016.[49]

It appears that the VSECU is the only credit union in any of these eight states that has started investing using this statute. Consequentially, cooperative advocates are working to identify credit unions in the other eight states to follow VSECU's lead and invest equity capital in coops. There is also talk of lobbying other state's legislatures, then eventually congress to

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"follow suit by broadening the range of credit unions that are legally permitted to make such investments."[50]

Market coop securities offerings through local investing clubs
We have seen the power of Direct Public Offerings[51] as a tool for raising equity investment capital directly from communities, with a number of important coops and coop conversions having raised funds using a DPO.[52] Local cooperative investing clubs[53] and local investment funds have played roles in bringing in lenders and investors for coop conversions and in educating and engaging communities about investments into worker-owned businesses. Investment clubs and networks that are values-aligned have also invested in worker coops. For example, Slow Money, with 18 local networks and 11 investment clubs,[54] claims to have catalyzed over $50M of investment into more than 500 small food enterprises across the U.S.[55]

Worker coop networks, in partnership with coop loan funds, could form or strengthen relationships with mission-aligned local funds or clubs to educate their investors about the worker coop model and make connections to regional or national infrastructure. Note that for cooperatives to publicize an investment offering through these networks or other channels, they must already have a legally compliant securities offering, through a DPO or a state exemption like California's Cooperative Corporation statute (see FAQs in the first paper of our series, The Original Community Investment for more detail).

Resources already exist to help create networked investment clubs. For example, the Coop Principal Investment Club in the Twin Cities offers a free and simple 'how to' for setting up your own local club.[56] Also, Slow Money supports the creation of new local networks and investment clubs aligned with their principles (aligned with and significantly broader than cooperatives). Engaging with an existing network of mission-aligned investors could help with the need to attract investors, keeping the effort focused enough, yet tapping a larger pool of investors than a 'pure play' worker coop investor club might be able to.

Could the field of worker cooperatives come together with a focused effort to build out local worker coop investment networks modeled after, or perhaps in partnership with, Slow Money or other national investment aggregators? And, to foster equity investments in coops, could they include a support system for creating compliant securities offerings that could be done at lower cost?

For example (this is hypothetical, and has not been discussed with the parties mentioned), a partnership between the US Federation of Worker Cooperatives and a collaborative of the national loan funds could lead a focused effort to scale the Coop Principal Investment Club model or to engage with existing Slow Money chapters across their 20 regional networks[57] of worker cooperatives. Figuring out ways to offer legal supports for setting up securities offerings that have economies of scale would be a significant help, perhaps supported through grant dollars or some shared services model, or perhaps starting off with a handful of states. The existing national and regional loan funds could be contracted to help provide investment analysis, due diligence and co-investment. Closely partnering with local groups focused on building investment pipeline and providing business TA and with loan funds that already have their ears to the ground and receive inbound investment requests would be important.

This approach could help raise awareness and interest locally and tap investors wanting to invest in their local community and provide patient capital, while connecting to the existing infrastructure and expertise of the regional and national loan funds.

Organize capital-raising campaigns
We can tap this moment in time for focused campaigns to raise patient capital. The confluence of the current political climate, the growing wealth and wage gaps that worker coops address, and opportunity presented by the Silver Tsunami of retiring baby boomers are calls to action that resonate with many people and communities. We've seen campaigns be successful before, for example, in 2006, the US Federation of Worker Cooperatives and Shared Capital Cooperative piloted a 'Worker Ownership Fund'

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created specifically for cooperatives and cooperative loan funds in need of additional capital. Today, the fund has a little over $1M in assets to deploy, and over its history has lent out $2.75M to cooperatives.[58] Looking outside the coop space, the National Federation of Community Development Credit Unions (NFCDCU, an umbrella organization) was able to raise significant funds that smaller credit unions could not, in order to strengthen the entire community development credit union movement with an influx of new capital. The fund was started in the 1980s, and as of 2016, the fund had reached $34M in total assets.[59]

AGGREGATE DEMAND THROUGH EXISTING FUNDS

As the supply (or pipeline) of deals grows, our field's existing capacity and infrastructure should be leveraged, and needs to grow into an increasingly effective (and efficient) marketplace for aggregating the demand, and growing capital under management—including patient, risk capital—at pace with the growth in supply. Researchers looking at the gaps in demand and supply for social impact capital noted,

> "Mobilizing new capital will require an efficient marketplace that helps aggregate supply and demand, vet readiness for investment, and deploy capital in various forms."[60]

Today, investors have chosen to invest $49.4M indirectly in cooperatives of all types through cooperative loan funds (see Appendix A for details) to gain access and to diversify their risk of default of any single investment. Investors benefit from having fund managers experienced with worker cooperatives handling the due diligence and loan / investment servicing for the individual investments. Two of these funds are 'pure plays,' or funds dedicated solely to worker or employee ownership (The Working World and the Common Wealth Revolving Loan Fund), and the others are more broadly coop focused (including worker cooperatives). These investments are in the form of loans, with returns typically ranging from 1%-8%, with the average interest paid to investors at 2.8%.[61]

As an efficient marketplace doesn't just create itself, we recommend that the existing capital providers continue to regularly come together, and spend some focused effort on mapping growth stages of this marketplace, so that as it grows, it remains values-centric, and keeps the existing funds in the driver's seat while fostering growth in the overall marketplace to bring in more 'mainstream' capital.

"Mobilizing new capital will require an efficient marketplace that helps aggregate supply and demand, vet readiness for investment, and deploy capital in various forms."

- Next Street in 'Bridging The Gap: Impact investment supply and demand in the Chicago region'

We will also need to ensure that the infrastructural capacity grows in tandem. In many fields, standardization is a key driver of growth and scale. The key will be to manage increased marketplace 'efficiency' (standardization) to maintain the values that drive worker coop investments, as well as the approaches the current loan funds take to ensure their investments are non-extractive (to borrow the Working World's phrase), and are structured to fit the needs of the specific coops (see the Lending Opportunity of a Generation for how the Cooperative Fund of New England approaches the 5 C's of Credit[62]). We offer the ideas here for consideration based on the issues that were raised in many of the interviews and recommend assessing the potential trade-offs between maintaining the individual natures of each fund vis-à-vis unlocking greater scale through some standardization or more integrated procedures. The loan funds themselves are the ones in the position to assess which (if any) make sense.

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Streamline process of CDFI loan fund investments
Our field of worker coop investing is still quite small, resulting in multiple investors sharing comments during our interviews that it can be hard to invest in small loan funds that aren't integrated with electronic investor platforms that many investors utilize. Ben Selden from LEAF echoes this, by recommending that loan funds use "platforms or services to make as little work as possible for asset managers to make a community investment."[63] He goes on to note, "Streamlining this process would help to further grow our fund and meet the high demand for our services. LEAF is happy to share our thoughts about various strategies for accomplishing this: it's been a key topic of discussion for LEAF internally in the last year." Micha Josephy of CFNE noted that "more and more CDFIs are becoming an asset class for big wealth management companies,"[64] which is great news and underscores the need to make it as easy as possible for those investments to be made into the CDFIs that fund worker coops.

The ability to issue securities electronically through brokerage platforms such as Schwab and Fidelity requires working with an indenture trustee and issuing CUSIP numbers through the Depository Trust Company. Calvert Foundation has been the most successful CDFI penetrating this market, but other nonprofits, such as ImpactAssets have launched Notes that also trade with CUSIPs. However, many brokers are hesitant to distribute CDFI securities on their platforms from a suitability perspective if they are not rated by S&P or if they offer below market returns.[65,66] For smaller loan funds, this process can be cost prohibitive (easily upwards of $100-150K). It could be worth investigating the option—to understand the benefits, costs and constraints—for the cooperative loan funds to pool a portion of their assets and register together to offer a single tradable note that could be invested in a new, pooled fund. Individual CDFI funds could also look to raise grant dollars to cover these costs until their funds are large enough to support the registration fees.

ImpactUs is a platform where CDFIs will be able to raise capital for their funds or specific investments. This platform is a good option for smaller loan funds to connect with investors, for whom the cost of the steps needed to register on the mainstream investment platforms may be prohibitive. ImpactUs is described on the Opportunity Finance website as follows,[67]

> "A conversation that began between 12 CDFIs about how to access mainstream financial markets has evolved into a full-scale platform that aims to create a marketplace where investors can browse by impact area or geography and connect with a CDFI, or CDFI-funded project…. We are looking to move $3 billion through the [ImpactUs] platform, with a significant amount of new money going into the community development sector. The Marketplace will put metrics and impact stories front and center, create transparency, and ultimately eliminate the barriers CDFIs face when trying to access the mainstream financial markets."

Ben Selden from LEAF additionally noted that custodial services are required for alternative / local investments that are often not provided by conventional custodians like Schwab. Groups like ImpactUs are trying to streamline these custodial services as a sort of broker-dealer for local / community investments.

The overall message? Ben Selden sums it up by paraphrasing a comment made by Donna Fabiani of the Opportunity Finance Network, "Have the CDFI community / local investing community speak the language of SRI asset managers, instead of waiting for them to understand us."

Other ideas for streamlining or standardizing that could be considered include:

Standardizing application processes: Similar to the 'common app' for college applications, existing funds could create a standard loan application process across their networks. This makes it easier for coops to shop around, and make data collection and impact metrics tracking standardized from the point of application. Loan funds had mixed reactions to this idea, noting the need for there to be some sort of incentive to change their processes, which could perhaps be

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overall growth of the field. Ben Selden at LEAF suggested that this standard application could potentially be adopted across all CDFIs through the Opportunity Finance Network (the leading professional organization of CDFIs), however there would still need to be some specificity to worker cooperatives, including ensuring that it captures the impact data to be tracked.

Assessing opportunity for shared services to help with scaling infrastructural capacity: Could the existing loan funds benefit from shared services, such as back office, due diligence, compliance, standardized underwriting processes, data collection systems, lender / investment management, syndicated deals, connections to other mission-aligned loan funds or clubs, and other shared resources? There has been some talk of this in past among loan funds, and some effort to raise grant funding for a feasibility study. However, organizations are deeply invested in their existing portfolio management software packages, which introduce a significant switching cost. So, the benefit would need to significantly outweigh the costs to make it worth it for the individual organizations.

Publicizing deals in a central clearinghouse: Having a centralized listing or clearinghouse where investors could 'shop' deals could simplify the process of identifying additional investors for specific deals. When potential deals are in process, they could be announce them through investor networks and create a 'worker cooperative clearinghouse' for investors to shop around for coop deals that are of particular interest.

Micha Josephy from CFNE also suggested that as the pipeline grows, loan funds could consider utilizing a clearinghouse or a national loan pool that the loan funds could share and pay into in order to pool funds and partner together for financing the deal.[68] There are lots of relevant examples, see Cutting Edge Capital's DPO clearinghouse Cutting Edge X, Locavesting's platform Investibule that gathers "community-based investment opportunities spanning Kiva, Credibles, Direct Public Offerings and JOBS Act-enabled crowdfunding offerings,"[69] Milk Money, "where Vermonters discover local investment opportunities [and] get tips on how to evaluate those opportunities,"[70] and Partners for the Common Good's CapNexus, "a searchable online database that matches money and partners to community development finance opportunities."[71] Some type of coding for employee ownership / worker cooperatives that is developed by the field (as discussed in Metrics section) could potentially be integrated through these types of listings.

Doing this could also serve to pool deals, alleviating the challenge noted in recruiting investors who have $10M minimum 'check size' thresholds for investments until the loan funds grow (requiring growth in deal flow).

From the loan fund's perspective, publicizing deals may introduce the challenge of engaging with co-financiers they don't have experience working with, so on the loan fund, thinking about ways to have investors invest in the fund rather than the individual deal could potentially help alleviate this challenge.

Self-Help
Federal Credit Union

Self-Help Credit Union, one of the largest CDFI credit unions in the country at $2 billion in assets as of 2016, went through the process of registering its Certificate of Deposits (CDs) as tradable securities and has been able attract investments from SRI funds like Trillium and Walden who otherwise wouldn't have been able to make one-off community investments. Self-Help was able to make the significant investment of time and money given its larger size. Calvert Foundation also sells its Community Investment Notes as securities, which allows it raise funds through commonly used electronic trading platforms.

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CREATE A NATIONAL EQUITY FUND

The need for patient capital in worker coop conversion deals has renewed interest in a national equity fund. Successful cooperative ecosystem in other parts of the world (Spain's Mondragón cooperative business group, Italy's Emilia Romagna region, or Quebec's cooperative financing ecosystem with nearly $200B in assets across five institutions) have a large-scale source of capital to support them, and a source of capital that is tightly connected to the federation of cooperatives. For example, Mondragón started their own credit union because of the challenges of getting capital, and grew it based on the successes of the cooperative enterprises it lent to. In addition to being a powerful institution for business loans to coops, Laboral Kutxa (rebranded from Caja Laboral in 2012 after a merger) provides a portion of its profits back to Mondragón that can be used as equity for start up or growth capital. There have been attempts at different points in U.S. history to develop such a capital source, but we have not been successful creating one that is as tightly woven into the cooperative business sector, such that it not only supports the development of cooperative businesses, but also gives back through profit sharing to the business network.

Sherman Kreiner, who was CEO of a $200M equity fund that invested in employee ownership in Manitoba, Canada, believes that this type of fund is critical to the growth of the sector.[72] He believes that, instead of focusing on a fund that invests in companies at the time of 'conversion' to employee ownership, investments should be made in companies well in advance of the owner exiting, to support the growth of the business in which the owner has indicated an interest in, or commitment to, sharing ownership with employees, and to lay the groundwork for an employee ownership exit. An additional benefit of this approach, also echoed in our interview with Kerwin Tesdell of the Community Development Venture Capital Alliance,[73] is that it can enable a base of employee equity to be built that could become a leveraging point for a future employee buy out, reducing the need for the conversion transactions to be as highly leveraged. In other words, this approach also reduces the need for the conversion transaction to have as much patient, equity-like capital available, since this capital has been built up over time within the company as employee equity.

A newly formed 'impact-oriented' holding company, New Root LLC, recently embarked on an effort to acquire companies to then 'exit' through employee ownership. They plan to identify a small number of acquisitions (6-10), and provide business process optimization and participatory culture support, to prep them for employee ownership. They are currently looking at the ESOP as their most likely structure, with broad-based ownership and participatory strategic decision-making, though an employee exit is years into the future. New Root publicizes, "Our ultimate goal is to transition our acquired businesses to some form of employee ownership."[74]

We don't have a clear roadmap to offer for how a national equity fund could be realized – that is beyond the scope of this paper. But we can frame some key high level questions that would need to be addressed:

- **What is the investment approach?** Is it to acquire or invest in companies, improve their growth and profitability and set them up for employee ownership transition? Or is it investment at the time of conversion? The investors we spoke with recommend the former.

> "I think the Silver Tsunami thinking is a mistake. You're bringing capital in too late in the game."
>
> - Sherman Kreiner
> Managing Director, University of Winnipeg Community Renewal Corporation, former CEO of the Crocus Fund, and lifelong cooperative change maker

CASE STUDY

CROCUS FUND

To learn from past efforts, we spoke with Sherman Kreiner,[75] who has dedicated his career to advancing employee ownership and worker coops, and was a key leader in successful campaigns to convert U.S. businesses to worker ownership in the 70s and 80s. Kreiner was CEO of the Crocus Fund in Manitoba, Canada—a groundbreaking venture capital fund with a focus on employee ownership that grew to $200M on Manitoba's population base of 1M people—for a period of about 10 years through 2004. Crocus was not exclusive to employee-owned companies, but strongly encouraged companies to set themselves up for a future transition to employee ownership by aligning incentives for all stakeholders. Crocus invested in several dozen companies, eight to ten of which were significant employee ownership initiatives with a range of types of employee ownership structures.

Crocus' ability to raise funds was aided significantly by tax breaks at both the federal and provincial levels (initially 20% / 20%, later dropped to 15% / 15%) which provided investors with an up front financial incentive, and in exchange, they had to keep their investment in for seven years (eight years if invested after 1997).[76] Investors were mostly individuals, with a $5K maximum investment. The fund raised most of their $200M by building out an impressive sales infrastructure which combined conventional sales channels (brokers and mutual fund dealers) with a sales force trained within the labor movement and licensed to sell through Crocus's brokerage office. The benefit of this retail approach went beyond funds raised; it got a lot of people thinking about economic democracy, not just those working in the investee companies. There was some modest institutional investment, with plans prior to the fund shutting down to significantly grow it through institutional investments.

The employee ownership structure was flexible. Several companies utilized a structure similar to the U.S. ESOP (Employee Stock Ownership Plan) to enable them to leverage corporate assets and repay pretax. In other instances, the Fund invested in a company and then had its shares in the investee company purchased by employees. This was often done through a pricing mechanism that was pre-determined and simple enough for employees to easily understand (for example, based on a percentage of book value) using formulas companies were already utilizing (for example investing and exiting at 2X book value). This approach simplified the transactions and simplified employees buying in. The fund had a seat on the board of each company they invested in, but didn't control the board. They invested in the people, especially the senior management.

The situation of this fund had some unique elements: Manitoba companies didn't have much other investment capital available, so there wasn't competition with other VC offerings. And since these businesses needed capital to grow, this put the fund in a good position to offer capital at terms that worked for the business, while encouraging employee ownership through such mechanisms as a regular CEO roundtable discussing participatory management practices and a year long University-affiliated continuing education course for senior managers on participative management. Their pitch of, "We help you grow, line up an exit strategy (the employees), and realize the benefits of a more engaged workforce" worked with some businesses. Employee ownership wasn't a fit for others, but this did not restrict them from receiving investment.

The fund closed down amidst some controversy. It is generally believed that its success and plans to grow significantly larger made it no longer a small unthreatening player. This, alongside the addition of some key managers with more mainstream backgrounds who wanted to make big changes to some of the internal workings that had supported the Fund's broader vision of economic democracy that had made the operation successful, helped led to its demise.

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- **How much capital is really needed?** The combined capital in the existing cooperative loan funds is just shy of $50M, compared with $200M raised by Crocus in the case study above. Clarity on investment approach would help define the target fund size.
- **Where does the capital come from?** Crocus Fund was successful raising capital from individual investors (see how they did it in the case study); a fund could utilize a DPO to raise money. Or, could there be a national network of equity funds utilizing municipal or state incentives or investments, where available?
- **Can investors be financially incentivized?** Could we push a policy agenda that could enable tax breaks at the federal level?
- **Is there existing infrastructure that could be used for such a fund?** For example, could Shared Capital hold a fund like this given its deep experience with worker coops and its ability to take in equity capital?

> "A city in decline with employee pension funds could invest 5% of its portfolio in a locally-targeted employee ownership equity fund, making this the VC portion of its diversified risk portfolio."
>
> - Sherman Kreiner

CREATE NETWORKED LOCAL COMMUNITY EQUITY FUNDS

Cutting Edge Capital, a leading organization dedicated to community capital and credited with making Direct Public Offerings possible, has a wealth of information about local investment funds, which they term "Community Investment Funds" or CIFs. According to Kim Arnone, Vice President of Cutting Edge Capital, local groups could utilize a DPO to raise a local investment fund, or partner with an existing nonprofit loan fund to utilize their infrastructure for targeted local investments.[77]

A major challenge to setting up and managing local investment funds is the very high regulatory costs for funds that raise money from investors to invest in other companies, so structuring a fund based on regulatory exemptions is important, unless the fund is large enough to make the six or seven figure regulatory costs manageable.

> "A CIF must navigate through two layers of securities law. The first, and more commonly understood, are the laws that regulate the offering of an investment to the community. This is regulated at the federal level by the Securities Act of 1933 and by each state's securities laws. In essence, a CIF must do its own DPO to raise investment. While this must be done carefully, it is not so burdensome as to prevent CIFs from flourishing.
>
> But there is a second layer of securities law that is unique to investment funds and presents another challenge. The Investment Company Act of 1940 (the 1940 Act) imposes burdensome regulations on an entity that raises money from investors and then invests that money in other companies. This is the law that regulates mutual funds, and the compliance costs are well into the six and seven figure range for funds of that type. Among other requirements, such a fund must conduct a full registration under the 1933 Act."[78]

The good news is that there are some approaches that can avoid these high regulatory costs, the most applicable exemptions are outlined briefly here, and explained in more depth on the Cutting Edge Capital blog:

1) **Charitable loan fund.** The nonprofit loan funds already discussed are charitable loan funds, and as nonprofits, these funds cannot accept equity investments, but they can accept debt capital with very patient terms. Local charitable loan funds can tap local investors,

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and could potentially be housed inside one of the larger, national nonprofit loan funds.

2) **Diversified business fund.** For this type of fund, investments in other businesses (coops) must comprise less than 40% of the fund's total assets, such that its investing activities supplement its core purpose. For example: a business whose core activities are to provide education about worker coops and conversions; a business conversions incubator; or a cooperative business accelerator. Investments made by this business that wouldn't count toward the 40% limit include:
   - Majority investment in another company
   - Real estate
   - Secured loans
   - Non-securities assets (equipment or other assets)
3) **Real estate fund.** The purchase of real estate by a fund. Due to the different layers of securities regulations, a real estate fund would need to raise funds using a single state DPO. Such a fund could be beneficial if we find that there are real estate heavy coop conversions or cooperative opportunities.

CHALLENGE #4: Constrained returns

Recommendations

✓ Augment with **social return reporting**
✓ Create **first loss** pools
✓ Consider **royalty financing** when it's a fit
✓ Consider **hybrid models** with limited voting for equity holders

Today, equity investments in worker coops are medium- to long-term investments with a target, fluctuating dividend rate, but with no potential upside or appreciation of the underlying stock value. Indeed, often they act like something in between equity and debt, and tend to confuse many investors. The challenge for equity investors is that these shares have the increased risk of equity, yet generally no upside potential, no voting rights and limited liquidity. In today's low interest rate environment, the target dividends being offered are high enough to make this trade-off worth it for some mission-aligned investors.

However, to expand beyond these highly mission-aligned investors, we can look at approaching these investments differently in order to address the issues of risk-return-control conundrum.

AUGMENT WITH SOCIAL RETURN REPORTING

Worker coops are an incredible impact investment opportunity. As discussed in more depths under *CHALLENGE #5: Need for Impact Data*, we aren't yet in a position to clearly demonstrate the social return on investment of worker coop investments. There's plenty of data to back up the positive impacts of worker cooperatives that could be leveraged to tell the story, and over time, social impact metrics could help impact investors feel more confident that they are augmenting the financial return on their specific investment with a social return.

CREATE FIRST LOSS POOLS

Because so few investors have experience with worker coops, the investment may feel riskier. But the data proves otherwise: The Cooperative Fund of New England has a 99% repayment rate over its 40 years of coop lending.

Credit enhancement—sometimes called 'first loss capital'—is a tool widely used in finance to improve the credit worthiness of specific investments, and is most typically used for debt.[79] Two types of credit enhancements, loan guarantee funds and loan loss reserve funds, are being used successfully today by existing coop loan funds. They could be expanded to apply to equity investments, and to help the field of coop loan funds play a more explicit 'market making' role.

A loan guarantee is a promise to assume all or part of the debt obligation of a borrower if that borrower

RECOMMENDATIONS

defaults.[80] A loan guarantee fund is a pool of money that lenders can earmark towards a specific loan or a group of loans to cover situations in which a given borrower doesn't have enough collateral or personal guarantee to meet the lender's requirements.

A loan loss reserve is a balance sheet accounting entry made by a lender to cover estimated losses on loans due to nonpayment or default.[81] A loan loss reserve fund serves more as insurance for a pool of loans, and allows a lender to be comfortable making investments that are above their typical risk profile, knowing that if some of the investments go bad, that there is a pool of funds that can recapture defaulted loan payments up to a certain amount.

For equity investments, a pool of money could serve similar purposes. Since equity is by definition in more of a 'first loss' position than debt, having a fund that provides collateral or a loss reserve for equity investors could help them reduce their risk (real or perceived risk). Many existing CDFIs have similar pools of money that have been financed by government or foundation grants. Funds can of course also diversify risk across their portfolios; taking on lower-risk projects to enable some higher risk investments.

A final word about risk: it is not a matter of cold calculation alone; it is actually a very relational transaction and based ultimately on familiarity with the investee—in other words, it is based on trust. There are investors in worker cooperatives who understand this well and are leaders of this type of risk assessment. For example, see RSF Social Finance's approach:[82]

> "Interconnectedness is the cornerstone of RSF's utility function. We have found that if investors and borrowers can be more visible to each other—if they can understand each others' needs and intentions, and sustain a personal connection whenever possible—then risk decreases and fulfillment increases. We have decreased our risk exposure due to the direct and transparent nature of the investment vehicle, and we are receiving a return on our utility through the support of the local community."

CONSIDER ROYALTY FINANCING WHEN IT'S A FIT

Royalty financing, also known as revenue-based financing, connects investor return to a company's financial performance. As different from conventional loans with fixed payments, with royal financing, payments shrink or grow along with the company's revenue.[83] Because of this, royalty financing may be best for growth companies with decent profit margins.

With royalty financing, the company receives investment capital, and in exchange, the investor receives a certain percentage of the company's future revenues (gross or net revenue[84]), over a defined period of time and up to a specified amount.[85] The total return is capped, as is the timeline of pay-outs, making the exit pre-defined.[86]

Royalty financing addresses some of the limitations of the most widely used form of equity investment in worker coops—non-voting Class B preferred shares, which were popularized by Equal Exchange and used by Namaste Solar, Organic Valley and others. Such shares have a targeted dividend, the shares' underlying value does not change over time, and they typically have to be held for at least five years, after which point they can be sold back only to the company. Preferred shares have priority for payment of dividends or for payment in the case of liquidation over member voting stock. In today's low interest rate environment, for investors who want a steady financial return alongside a high social return, this type of investment can be a great fit.

Since Equal Exchange began offering Class B preferred shares in 1989, it has paid out a dividend at or above the 5% target every year except two (averaging 5.18%), and has high demand for its shares when it has them available.[87]

RECOMMENDATIONS

However, equity investors typically expect that, in exchange for their riskier investment position, they have more of an upside potential: when the company does well, they want their investment to pay them back at a higher rate. This return on investment can be realized through increased value of the underlying stock that can be redeemed at its higher price, or through being paid out higher dividends in times of strong financial performance. Royalty financing addresses this based on the potential upside if the company's financial performance is strong; if the payback period is faster, the investor's return is higher.

The governance advantages of royalty financing are also clear: as with non-voting preferred shares, investors who provide royalty financing do not have a role in governance, and cooperative members retain full control of the business. Plus, since royalty financing most resembles debt, the company can save time and money on legal fees and securities filing as these deals may not be subject to state and federal securities laws as some equity offerings are.[88]

Startwise is a new company promoting a variation on this model. it is a revenue-sharing online investment platform where businesses share revenues with investors instead of equity. Growing businesses can offer 1-10% of their revenues over a period of time to investors (terms determined by the business) to until the investment is paid back. The advantage to the business is that money comes in as the enterprise grows without the need for an exit; the advantage to the investor is the simplicity and ease of the model.[89]

Structuring patient capital as debt—the terms of which can be created to closely mimic equity—can be better for coops, given that interest payments are tax deductible. Cooperative Development Institute summarizes the financial advantages on their blog,

> "While many cooperatives have utilized preferred stock, they could also have constructed member loans to be similar in terms of being subordinate to other indebtedness, with the ability to defer interest and change maturities depending upon the conditions at hand. The significant difference is that dividends co-ops pay on preferred shares are not tax deductible, while interest (including interest that is accrued and unpaid) is tax deductible. When a co-op issues preferred shares, it is essentially taking a large part of the tax burden of those dividends and placing it on the cooperative, and by extension its member-owners. Given that corporate tax rates increase pretty quickly, a preferred stock paying 6% dividends may have the same costs as a member/supporter loan or note at 8% or 9%."[90]

As of the date of the publication of this paper, LEAF, one of the national CDFI loan funds that specializes in cooperatives, is preparing to release a report in partnership with the Carsey School of Public Policy on Royalty Financing and Direct Public Offerings.

THE WORKING WORLD

One cooperative investment fund, **The Working World** (TWW), has pioneered and adapted the royalty financing approach for worker cooperatives. TWW utilizes a unique debt/equity hybrid vehicle to provide patient capital in the form of loans to worker cooperatives, with repayment required only once the business is profitable and able to pay back the loan. The organization calls this financing "non-extractive and inclusive" and has achieved a 98% repayment rate. They have creatively addressed cooperatives' dual challenges of loan capital (TWW does not require collateral) and equity financing (TWW acts like an investor in many ways: their flexible repayment plans mirror those in the investment space; and they have profit sharing arrangements with many cooperatives). As a nonprofit loan fund, TWW is able to provide this level of patient, flexible capital and has been successful in attracting mission-aligned investors that are able to provide capital under these terms.

RECOMMENDATIONS

CONSIDER HYBRID MODELS WITH LIMITED VOTING FOR EQUITY HOLDERS

Equity investors often have voting shares, which gives them some input into the direction of the company. For those with significant investments, having some say over the strategic decisions of the company can be important as a way to safeguard their investments.

In a worker-owned cooperative, the structure itself limits voting control only to the worker-owners. A hybrid model—that has more than one class of voting shares—would be a way to give equity investors some (limited) control. The investor voting shares could have votes only on highly strategic decisions, such as taking on additional financing, opening a new line business, dissolving the company, etc. Or, alternatively, there could be higher level of control that diminishes in stages as the financing is paid back. Or finally, voting rights over certain decisions could kick in only in situations of low financial performance or certain thresholds of Key Performance Indicators that serve as pre-indicators of financial performance.

In worker coop conversions, in situations in which the selling owner holds a significant note, it is not uncommon for the owner to also hold onto some elements of increased voting rights or veto power until the note is paid down to below a certain threshold. Investors such as Morgan Simon with Pi Investments Investments and Kerwin Tesdell with Community Development Venture Capital Alliance, indicated that having flexibility in structure and control could be one way to expand investor involvement, opening up a broader spectrum of employee ownership, and giving investors a way to gain experience with the model. This approach doesn't adhere to the 'pure' cooperative model, one in which financial return and control are only available to the coop's members (its workers), but it could open up opportunities, while still keeping the coop's worker-owners in the driver's seat.

Any of these approaches, and at best, a combination of them, could increase the financial attractiveness of equity investment and open up the opportunity for more worker coops to attract investment capital.

CHALLENGE #5: Need for impact data

Recommendations

✓ Develop standardized **social impact metrics**

✓ **Track** social and financial performance

DEVELOP STANDARDIZED SOCIAL IMPACT METRICS

There is significant research that finds that companies with broad-based employee ownership and participative workplace practices outperform their peers without these. In addition, there has been specific research on worker cooperative performance and the impact on the wellbeing of its workers. Much of this research is summarized in Worker Cooperatives: Pathways to Scale,[91] and the Rutgers' School of Management and Labor Relations is continuing to advance a large body of research on these topics.[92] Worker coops provide a myriad of benefits. For worker-owners, benefits include better paying jobs, asset and skill building, and enhanced control over their work lives. For businesses, benefits include reduced employee turnover and increased profitability and longevity. For society more broadly, worker cooperatives foster social innovation, expand access to business ownership, and train people in democratic practice. Worker cooperatives are also positively correlated with health and other social benefits.[93]

TRACK SOCIAL AND FINANCIAL PERFORMANCE

It is well known that "you can't manage what you don't measure." Having a set of shared metrics that effectively capture the social impact of worker cooperatives will be important for investors who care about both quantitative and qualitative reporting and for worker coops to create and monitor their own impact. We recommend an effort to develop these metrics that aligns with the three to five leading social metric indicators, such as the Global Impact Investing Network's IRIS metrics,[94] the B Impact Assessment (note the mapping of their assessment's alignment with IRIS metrics),[95] and possibly others.

RECOMMENDATIONS

Further indicators of qualitative measures could be explored. For example, a recent collaboration between Pi Investments, Huntington Capital, and Transform Finance seeks to improve impact metrics about quality job creation (as compared to only tracking the number of jobs created). The partnered organizations devised a system called the "Floor and Ladder" approach, which would,

> "require that all companies in the fund meet basic, minimum requirements in five areas (living wage, health care, paid leave, opportunities for advance, and employee ownership) or show an action plan for achieving this minimum 'floor' within a year of investment. They would then set annual goals to climb the 'ladder,' with support as needed from the Huntington management team and consultants."[96]

These types of filters on investments would enable investors to target their capital to businesses with quality jobs, having employee / worker ownership as one of the impact metrics. Given the low volume of worker coop investments today, integrating employee ownership and worker cooperatives into impact metrics with a broader focus makes sense. Over time, as the volume of worker coop investment opportunities grows, more customization could make sense.

One of the benefits of worker-owned cooperatives is that the workers decide how to prioritize their compensation, and investment in job quality. While constrained by the market, they are internally regulated rather than needing investor or other regulation to push for improved job quality.

In addition to the social impact of these investments, investors also want to know that their investments have positive financial returns, and that the success rate of the businesses following their transition to worker ownership is high. According to research from Rutgers University, implementing employee ownership leads to a 4 percent permanent increase in productivity and a 2 percent increase in shareholder value.[97] We can also look to existing loan funds to address the question of returns based on their track records, and will need the field to track the success of converted cooperative businesses post transition.

For investors interested in investing in CDFI loan funds with which they don't already have personal relationships, there is a ratings system for CDFIs called AERIS that captures the CDFI's impact, as well as their financial strength and performance. Locavesting has a nice write up about this ratings system and what it does and doesn't do.[98] However, this ratings system doesn't currently allow investors to search for CDFIs with specific mission or impact focus areas. Ben Selden from LEAF noted that AERIS and the CDFI Fund are working together to standardize and improve impact metrics for CDFIs. Today, in CDFI metrics reporting, a worker coop job is counted the same in an impact report as any other small business job, not taking into account that a worker coop job includes ownership, an equity stake, voting rights, etc. Selden believes that the "Floor and Ladder" approach could be further customized to showcase the benefits of worker coops, instead of just having ownership as one of several pillars.

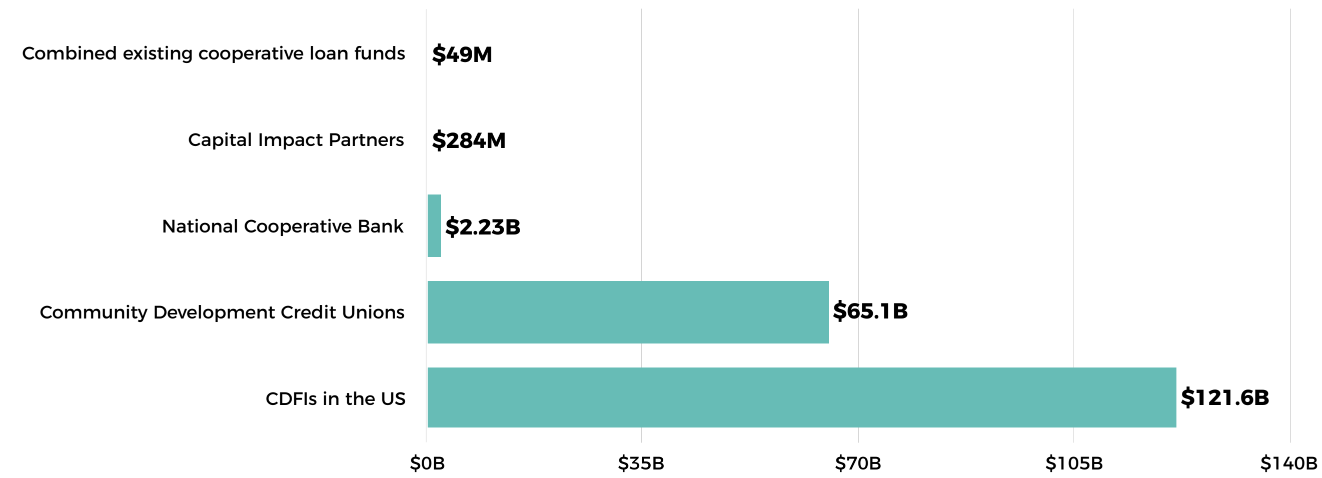
The Worker to Owners Collaborative, convened by the Democracy at Work Institute (and of which this report's author Project Equity is a steering committee member) is a national collaborative of leading U.S. practitioners focused on worker ownership conversions. This group is in a strong position to lead an effort that engages experts to develop and demonstrate investment metrics for the field as a whole.

CURRENT STATE SNAPSHOT

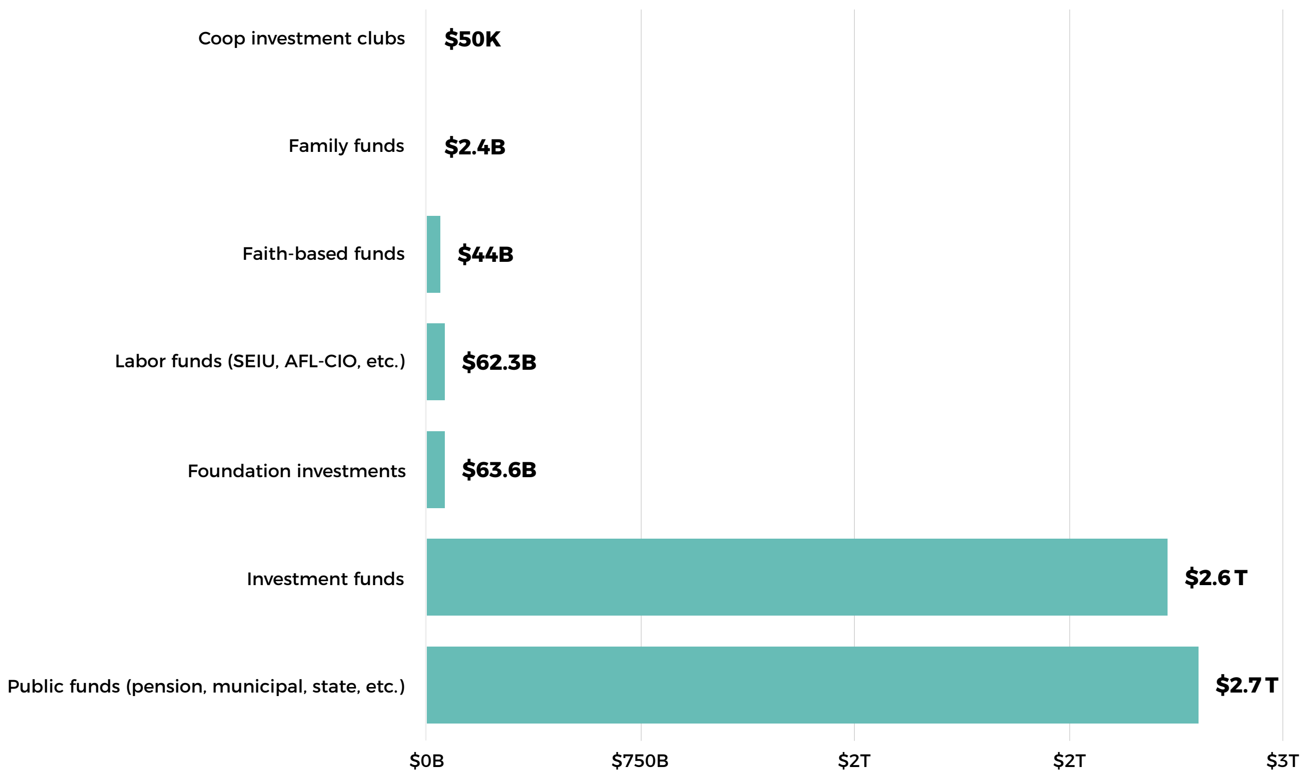
The figures below show an estimation of current dollars under management that could be tapped for worker cooperative conversions. The message is clear: what is currently targeted to worker cooperatives is a drop in the bucket compared to potential capital.

The authors used a variety of sources to populate this data: the funds' own annual reports and financials provided most of it; the rest was gathered from US-SIF's 2016 Report on US Sustainable, Responsible and Impact Investing Trends. See Appendix B for more detail.

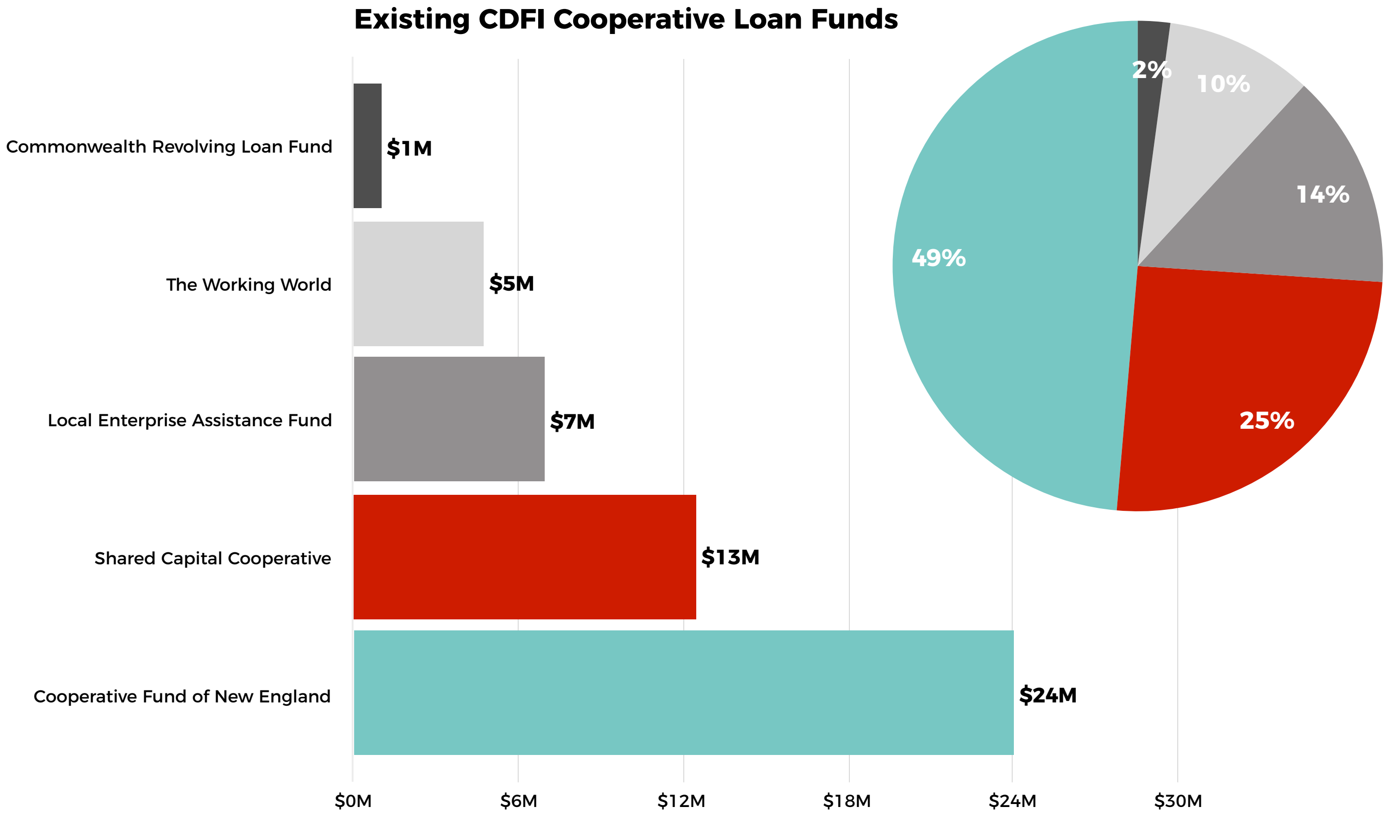
Existing and Potential Debt Sources



Existing and Potential Equity Sources
from funds that incorporate impact investment criteria



CURRENT STATE SNAPSHOT



CONCLUSION

Our recommendations have highlighted 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.

Being able to effectively tap larger sources of capital requires 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 enough on its own to attract the increased investment?

The other major question underscored in this paper is about the need for an equity fund. Today, there is an estimated $25M in existing cooperative focused 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 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, risk 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 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 can continue their coordination with an explicit focus on growing the marketplace for patient, risk capital.

*There is some equity or equity-like debt being utilized: Shared Capital has the ability to place equity, The Working World utilizes equity-like debt, and the other funds have some capacity to tap first loss capital to increase the flexibility of their debt.

READ OUR COMPANION PAPER

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

APPENDIX A

COOPERATIVE LOAN FUND SOURCES & SIZES					
	Fund	**Fund type**	**Size** as of 2016 unless otherwise noted	**Average $ investment** into a single worker coop	**Average rate of return to investors**
	Commonwealth Revolving Loan Fund	CDFI/Cooperative loan fund (regional; 100% to worker coops)	$1.05M	$125K	2%
	The Working World	CDFI/Cooperative loan fund (national; 100% to worker coops)	$4.8M	$75K	Equity-like profit sharing model: 3-8% Higher at longer terms (5+ years, variable)
	Local Enterprise Assistance Fund	CDFI/Cooperative loan fund (national)	$7M	$150K	1-2 yrs= 2% 2-4 yrs= 2.5% 5 + yrs= 3%
	Shared Capital Cooperative	CDFI/Cooperative loan fund (national)	$12.5M	$60K	2% avg Highest is 4.5% (higher at longer terms and larger investments)
	Cooperative Fund of New England	CDFI/Cooperative loan fund (regional)	$24M	$170K	0-2%
Total funds under management			**$49.4M**		

APPENDIX B

CURRENT AND POTENTIAL SOURCES OF CAPITAL FOR WORKER COOPS			
Source of capital	**Type**	**Size**	**Invest in worker coops?**
DEBT			
Cooperative loan funds (5) see Appendix A for detail	CDFI Loan funds	$49.4 Million	Yes. These loan funds invest in cooperatives of all kinds, including worker coops.
National Cooperative Bank	Mission-connected cooperative bank	$2.23 Billion (as of 2015)	Some
Capital Impact Partners	CDFI Loan fund	$284 Million (as of 2015)	Some $5M lent to coops of all types in 2015
CDFIs in the US (total funds: includes CDCUs)*	CDFI	$121.6 Billion	Some
Community Development Credit Unions in US*	CDCU	$65.1 Billion	Some
EQUITY			
Coop Investment Clubs	Investment club	$50,000	Yes. Clubs invest in cooperatives of all types, including worker coops.
Investment Funds (all types) Incorporating ESG and impact investment criteria*	Investment funds	$2.597 Trillion	Some
Foundation investments incorporating ESG and impact investment criteria*	Foundation endowments	$63.6 Billion	Some: indirectly through CDFI funds
Family Funds incorporating ESG and impact investment criteria*	Investment funds	$2.4 Billion	Some
Public Funds (pension funds, municipal, state, etc.) incorporating ESG and impact investment criteria*	Publicly managed funds	$2.71 Trillion	Very little
Labor Funds (SEIU, AFL-CIO, etc.) incorporating ESG and impact investment criteria*	Labor	$62.3 Billion	Very little
Faith-based Funds incorporating ESG and impact investment criteria*	Funds, endowments	$44 Billion	Some: indirectly through CDFI funds

*All sources with an * collected from US-SIF's Report on US Sustainable, Responsible and Impact Investing Trends, 2016.

APPENDIX C

WORKER COOPERATIVE PATIENT CAPITAL INVESTMENT OPTIONS

There are four main ways that worker cooperatives raise patient capital. All but the first are available to outside investors.

Type	Equity, debt, or hybrid	Distinguishing features
1. Member Equity Voting Shares	Equity	Class A stock (full voting rights) reserved for worker-owners. One member, one share.
2. Private Offering of Class B Preferred Stock	Equity	Class B stock confers limited/no voting rights and a target dividend. Only available to accredited investors. Advertising not allowed.
3. Investment Crowdfunding		
Direct Public Offering (DPO)	Equity, debt, revenue share or other	Shares available to accredited or unaccredited investors, voting rights vary. Registration process and costs vary. Advertising is allowed.
Title III Federal Crowdfunding	Equity, debt, revenue share or other	Shares available to accredited or unaccredited investors, voting rights vary. Registration process and costs vary. Advertising not allowed.
Investor-Member Shares through California Worker Cooperative Act (AB 816)	Equity only	Shares available to accredited or unaccredited investors with limited voting rights. Low barrier due to minimal costs and no registration requirements. Offered in CA only. A small number of other states may have similar statutes.
4. Indirect investments through Cooperative Loan Funds	Equity, debt, revenue share or hybrid / other	Investment of debt or equity into funds dedicated to worker cooperative development. Return rates and terms dependent on the fund.

APPENDIX D

SAMPLE TERM SHEETS

LEAF SAMPLE TERM SHEET

Reproduced with permission from Gerardo Espinoza, Executive Director, Local Enterprise Assistance Fund

SUMMARY OF TERMS

[DATE]

INVESTOR:	[investor name]
SSN:	[social security number]
BORROWER:	LEAF (Local Enterprise Assistance Fund, Inc.)
FACILITY:	Unsecured Term Loan
PRINCIPAL AMOUNT:	$100,000
TERM:	Five (5) Years
INTEREST RATE:	Three percent (3%) per annum, payable annually in arrears
AMORTIZATION:	No repayments prior to the Maturity Date
MATURIY DATE:	On the Fifth anniversary or the Closing Date
CLOSING DATE:	[date]
NOTICES TO INVESTOR:	[contact information]
NOTES TO BORROWER:	[contact information]

SHARED CAPITAL COOPERATIVE EXAMPLE INVESTMENT NOTES TERMS AND RATES

Summarized with permission from Christina Jennings, Executive Director, Shared Capital Cooperative

Investment notes have been issued to members and accredited investors, where allowable. Below is a sample of terms and rates:

INVESTMENT NOTES					
	1 Year	3 Years	5 Years	7 Years	10 Years
Under $25,000	1.00%	1.50%	2.00%	2.50%	3.00%
$25,000 TO $99,000	1.25%	2.00%	2.50%	3.00%	3.50%
$100,000 TO $499,000	1.50%	2.50%	3.00%	3.50%	4.00%
$500,000 and up	1.75%	3.00%	3.50%	4.00%	4.50%

APPENDIX D

SUMMARY OF SAMPLE PREFERRED STOCK OFFERING TERMS

SHARED CAPITAL COOPERATIVE EXAMPLE INVESTMENT NOTES TERMS AND RATES

Summarized with permission from Christina Jennings, Executive Director, Shared Capital Cooperative

Note: These were the stated terms of Shared Capital Cooperative's (SCC) last private placement offering. This offering is no longer open to investors interested in SCC. Shared Capital Cooperative is planning to open a new preferred equity offering in 2017.

Total Offering	The total amount shall not exceed $1,500,000.
Class A Preferred Stock	A maximum of 150,000 shares.
Offering Price	$10.00 per share.
Minimum Investment	An investor must purchase a minimum of $5,000 or Five Hundred (500) shares of Class A Preferred Stock and a current debt holder must convert at least $5,000 of principal.
Debt Conversion	Current debtholders of SCC may convert the principal amount of such debt into shares of Class A Preferred Stock at a rate of one (1) Share for each $10 of principal outstanding.
Redemption Right	A holder of Class A Preferred Stock may request redemption in writing and the Board of Directors, at its sole discretion may redeem such holder's Shares at an amount equal to the per share purchase price plus any declared but unpaid dividends.
Dividends	Up to 8% per annum, non-cumulative, at the discretion of the Board of Directors of SCC payable in the form of cash or additional shares of Class A Preferred Stock. The Board of Directors anticipates that dividends, if declared, will range between 2% and 6% per annum.
Liquidation Preference	Shares of Class A Preferred Stock have a liquidation preference prior to all other equity of SCC.
Voting Rights	None.
Transferability	Shares of Class A Preferred Stock are only transferable at the discretion of the Board of Directors.
Use of Proceeds	To provide loans to SCC's members consistent with lending policies or for other corporate purposes.

APPENDIX D

NAMASTE SOLAR: FUNDRAISING PLAN & OFFERING SUMMARY

This is the Fundraising Plan section of Namaste Solar's August 2015 Business Plan for a 2015 private offering.
Reproduced with permission from Blake Jones of Namaste Solar.

OUR FUNDRAISING PLAN

Private Offering
Namasté Solar is seeking up to $5M in external investment via a private offering of preferred stock that will have the following attributes:

1) 6.5% annual target dividend (non-guaranteed and non-cumulative)
2) $10k minimum investment amount
3) 5-year minimum investment term
4) No voting rights (in order to maintain our cooperative structure – i.e. one employee, one vote)
5) Preferred rights for dividends, redemption, and dissolution/liquidation
6) Non-assignability and non-transferability
7) A non-guaranteed "put" option – i.e. an option to request redemption by the company that can be granted at the Board of Director's discretion (for example, while considering the overall financial health of the company).
8) It is not our intention to sell Namasté Solar, but if this were ever to happen, any residual value would be divided as follows:
    a) First, declare and redeem any "undeclared" and/or "unredeemed" preferred dividends in any year(s) in which the full dividend target was not met;
    b) Second, divide the remaining residual value as follows:
        i) 33% to preferred stockholders collectively, divided pro-rata on a dollar-for-dollar basis;
        ii) 33% to common stockholders collectively (i.e. "Co-Owners"), divided per person;
        iii) 34% to one or more charitable organizations, as selected by the Board of Directors.

Investor Profile
Since our private offering is very unconventional, we realize that it will not appeal to most traditional investors. Our "ideal" investor would have the following attributes:

- Identifies with being an "Impact Investor" and "Patient Investor";
- Is interested in or is passionate about cooperatives, employee-owned companies, and/or democratic workplaces;
- Supports our high level of charitable giving (as opposed to using those funds to increase stockholder return);
- Believes in our mission and has personal values aligned with ours;
- Measures investment return holistically, not just in terms of financial gain.

In general, this investor profile also: (a) resembles the profile of our "ideal" Co-Owner who measures happiness and compensation holistically; and (b) aligns with how our company measures its profit and success in the same way.

APPENDIX D

"Exit Strategy"

Our vision for Namasté Solar is to remain an employee-owned company in perpetuity and to never sell the company. Despite this, our Bylaws stipulate that the company can be sold with a two-thirds passing vote by Co-Owners. In the absence of a company sale, the "exit strategy" for each individual Co-Owner and preferred stockholder is for the company to redeem their stock using a combination of: (a) paid-in capital from new preferred investors and Co-Owners; and (b) cash generated by the company's operations. We intend to hold a private offering of preferred stock every few years (or as needed) in order to create a continual cycle of investment whereby new investors would essentially replace redeeming investors and Co-Owners. From the proceeds of each private placement, we envision that a portion would be allocated towards redemptions – depending on the number of redemption requests – and the balance of the proceeds would go towards funding the company's growth and operations. Ultimately, additional capital will be raised only as/if needed, and the amounts will depend on future requirements for both redemption requests and pursuing growth opportunities.

Equity Capital Structure

Namasté Solar is an employee-owned cooperative with separate classes of voting common stock and non-voting preferred stock. Only employees can purchase a single share of voting common stock for $5,000 per share, but first they must complete a one-year "candidacy" period and be approved by a two-thirds vote of existing Co-Owners. If a Co-Owner departs from the company, or if their employment is terminated for whatever reason, the company must redeem their single share of common stock at its original purchase price. Thus, only Co-Owners can own voting common stock on a one-person, one-share, one-vote basis. Non-voting preferred stock can be purchased both by Co-Owners and by select, mission-aligned external investors (see "Investor Profile" section above) as part of a registered private offering (see "Private Offering" section above).

WHAT WE DO

Namasté Solar is a solar photovoltaic (PV) contractor and consultant that specializes solely in solar PV or solar electricity (as opposed to solar thermal or solar hot water). We are often referred to as an Engineering, Procurement, and Construction (EPC) contractor, meaning that we provide "turnkey" solutions whereby we sell, custom design, procure, install/construct, and service solar PV systems for each of our customers. We do not manufacture any products. We serve residential, commercial, government, and non-profit customers, and we have implemented solar PV projects at homes, office buildings, banks, credit unions, hospitals, schools, government buildings, municipal landfills, homeless shelters, and low-income housing projects. In addition to turnkey solutions, we also provide consulting services that assist with any one or more of the steps that are required in order to implement a solar PV project from start to finish.

APPENDIX E

INTERVIEWEES AND REVIEWERS

We wish to acknowledge the individuals listed below—our interviewees and reviewers—without whom this paper would not have been possible. We are so appreciative of all of your time, insight, and critical feedback. From impact investors to worker-owners to asset managers and cooperative developers, all of your contributions were tremendously helpful. Thank you.

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- Andrea Armeni, Executive Director, Transform Finance
- Annelise Grimm, Program Officer, James Irvine Foundation
- Ben Selden, Development and Marketing Manager, Local Enterprise Assistance Fund
- Brendan Martin, Executive Director, The Working World
- Camille Kerr, Associate Director, The ICA Group
- Catherine Yushina, Founder and COO, Startwise
- Christina Jennings, Executive Director, Shared Capital Cooperative
- Christina Oatfield, Policy Director, Sustainable Economies Law Center
- Corinne Florek, Executive Director, Religious Communities Investment Fund
- Dan Fireside, Capital Coordinator, Equal Exchange
- David Henry, Community Investment Portfolio Associate, Trillium Asset Management
- Drew Tulchin, Founder, Upspring Associates
- Estee Segal, Loan Officer, Capital Impact Partners
- Esther Park, Cienega Capital
- Gary Wyngarden, Investor in Namaste Solar
- Gerardo Espinoza, Executive Director, Local Enterprise Assistance Fund
- Hilary Abell, Co-founder, Project Equity
- Jessica LaBarbera, Vice President: Strategic Innovation, Nonprofit Finance Fund
- Justin Conway, Vice President: Investment Partnerships, Calvert Foundation
- Kate Danaher, Lending Manager, RSF Social Finance
- Kerwin Tesdell, President, Community Development Venture Capital Alliance
- Kim Arnone, Vice President of Cutting Edge Capital
- Lauryn Agnew, President, Seal Cove Financial
- Lor Holmes, CERO Cooperative
- Lynne Hoey, Underwriting Manager, RSF Social Finance
- Marco Vangelisti, Founder, Slow Money California
- Margaret Lund, cooperative developer and consultant
- Mary Ann Beyster, Foundation for Enterprise Development
- Matt Glatting, Investor Management, Capital Impact Partners
- Matt Meyer, Boston Cooperative Investment Club
- Melissa Hoover, Executive Director, Democracy at Work Institute
- Micha Josephy, Program Manager, Cooperative Fund of New England
- Miriam Joffe Block, former Program Manager, Beneficial State Foundation
- Morgan Simon, Managing Director, Pi Investments
- Nicole Grabos, Operations & Communications, Cutting Edge Capital
- Rebecca Dunn, Executive Director, Cooperative Fund of New England
- Sandy Osborne, Senior Officer of Investments, Impact Assets
- Scott Budde, Project Director, Maine Harvest Credit Project
- Sherman Kreiner, Managing Director, University of Winnipeg Community Renewal Corporation
- Simeon Chapin, Director of Community & Social Development, VSECU
- Stacey Cordeiro, Boston Center for Community Ownership
- Tom Abood, Investor in Namaste Solar

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