BUILDING *the* INCLUSIVE ECONOMY

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Broad-Based Ownership Models

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STRATEGIES FOR FINANCING THE INCLUSIVE ECONOMY

Financing strategies that support broad-based ownership models in creating jobs and building community wealth.

Marjorie Kelly, Violeta Duncan, and Steve Dubb *for The Democracy Collaborative*
With contributions from Oscar Perry Abello and Corey Rosen

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DEMOCRACY COLLABORATIVE

Building the Inclusive Economy series: Through three groundbreaking reports funded by Citi Community Development, the *Building the Inclusive Economy* series sets out effective, cutting-edge economic development models for city leaders and community development practitioners interested in embedding equity, community wealth, and sustainability into their local economic growth plan. This series, authored by The Democracy Collaborative, the Democracy at Work Institute, and Project Equity, lays out key tools and building blocks for equitable local economic growth through which all residents are able to maximize opportunities, thereby expanding urban economies where all can meaningfully participate and benefit.

The Democracy Collaborative: This nonprofit, founded in 2000, is a leader in equitable, inclusive, and sustainable development. Its work in community wealth building encompasses a range of advisory, research, policy development, and field-building activities aimed at enhancing the economic prospects of low- and moderate-income individuals. Its mission is to help shift the prevailing paradigm of economic development—and of the economy as a whole—toward a new system that is place-based, inclusive, collaborative, and ecologically sustainable.

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FOREWORD

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Citi Community Development and Inclusive Finance

Today, commercial corridors and property values in cities across the nation are benefiting from revitalization, yet at the same time, many local residents who have lived and worked in these communities for decades have not experienced the same benefits of increased wealth. As a founding member of the Asset Building Policy Network (ABPN), Citi has gained insights that taught us how to better understand the contributing factors and challenges associated with closing the racial wealth gap in America. We recognize that creating solutions for low-and moderate income communities, particularly communities of color and immigrant populations, requires intentional economic development strategies designed to preserve and build wealth within neighborhoods where people live and work. Utilizing this lens, Citi Community Development is collaborating with The Democracy Collaborative, to better understand ways to support economic development models that have the potential to facilitate local job growth and retention, stabilize neighborhoods, and create sustainable wealth. At Citi, we are excited to look at these models that focus on how to sustain locally-owned, "legacy" businesses that are at-risk of closing especially in low-income neighborhoods, in order to help bridge the racial wealth gap and boost minority small business.

Through our partnership, we have learned how key stakeholders in major cities are collaborating across industries and sectors to leverage and combine financing tools to complete projects and demonstrate employee-ownership models that prove a business case for investing in more equitable and inclusive economic growth. Broad-based business ownership models can be a transformative way of enabling businesses to remain in neighborhoods, continue to evolve and grow their business model and services, and expand wealth among employees who tend to live in the neighborhood of the business. Employee ownership, particularly among people of color, presents a tremendous opportunity but increased knowledge and focus on how to finance these models efficiently is necessary to achieve scale. A number of case studies highlighted in this publication are compelling and will likely continue to be researched and documented to amplify the economic impact of the company and spillover impact for the local community.

At Citi, we believe that community development is most successful when *all* have access, can participate, and benefit from their contributions to the local economy. With a particular focus on urban communities, we aim to help build more inclusive cities and value unique investment approaches and partnerships that contribute increased growth and ownership for local businesses and residents. We look forward to following the highlighted case studies, learning about new projects, and continuing the dialog about financing the inclusive economy.

September 2016

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Broad-based ownership models bring substantial benefits to communities and workers, particularly those of low and moderate income.

EXECUTIVE SUMMARY & INTRODUCTION

These models are poised for substantial growth as tools for solving the massive problem of economic inequality. In an economy where wages have been stagnant for decades—and a disturbing 40 percent of jobs are now part-time, temporary, or contingent—public interest in models fostering broad-based ownership has grown substantially.[1] Worker-owned companies, social enterprises, and related models with broad-based ownership are increasingly being seen as highly valuable tools for stemming and reversing rising economic inequality. How can these models grow to create more and better jobs and broader ownership opportunities? Every enterprise needs financing to grow. Where can the financing for broad-based ownership models be obtained? This report identifies ways to address these challenging questions.

Designed as a guidebook, this report seeks to demystify the financing of broad-based enterprise, and to show how and where these kinds of enterprises may be well positioned for job-creating growth. It was written with the hope of increasing understanding and comfort levels regarding financing these enterprises. The intended audience includes financial service providers, impact investors, foundations, local government, community development leaders, and others.

This guidebook forms the third part of a three-volume series, *Building the Inclusive Economy*, which focuses on the power of broad-based ownership models. The first report in the series offered an introduction to six models, showing how these models create jobs and broadly held wealth. The second looked at a cooperative development ecosystem. This report looks at how broad-based ownership models are financed to build community wealth. The models explored here are: cooperatives, employee stock ownership plans (ESOPs), social enterprises, hybrid enterprises, and municipal enterprises. Sidebars also look at how community development financial institutions (CDFIs) are supporting these efforts.

Broad-based ownership models, in many cases, employ traditional financing. The basic tools of debt and equity still apply to these ownership forms. Yet because these models have worker and community benefit as part of their core purpose, they have also evolved particular financing approaches that match their social aims. As these models spread, the role of lenders and investors will grow in coming years. That makes it critical to increase the field's understanding of the role of finance in supporting these models, how that role differs from traditional finance, and how that role is evolving.

Five key characteristics of financing broad-based ownership models that build community wealth for low- and moderate-income residents are:

Investor returns on financing broad-based ownership models vary across the spectrum of enterprise ownership. ESOP financing fits well within the frame of traditional investing. Indeed, research shows that investors in companies with broad-based employee ownership plans yield better returns than those with concentrated executive ownership.[2] No tradeoff is needed. Municipal bonds, on a risk-adjusted return basis, are also competitive. Given the tax advantages, public bonds can even offer superior returns. However, financing of worker co-ops and nonprofit social enterprises may need to be on the basis of below-market returns. In these cases, the aim is to permit investors and lenders to generate positive returns, while also allowing workers and the community to share in the benefits and build community wealth.

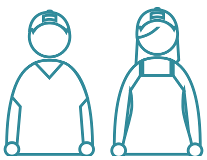
Philanthropic and government funding are important in business development in low-income communities. Traditionally, a new business often starts with personal and family financing and then proceeds to qualify for lender and investor capital. By contrast, when working with low-income populations, philanthropic and government funding at startup and growth stages can be critical; private capital tends to come later. Often—though not always—this private capital is socially oriented, patient capital. Among the reasons: Low-income, low-wealth workers and community members often lack the resources to finance a business on their own. Also, outside support may be needed to cover the technical assistance involved in the financing transaction.

Non-traditional, specialized, and innovative forms of finance are often involved. Cooperatives traditionally use membership fees and member loans as forms of financing. The co-op sector also has a handful of specialty lenders dedicated to that sector. Similarly, the ESOP field includes consulting and financing firms that specialize in ESOPs, and some financial service providers specialize in this type of lending. Another innovative model is the direct public offering (DPO), in which enterprises raise capital directly from their stakeholders, such as customers and neighbors; the DPO is in contrast to the more anonymous, dispersed relationships of an initial public offering (IPO) linked to stock market trading. Also of increasing importance are new crowdsourcing methods, such as those for non-accredited investors that are incorporated into the Jumpstart Our Business Startups (JOBS) act.

Ecosystems of support reduce risk and increase likelihood of success. The cultural view of traditional firms tends to embrace a myth of the lone, heroic entrepreneur, succeeding against the odds and amassing untold wealth. Broad-based ownership models, by contrast, are aimed at broadly held wealth, and they succeed best when embedded in community ecosystems of support. New York City, for example, has in recent years committed millions of dollars to supporting worker cooperatives, and the first year of this initiative saw the number of worker-owned cooperatives nearly double in that city.[3] Rising Tide Capital, based in Jersey City, New Jersey, supports low-income and immigrant entrepreneurs, and has achieved an impressive five-year survival rate for its entrepreneurial businesses of 87 percent.[4]

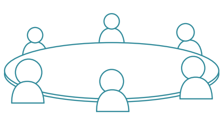
Knowledgeable lenders are needed to transition entrepreneur- and family-owned firms to worker ownership. Consensus is growing among economists that locally owned companies—particularly small and fast-growing companies—are one of the primary sources of job and economic growth in the United States.[5] This is leading increasing numbers of community economic development leaders, foundations, and local governments to begin supporting the startup and growth of locally owned firms, most of which are owned by founders and their families. Far less attention goes to *exit strategies* for these owners. Yet no entrepreneur lives forever, and very few family firms make it to the second or third generation of family ownership. Too often these firms ultimately are closed, or are sold to private equity or to competitors, which frequently means many jobs are lost. Transitioning these firms to worker ownership preserves jobs and helps halt the trend toward growing inequality. Traditional lenders, by becoming knowledgeable about financing sales to workers, can play a leading role in this vitally important transition, which is poised today to grow massively as baby boom entrepreneurs retire. This has been termed by leading cooperative community developers "the lending opportunity of a generation."[6]

Each of the five models covered here has its own nuances in financing methods. To summarize key takeaways of this report:



Financing Cooperatives: Cooperatives are member-owned businesses, based on the principle of one member, one share, one vote. As the oldest form of broad-based ownership, the cooperative model in some sectors has highly developed financing systems. Rural cooperatives (farmer-owned and rural utility co-ops) have the federally backed Farm Credit System; one part of this national network is CoBank, a national co-op bank with $117 billion in assets, which in early 2016 paid out more than half its annual earnings as dividends to member-owners. It has been named one of the world's safest banks. It offers a model of what a highly developed financing sector might look like one day for other types of cooperatives.[7]

Particularly promising for job creation are worker-owned cooperatives, the number of which is increasing rapidly today, although there are still only 350 in the United States. Innovative or alternative forms of finance include member contributions (often a relatively small proportion of capitalization), peer financing among cooperatives, sales of preferred stock (with lower voting rights), direct public offerings (in which shares are sold to stakeholders, with less expensive legal fees than initial public offerings), and foundation funding.



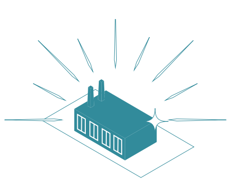
Financing ESOPs: An ESOP is a form of employee ownership where employee shares are held in a retirement trust. There are far more ESOPs than worker co-ops—about 6,800 ESOPs in the United States, with a total of 10.5 million employees; about 4,000 of these companies already are or will become majority employee-owned. This well-established sector has a large advising industry, with specialty consulting and financing firms that serve these companies. Close to three-quarters of ESOP conversions are leveraged via bank and seller loans. In contrast to cooperatives, employees become owners in ESOPs without paying a cent; companies fund contributions to an ESOP trust, and employees receive shares in the trust as a retirement benefit. Significant tax advantages accrue to those who sell to an ESOP, and to ESOP companies themselves.[8]

The coming retirement of baby boom entrepreneurs offers an enormous opportunity to grow worker ownership, both ESOP- and cooperative-owned. One estimate says 671,000 middle market businesses (between $10 million and $1 billion in revenue) will have to be sold, closed, or otherwise disposed of between 2011 and 2029, by baby boomers alone.[9] ESOPs will not be appropriate for all of these, but could be used for many of these.[10] UCSD business professor Martin Staubus estimates more than 150,000 may be well suited for conversions to ESOPs.[11] Still others, especially smaller businesses, could convert to worker cooperatives.[12] Employee ownership thus could ride this wave to become a force for reducing inequality and benefitting communities.

State or city employee ownership programs and other public incentives are among the growing supports for ESOP financing. A potentially large yet little-used incentive for ESOP financing is the Small Business Administration's 7(a) program, which offers partial loan guarantees; it includes special incentives for ESOPs that are not widely known.

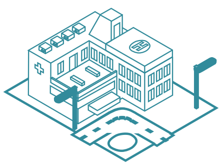
Financing Social Enterprises: Social enterprises, broadly construed, are organizations that employ commercial strategies to achieve a social mission. They can be divided loosely into two categories: 1) *nonprofit social enterprises*, which have a revenue-generating model covering part or all of operating costs, and 2) *for-profit social enterprises*, which encompass companies that are more traditional in their business models and have a strong social mission. The second kind is most likely to be capable of attracting financial capital and providing a competitive return.

Innovative financing methods for nonprofit social enterprises include program related investments by foundations, social impact bonds, and the federal Social Innovation Fund created in 2009. For-profit social enterprises may attract impact investments. In recent years, impact investing portfolios have been established by firms such as JP Morgan, Morgan Stanley, Deloitte, Deutsche Bank, and Goldman Sachs. Impact investors also gather in networks like the annual Social Capital (SOCAP) Markets Conference, which draws upwards of 10,000 attendees to its annual gathering.[13] Community-based enterprises—such as local, worker-owned firms—have not, to date, been given much attention by impact investors, but this may be on the threshold of changing.



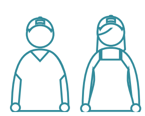
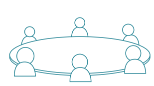
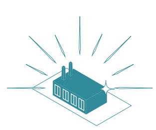
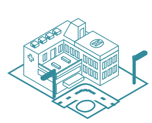
Financing Hybrid Enterprises: Hybrid enterprises are those that have adopted legal forms that embed social mission in their articles of incorporation and bylaws. Two primary forms have emerged: *low-profit limited liability corporations (L3Cs)* (designed to facilitate foundation investments) and *benefit corporations* (where companies declare social benefit to be a core purpose). Nationally, more than 1,300 L3Cs and 1,600 benefit corporations exist, a tremendous advance given a baseline of zero a decade ago.
A leading L3C philanthropic investor is the MacArthur Foundation, in Chicago, which made two impact investments totaling $5 million to help launch Commons Energy L3C, a company with a mission of helping underserved markets reduce energy and water

costs.[14] Two examples show the kinds of mainstream companies that are part of the benefit corporation community. Kickstarter, the online crowdfunding platform, became a benefit corporation in 2015.[15] Also in 2015, the online handicrafts marketplace Etsy became one of the first certified B Corporations to sell shares in an initial public offering, raising $267 million.[16] (B Corporation designation is a certification process by a nonprofit; becoming a benefit corporation is a matter of incorporation under state law.)



Financing Municipal Enterprises: Municipal enterprises are businesses owned or chartered by local public authorities that provide services and generate revenue. Four particular areas for new job creation are municipal water, transit-oriented development, high-speed internet, and hotels. For example, Jobs to Move America is a growing movement, promoted by the Los Angeles Alliance for a New Economy, with a plan to bring tens of thousands of manufacturing jobs back to America, using public dollars already pledged to mass transit development.

Among innovative forms of finance for municipal enterprise are economically targeted investments (ETIs)—socially oriented investments by public sector pension funds—which are on the rise in part due to recent U.S. Department of Labor guidance in favor of ETIs.[17] In addition, institutional investors are increasingly attracted to green bonds, which channel investments to green projects. Massachusetts in 2013 floated the first municipal bond labeled green by its issuer, a $100 million bond to back environmentally sound infrastructure projects.[18]

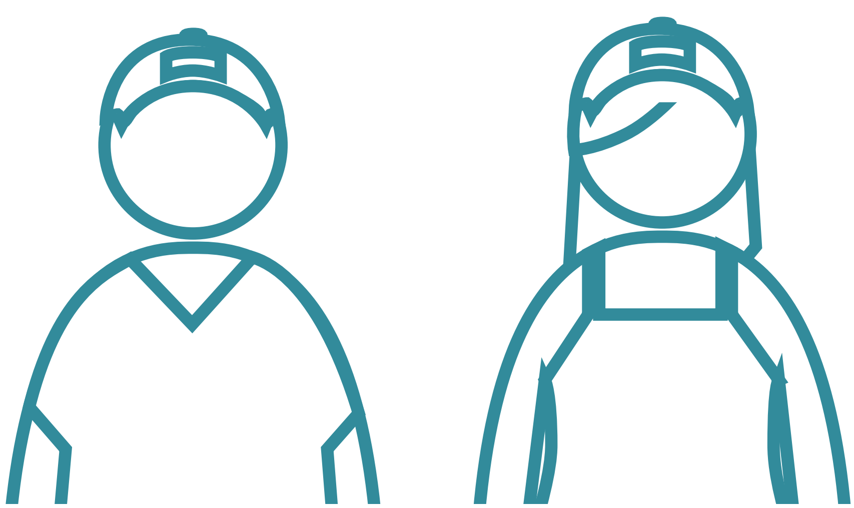
Broad-Based Ownership Models		Financing Strategies
COOPERATIVES		Specialized lenders; peer financing; preferred shares; foundation funding; direct public offerings.
ESOPs		SBA guarantees for loans; city/state employee ownership centers; public incentives.
SOCIAL ENTERPRISES		Mission-related investments; blended finance; social impact bonds, impact investing.
HYBRID ENTERPRISES		Initial public offerings; program related investments; municipal support.
MUNICIPAL ENTERPRISES		Muni-bond programs; green bonds; financing partnerships; economically targeted investments.

The poster child for broad-based ownership models today is the cooperative, a model gaining rapidly in popularity and visibility.

Cities like New York; Madison, Wisconsin; Austin, Texas; Richmond, California; and Rochester, New York have all taken recent steps toward systematically supporting the growth of cooperatives.[19] Of particular interest are worker co-ops and consumer food co-ops in food deserts as development tools in low-income communities and communities of color. Today, philanthropy and municipal governments are partnering with community groups and nonprofits to expand these efforts through grants, technical assistance, and investments in cooperative incubators. Impact investors and lenders are also beginning to finance cooperative businesses.

Financing Cooperatives

The cooperative is one of the oldest forms of broad-based ownership, dating back more than a century. A cooperative is a member-owned business, based on one member, one share, one vote. Depending on the business need and model, a cooperative can be owned by consumers, workers, producers (providing joint marketing for members, such as most farming co-ops), or purchasing members (providing purchasing services on behalf of business members, such as Ace Hardware). The cooperative sector already has tremendous scale and financing capacity. Indeed, credit unions and farm credit institutions in the U.S. have over $1.5 trillion in assets.[20] Overall, co-op assets in the U.S. exceed $3 trillion, while total co-op revenues exceed $500 billion a year.[21]



Traditional Financing for Cooperatives

A key source of funds for member-owned institutions is, and has historically been, the members. Indeed, raising equity from members encourages the success of the cooperative. In *Worker Cooperatives: Pathways to Scale*, cooperative developer Hilary Abell notes that co-ops which are founded with member shares or loans from members have been demonstrated to be most likely to survive.[22]

Community development financial institutions (CDFIs), which are chartered to serve the disadvantaged, are another source of financing for cooperatives. While most CDFIs do not provide substantial financing for worker-owned cooperatives, those that do include Capital Impact Partners, Common Wealth Revolving Loan Fund (which is part of the Ohio Employee Ownership Center), the Cooperative Fund of New England, the Local Enterprise Assistance Fund, and Shared Capital Cooperative of Minneapolis. For example, in 2014, the Cooperative Fund of New England and Coastal Enterprises, Inc., of Maine joined forces to finance a $5.6 million worker buyout from retiring business owners of three rural Maine businesses, converting those businesses into the 45-member worker-owned Island Employee Cooperative.[23]

Some cooperative sectors are today well served by larger financial institutions—which can provide a vision of how financing for worker-owned co-ops might potentially grow over time, as this sector expands. The most highly developed cooperative lending network is found in the farm sector. Particularly notable is the federally backed Farm Credit System, a national network of lending associations chartered to support agriculture and the rural economy. One part of this system, for example, is CoBank, a national cooperative bank with $117 billion in assets, which serves not only agribusinesses but also rural power, water, and communications providers.[24] These rural enterprises both own and borrow from the bank. Because it is a cooperative, its purpose is to serve them.[25] The bank in 2015 provided to its active members a 19.76 percent return on investment. In March 2016, CoBank distributed a record $514 million in total "patronage refunds" (a form of dividend) to its members, which is more than half the bank's earnings for that year.[26] This highly successful bank has been named by *Global Finance Magazine* one of the "World's 50 Safest Banks."[27]

Another dedicated financing entity, aimed more broadly at all cooperatives, is the National Cooperative Bank, the commercial bank subsidiary of National Consumer Cooperative Bank, with assets of $2.1 billion.[28] In 2015, this lender committed $290 million to lending and investments that served low- and moderate-income communities, including support for housing cooperatives, renewable energy, and small business.[29]

Challenges, Solutions, Opportunities

Existing large-scale cooperative financing entities generally support mature sectors, such as agriculture, rural power, and water. Worker cooperatives are less developed, but provide an important form of economic empowerment for low- and moderate-income individuals, especially in urban communities. Financing worker co-ops today often remains a challenge, for a variety of reasons. Here we summarize key challenges, some of which were explored in the recent report, *The Lending Opportunity of a Generation*, by the Cooperative Fund of New England, Project Equity, and the Democracy at Work Institute:

- **Worker-owners can generally contribute only a small amount in member financing.**[30] This is particularly the case when workers come from low-wealth backgrounds. Solutions, explored below, include using philanthropic dollars to subsidize member contributions and raising capital from outside investors via preferred share offerings and direct public offerings.[31]
- **Personal guarantees, often requested by lenders, are a challenge for lenders to collect on in a worker co-op** because many people own small parts of the business. A key solution can be limited loan guarantees from top management, key stakeholders, or the selling owner (in the case of a company converting to worker ownership).[32]
- **Credit scores are harder to assess in a co-op with many owners.** Instead, lenders can consider the strength of leadership, commitment of worker-owners, and the skill and experience in governance.[33] In short, underwriting for worker co-ops involves asking different questions and applying different standards. The CDFIs that are lending to worker co-ops have developed appropriate underwriting standards, but this knowledge has yet to be disseminated broadly through the financial services sector.
- **Worker-owned co-ops that are starting or transitioning to worker ownership often cannot afford** the full cost of legal and tax services, feasibility studies, valuations, and worker training.[34] These costs may need to be covered by grants, donations, local economic development agencies, or donated services of a CDFI or worker ownership center.
- **Lenders may lack knowledge of and comfort with cooperative lending.**[35] One solution is for lenders to partner with other organizations, technical assistance providers, or specialty lenders that have developed expertise in underwriting and financing these deals. Organizations like the Ohio Employee Ownership Center, Project Equity, the University of Wisconsin Center for Cooperatives, The Working World, and others can vet deals and offer needed business support to cooperatives—particularly in cases of conversions—allowing other lenders and investors to participate with greater confidence. Investors and lenders can also can make direct loans to CDFIs with cooperative finance specialization, such as the Cooperative Fund of New England and the Local Enterprise Assistance Fund. Lending to cooperatives can then be done by those funds.[36]
- **While local investors often are the most likely prospects, local investing has long remained legally difficult** due to securities restrictions. Change is under way, thanks to the passage of the JOBS Act, which is designed to enable small businesses to more easily raise up to $1 million a year through crowdfunding. Final rules for implementation were released in October 2015 by the Securities and Exchange Commission.[37] Similar rules also exist in many states.[38]

- **While there certainly remain challenges, the chance to transition more companies into ownership by workers is highly significant.**[39] One financial advising firm, drawing on PriceWaterhouseCoopers survey data, has calculated that over the next 15 to 17 years, almost 500,000 businesses could be sold to firm employees.[40]
- **One place financing is already flowing is to cooperatives—including worker co-ops—in food manufacturing and retail.**[41] Worker cooperatives like First Alternative in Oregon are taking advantage of resources like the National Cooperative Grocers Development Cooperative (NCG-DC) Loan Fund, which provides financing to food cooperatives seeking to expand, consolidate debt, and make capital improvements.[42] They have also successfully used federal funds from the Healthy Food and Financing Initiative (HFFI), which aims to eliminate food deserts and promote healthy food.[43] Green City Growers Cooperative in Cleveland received almost $800,000; Mandela MarketPlace in San Francisco received a $400,000 grant.[44] With its $3 million HFFI grant, the Cooperative Fund of New England in Amherst, Massachusetts, was able to expand its cooperative lending program and help create 400 new jobs.[45]

Innovative Financing for Cooperatives

In addition to traditional financing, innovations in financing cooperatives are emerging. Some examples:

Subsidizing member capital contributions: The consumer cooperative Mariposa Food Co-op in West Philadelphia, which employs almost 50 people in a mixed-income community, raises donations to subsidize its $200 capital requirement for new members when they cannot afford the fee.[46] The cooperative aims to sponsor at least 10 percent of its members.[47] When Mariposa expanded in 2012, it succeeded in getting 60 percent of its members to increase their member equity (a refundable financial investment); the cooperative also received loans, from $1,000 to $25,000, from 10 percent of members, helping it meet its goal of raising $2.5 million for the new store.[48]

Matched savings programs: The worker-owned Mandela Foods Cooperative in Oakland, California, uses a matched savings program to build the wealth and purchasing power of potential members. The cooperative dedicates one-third of its profits to a matched savings account held by People's Federal Credit Union, a local credit union that is a division of Self-Help Federal Credit Union.[49]

Peer financing among cooperatives: Some cooperatives devote a portion of profits to funds for investment in co-op development. The Evergreen Cooperatives in Cleveland, a network of three worker-owned cooperatives employing 120 people, sets aside 10 percent of profits for a common fund to be used to finance growth and the startup of new cooperatives. In western Massachusetts, seven worker co-ops in the Valley Alliance of Worker Cooperatives each contribute 5 percent of profits to a development fund.[50] The fund, now totaling $14,000, can count these assets as added collateral for other lending activity.[51] Shared Capital Cooperative, a CDFI based in Minneapolis, has a $10 million revolving loan fund, where half the capital comes from members, of which there are more than 200 organizations and 250 individuals. Only members may borrow, and almost 90 percent of lending has been to organizations in low- or moderate-income communities.[52]

Sales of preferred shares: In addition to shares for primary members—which form the basis for cooperatives' democratic ownership and governance design—cooperatives can also sell shares with limited voting rights in the form of preferred shares. Unlike traditional common stock, preferred stock does not increase in value over time; it pays a dividend at the discretion of the board. Preferred stock has long been a mainstay of public corporations, but it assumes particular importance in co-ops, where it often is the primary available vehicle for co-ops to raise outside equity capital.

Direct public offering (DPO): In a direct public offering, cooperatives use certain securities rules to make an investment offering to the public—most particularly to their own local stakeholders, who can include both accredited and unaccredited investors. Such offerings can be structured to limit legal fees. In 2015, for example, the Massachusetts startup CERO Cooperative, a composting and recycling worker-owned cooperative, successfully completed a DPO that raised $340,000. More than 80 investors participated, each placing an investment ranging from $2,500 up to $25,000. CERO's DPO offered a 4 percent targeted divided over five years.[53]

Increased foundation funding: In recent times, foundations have been showing increased activity in support of cooperative development. For example, the Denver Foundation funded a 75 percent time position for an urban cooperative director at the Rocky Mountain Farmers Union.[54] This has contributed to the development of the new Westwood Food Cooperative, which will help low-income immigrant and refugee families with backyard gardens earn extra income by selling produce to the cooperative.[55] The San Francisco Foundation has regularly supported the nonprofit worker-cooperative incubator Prospera (formerly Women's Action to Gain Economic Security, or WAGES) which has launched five cooperatives in the green cleaning industry, creating 92 positions for Latina worker-owners; nearly all (95 percent) of these worker-owners are immigrants, and 90 percent live below the poverty line.[56] The W.K. Kellogg Foundation gave $200,000 to the National Center for Employee Ownership in 2015, to improve understanding of how employee ownership can contribute to asset development and economic mobility for working parents of young children.[57] Kellogg has also supported employee ownership in Detroit with a $225,000 grant in 2014 to the Center for Community Based Enterprise to "assist low-/moderate-income Detroit residents in generating jobs with worker equity."[58]

ADDITIONAL RESOURCES

- ***Case Studies: Business Conversions to Worker Cooperatives,*** Project Equity, April 2015, http://www.project-equity.org/case-studies-business-conversions/download/
- ***The Lending Opportunity of a Generation: FAQs and Case Studies for Investing in Businesses Converting to Worker Ownership***, by the Cooperative Fund of New England, Project Equity and the Democracy at Work Institute, 2016, http://www.project-equity.org/wp-content/uploads/2016/02/LendingOpportunity-OfAGeneration_WorkerCoopConversionsFAQ_CaseStudies.pdf
- ***Worker Cooperatives: Pathways to Scale***, by Hilary Abell, The Democracy Collaborative, June 2014, http://democracycollaborative.org/content/worker-cooperatives-pathways-scale
- **Direct public offerings**, see Cutting Edge Capital, http://www.cuttingedgecapital.com/financing-strategies/
- **Cooperation Works!**, a national network of cooperative developers, http://www.cooperationworks.coop/
- **Free feasibility consultation**, contact the Democracy at Work Institute, conversions@institute.usworker.coop; http://institute.coop
- **Service Provider Directory,** Democracy at Work Institute, http://institute.coop/service-provider-directory

The worker-owners of Real Pickles in Massachusetts raised $500,000 through a direct public offering (DPO)—a fundraising vehicle similar to an initial public offering in that a business can advertise the offering openly and can accept non-wealthy investors. However, DPOs require substantially less in legal costs, are targeted at stakeholders such as customers and neighbors, and are able to raise up to $1 million.

Photo c/o Real Pickles

Case Studies in Financing Cooperatives

CASE STUDY

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REAL PICKLES DPO: HOW WORKERS RAISED A HALF A MILLION DOLLARS TO BUY A BUSINESS

Real Pickles sold its first jar of organic dills in 2001, when founders Dan Rosenberg and his wife, Addie Rose Holland, decided to turn their pickle-making hobby into a business.[59] It has grown to more than $1 million in revenue in 2015, earning $125,000 in net income.[60] How workers bought this business from the founders, using the innovative model of a direct public offering, offers lessons in grassroots financing for worker ownership.

In 2012, the co-founders and staff members formed a new worker cooperative to purchase the business. The five worker-owners each purchased a $6,000 membership share, a price determined based on worker affordability. The workers then faced the hurdle of raising more than $500,000 to buy the business and have operating capital.[61]

Preferred stock was considered the most viable option. The aim is to pay investors a 4 to 5 percent annual dividend; this was deemed more workable than the 8 to 12 percent interest on a subordinated loan, or the 15 percent annual return needed for a royalty arrangement (in which royalties are a percent of profits). Real Pickles added the innovation of selling preferred shares through a direct public offering (DPO).[62]

A DPO is similar to an initial public offering (IPO), in that the business can advertise the offering openly and can accept non-wealthy investors; yet a DPO costs substantially less in legal fees, raises only up to $1 million, and is targeted at stakeholders, such as customers and neighbors.[63] Real Pickles was assisted by Cutting Edge Capital, which has helped more than 60 clients launch DPOs.

Real Pickles set the minimum investment at $2,500. This was a "key decision," Rosenberg has said. "It was a figure low enough to allow for relatively broad participation, while high enough to keep our investment pool a manageable size."[64] Shares are non-transferable except to the co-op, and they include a 4 percent dividend target when the board decides to distribute dividends. Shares must be held for at least five years to be sold back at the same price for which they were purchased.[65]

Real Pickles sold $500,000 in shares to 77 investors; some used their self-directed individual retirement accounts. Institutional investors included consumer co-ops that purchase from Real Pickles, other wholesale customers, one supplier, a foundation, and a CDFI. The company planned a six-month campaign, but the shares sold out in two months. Workers completed the purchase of the business in May 2013.[66]

Financing the Worker Buyout of Real Pickles[67]

Source	Amount	Notes
Cooperative Capital Fund	$69,000	5-year term, interest only
DPO: Preferred Shares	$500,000	From 77 investors
Worker-Owner Equity	$30,000	Member Fees, $6,000 each worker-owner
Bank Line of Credit	$150,000	Local bank
Total	**$749,000**	
Uses	Amount	
Purchase of business	$622,239	
Working capital	$126,761	
Total	**$749,000**	

Pioneering the sale of preferred shares to impact investors, the 120-member worker-cooperative Equal Exchange has been able to raise $16 million. Preferred shares are a form of equity with limited voting rights; the stock price does not rise over time and investors instead enjoy a stream of dividends.

Photo c/o Joe Driscoll, Creative Commons licensing

CASE STUDY

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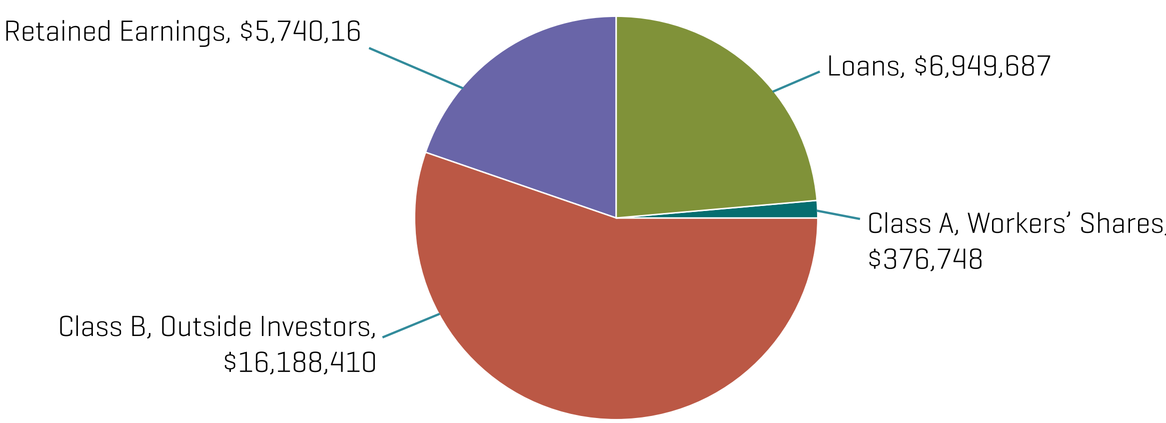
EQUAL EXCHANGE: INNOVATION IN USE OF PREFERRED STOCK

Massachusetts-based Equal Exchange is a $60 million importer and wholesaler of high quality, organic coffee, tea, olive oil, bananas, and other foods to customers across the U.S. All Equal Exchange products are intended to benefit its suppliers, who include more than 50 small farmer co-operatives in 40 countries around the world. This approach, known as fair trade, is one that Equal Exchange was a pioneer in creating.[68] It has pioneered in another area as well, using the sale of preferred shares to impact investors as a way to bring some $16 million in financing into a worker-owned cooperative.[69]

Preferred shares are a form of equity with limited voting rights, where the stock price does not rise over time and investors instead enjoy a stream of dividends. Equal Exchange's annual dividends have fairly consistently been 5 percent an-

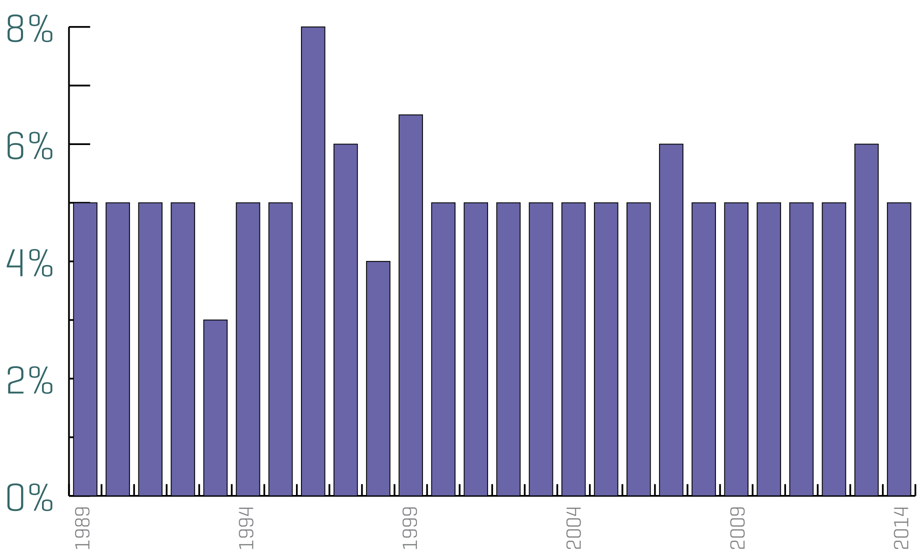
Equal Exchange Capital Mix 2015[70]



nually over fifteen years. This reliable—and today, relatively handsome—return on investment has enabled Equal Exchange to raise more than $16 million using this method. Most recently, in April 2015 the 120-member worker cooperative completed an offering of $4 million in preferred shares. This was the largest stock sale ever by a worker co-op in North America.[71]

As Daniel Fireside and Rodney North of Equal Exchange wrote recently, "This isn't high-stakes venture capital where backers expect the company to either sell out or go public. Instead it's slow financing from over 600 people and institutions that share the company's values, and who want to help it grow without ever putting those values at risk, or undermining the absolute control" of worker-owners. The model was introduced to Equal Exchange by Boston's ICA Group, which has been supporting worker-owned enterprises for 40 years.[72]

Equal Exchange Annual Dividend Payments 1989-2014[73]



Fireside and North report that as a result of the use of preferred stock, Equal Exchange now has twice as much equity capital as debt. That gives it its pick of possible lenders. The company borrows from mission-aligned entitles such as the Cooperative Fund of New England, National Cooperative Bank, the Calvert Foundation, and RSF Social Finance.[74]

CASE STUDY

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RENAISSANCE COMMUNITY COOPERATIVE: RAISING $2.48 MILLION FROM DIVERSE STAKEHOLDERS IN A FOOD DESERT

For residents of northeast Greensboro, North Carolina, the closing of a Winn-Dixie store in 1998 created a food desert.[75] By 2016, however, residents had joined together to create the Renaissance Community Co-op (RCC), expected to open by fall 2016.[76] RCC provides a powerful example of how community members, philanthropy, local government, and CDFIs can come together to build community wealth—creating jobs, making affordable food available to low-income families, and developing a community asset.

The estimated cost of financing is $2.48 million. The store is expected to employ 15 full-time and 13 part-time employees, and to generate over $3.6 million in sales in its first year.[77] By grocery standards, $2.48 million in capital is a relatively small number. Yet co-op member-owner equity was unlikely to raise this amount, and in fact contributed just $100,000. All told, the project raised $1.5 million in equity and $983,000 in debt financing. Sources are listed below:[78]

Financing the Renaissance Community Cooperative

Source	Amount	Notes
Shared Capital Cooperative & The Working World (CDFIs)	$733,000	Debt
Self-Help Ventures Fund (CDFI)	$590,000	Equity
Fund for Democratic Communities, Cone Health, Food Co-op Initiative, & Mt. Zion Baptist (Philanthropy)	$376,400	Equity
City of Greensboro	$250,000	Grant & Equity
Owner loans	$200,000	Debt
The Working World (CDFI)	$150,000	Equity
Member shares	$100,000	Equity, shares purchased @ $100 each
Community Foundation of Greater Greensboro (Philanthropy)	$50,000	Debt
Grassroots fundraising	$33,177	Equity
Total	**$2,482,577**	

One key partner is the Self-Help Ventures Fund, part of Durham-based Self-Help Credit Union, the nation's largest community development credit union. In January 2015, Self Help purchased the former Winn-Dixie site from the city for $490,000, with the intent to lease to RCC.[79]

The city government contributed financing of $250,000.[80] Community-based financing (owner equity, owner loans, and crowdsourcing) raised an additional $333,177. Philanthropy and churches provided $376,400 in grants and another $50,000 in low-interest loans. Community development financial institutions were the largest funding source: Self-Help Ventures provided $590,000 in cash (equity) for build-out, while other CDFIs provided loans totaling $733,000.[81]

One unique funding stream was from Regenerative Finance, a group of young impact investors who committed $253,000 to the project for terms of 11 to 15 years. These investments were placed via a co-op loan fund with The Working World, which is providing capital to RCC. Rather than use conventional debt, The Working World relies on royalty payments tied to profitability, so that payments are not made to investors until the business is profitable, making this financing more like equity.[82]

The Working World also provided $150,000 in pure equity through the purchase of preferred shares.

A $1 million loan from The Working World helped workers at New Era Windows convert a failing factory into a thriving worker-owned business. The Working World, which has made more than 1,000 non-extractive investments in worker-owned companies, is repaid from profits generated by a business, much like an equity investment, though without taking ownership from the workers. This "royalty" financing allows the business to expand without excessive debt burdens.

Photo c/o The Working World

CASE STUDY

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THE WORKING WORLD: FINANCING STARTUPS AND CONVERSIONS TO COOPERATIVES

Since its founding in 2005, The Working World has helped to demonstrate that capital can be subordinate to labor in a thriving cooperative economy. During the past eleven years, this organization has made more than 1,000 non-extractive investments in hundreds of worker-owned companies. More than 98 percent of the projects have succeeded, generating enough income for The Working World fund that it has never had a losing year. The Working World currently has assets of $5 million, built mostly on investments leveraged on an initial cushion of philanthropic funding. It has investment offices in Nicaragua and Argentina as well as the U.S. Its next aim is to build a $20 million fund and become self-sustaining within five years as investment income becomes sufficient to cover operating costs.[83]

The Working World's first cooperative project in the U.S. was New Era Windows in Chicago, where a $1 million investment helped convert to worker ownership a window business that had imploded amid financial scandals and labor abuses by its former owners.[84] In the New York City area, The Working World has helped three cooperatives get started. It is currently in the process of starting five more NYC worker-owned cooperatives—helping them either start from scratch or convert from existing enterprises.[85]

In addition to financing, The Working World provides technical assistance to cooperatives in formation, and to businesses converting into cooperatives. Financing from The Working World is repaid only from profits generated by the business, much like an equity investment, though without taking ownership from the workers. This leaves the workers with zero debt until the business is profitable and can begin to pay back the financing. Even after cooperative formation, The Working World will stay on board to assist with further financing. For example, the fund has extended New Era Windows three lines of credit, for a total of $500,000, to help with growth, including a line of credit in March 2015 needed to cope with landing a large municipal contract.[86]

As of April 2016, The Working World was in the midst of applying for federal certification as a CDFI.[87]

CASE STUDY

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CAPITAL IMPACT PARTNERS: CONVENING A WORKING GROUP OF CO-OP LENDERS

One of the leading CDFIs financing cooperatives is Capital Impact Partners, originally created in 1981 as the high-risk development arm of the National Consumer Cooperative Bank (NCCB).[88] Over the course of its history, Capital Impact Partners has deployed $278 million in capital to 208 cooperatives, both consumer and worker/producer types.[89] While its current loan portfolio of around $200 million includes significant lending for a variety of purposes—including charter schools and affordable housing—lending to cooperatives remains a strategic imperative, and it promises to become more important in coming years.[90]

In 2014, Capital Impact Partners helped organize a working group of co-op lenders that continues to meet regularly via phone calls and at various conferences—and to explore together how they can more effectively finance cooperatives. The group includes the Local Enterprise Assistance Fund (also associated with ICA Group), the Cooperative Fund of New England, Shared Capital Cooperative (formerly Northcountry Cooperative Development Fund), National Cooperative Bank, The Working World, and the Ohio Center for Employee Ownership. Topics the group has discussed include technical assistance to others to support the growth of lending to cooperatives, building the co-op lending pipeline, cooperative conversions in low-income communities, and broad field-building challenges and opportunities.[91]

Many of these CDFIs fund worker ownership conversions. In one example, in 2014, the Cooperative Fund of New England and Coastal Enterprises, Inc., joined forces to finance a $5.6 million worker buyout from retiring business owners of three rural Maine businesses and converted those businesses into the 62-member worker-owned Island Employee Cooperative.[92]

Most recently, in 2015, Capital Impact Partners established the National Cooperative Grocers Development Cooperative (NCG-DC) Loan Fund, a partnership with the National Cooperative Grocers, which provides financing to food cooperatives seeking to expand, consolidate debt, and make capital improvements. Member cooperatives invest in the NCG-DC Loan Fund, which lends money to other members. The fund has made one investment so far.[93]

Capital Impact Partners also launched a grant program in 2015, the Co-op Innovation Award, a small pool of money for national organizations working to increase coops in low-income communities, specifically focused on scale and replication. The first two recipients were the U.S. Federation of Worker Cooperatives and the Democracy at Work Institute.[94]

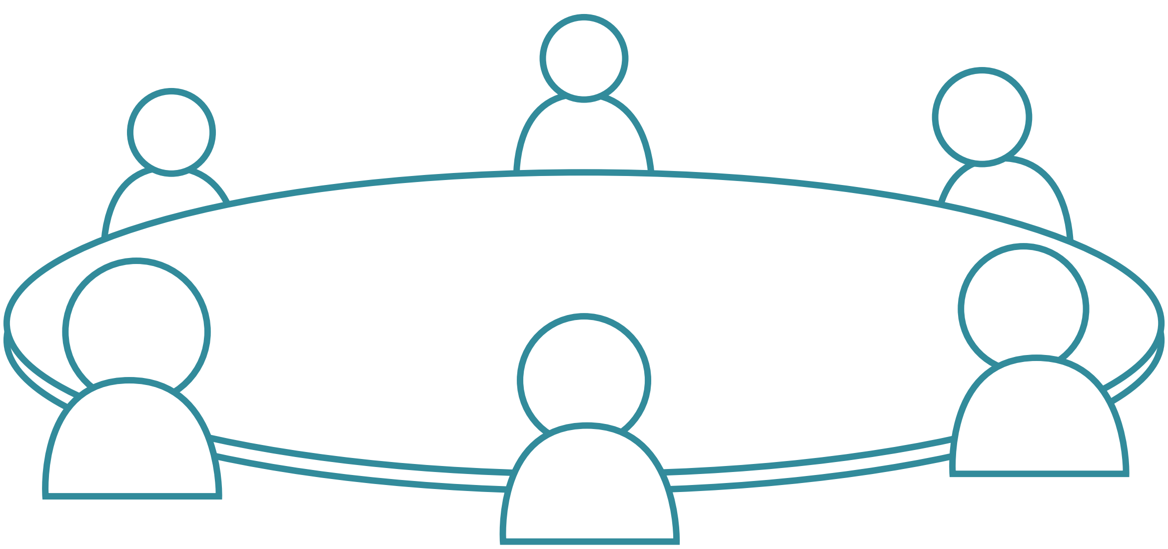
Every day, millions of customers pour into Publix Super Markets and Wawa Gas & Convenience Stores, two of the most successful companies in their industries.

Both are known for having nearly cult-like brand loyalty due to the superior service of their highly engaged employees.[95] There's something else these chain-retailers have in common: both are owned wholly or in part by their employees through the structure of an employee stock ownership plan (ESOP).

Financing Employee Stock Ownership Plans

While the worker cooperative form works for both startups and conversions to employee ownership, the ESOP model is primarily used in conversions of existing companies (and also as an employee incentive program). The ESOP form is appropriate for larger companies, generally 20 employees or more. Indeed, ESOP companies can be extremely large. Publix, which is approximately 85 percent worker-owned, has 179,000 employees and in 2015 had revenues of $32 billion—placing it at 101 on the Fortune 500 list of largest companies.[96]

There are at least 6,795 ESOPs in the United States, compared with only 350 worker cooperatives.[97] About 4,000 of the ESOPs are or are on a path to becoming majority employee-owned.[98] The economic impact of ESOPs is significant: These companies employ over 10.5 million workers, and ESOPs control assets of $1.23 trillion.[99]



The coming wave of retirement among baby boomer enterprise owners offers an enormous opportunity to leverage the ESOP structure for the benefit of workers and communities. David Freedman of The McLean Group estimates that more than 671,000 middle market businesses worth some $2.5 trillion will have to be sold, closed, or otherwise disposed of between 2011 and 2029 by baby boomers alone. That's about 35,000 middle market businesses per year.[100] If even one fifth of these businesses were to convert to employee ownership, that would double the number of employee-owned businesses in a single year. (Middle market firms have between roughly $10 million and $1 billion in revenue.)

How this sea change affects communities depends on who buys these businesses. Indeed, who buys the businesses will help determine who benefits from what is poised to be the largest generational transfer of wealth in U.S. history.[101] Employee ownership could ride this wave to become a major force for preserving jobs, enhancing employee wealth, reducing inequality, and creating a broader and more racially diverse class of business owners.

Employee ownership has begun to appear more prominently on the national policy agenda. For example, the Center for American Progress, a major progressive think tank, has released a series of reports on employee ownership, including one in July 2015 entitled *Capitalism for Everyone*, which explores federal policies to promote broad-based worker ownership and profit sharing.[102] Jared Bernstein, former chief economic advisor to Vice President Joe Biden, released a report in January 2016 entitled *Employee Ownership, ESOPs, Wealth, And Wages*, in which he concluded that if ESOPs were to proliferate, "their impact on inequality reduction could well be significant."[103]

Interest in employee ownership among philanthropic leaders is also rising. For example, Phillip Henderson, president of Surdna Foundation, published an op-ed in the *Chronicle of Philanthropy* in spring 2016 in which he said, "Philanthropy should embrace the largely untapped potential of worker ownership" as a solution to inequality, and he called for a new alliance of foundations to collectively take on this challenge.[104]

Understanding ESOPs

Unlike a worker co-op—where one share is held directly by each employee-owner—in an ESOP shares are held in trust, and the number of shares can vary among employees. ESOPs are a form of retirement plan. Employees cash out upon retirement or when they leave the firm. Companies can be wholly or partially owned by employees through the ESOP trust, which is managed by a trustee.

With co-ops, employees make a modest payment for their membership share, sometimes out of a payroll deduction. In ESOPs, by contrast, employees become owners without paying a cent. How is that possible? Instead of employees purchasing shares in the company, the company funds contributions to the trust, and employees receive those shares as a benefit.

Because both models enable business ownership to be shared among a broad base of employees, both ESOPs and worker cooperatives are valuable in promoting inclusion. The National Center for Employee Ownership finds that employees at ESOP firms on average enjoy 5 to 12 percent more in wages than workers in comparable non-ESOP firms, and have more than double the retirement savings. ESOP companies also have 2.5 percent per year greater growth in employment, sales and productivity than would have been expected absent an ESOP.[105] In 2014, when close to 10 percent of employees without stock ownership reported being laid off, a layoff was reported by just 1.3 percent of employees at firms with employee ownership.[106] Employee-owned companies are, in addition, disproportionately represented among *Fortune*'s 100 Best Companies to Work For. Of the 100 companies for 2015, 37 had some kind of broad-based ownership plan.[107]

Employee ownership benefits communities as well, since it keeps companies rooted locally over the long term; employee-owned companies are typically locally owned and thus less likely to relocate. A large number of studies have shown that about three times more revenue recirculates in a community when spent at a business that is locally owned than with national chains.[108] Due to these and other social benefits, Congress has provided tax advantages to incentivize the creation of more ESOPs and employee-owned firms.[109]

Tax Benefits for ESOPs

There are three forms of tax advantages for ESOPs and for owners who sell to them:

- **Company contributions to an ESOP are tax deductible.** This means both principal and interest on a sale to an ESOP are deductible; in a non-ESOP transaction, only interest is deductible.
- **An owner selling at least 30 percent to an ESOP can defer capital gains taxes,** by investing the proceeds in another U.S. company. Capital gains from the sale are not taxed until that newly purchased stock is sold.
- **S corporation ESOPs pay lower or no taxes on company income.** S corporations pass gains and losses through to shareholders. When an ESOP trust is a shareholder in an S corporation, income to the trust is not taxed until employee-owners cash in their shares upon leaving the company. If an S corporation is 100 percent owned by an ESOP trust, it pays no corporate income tax. (This is a key reason S corporation ESOPs are today a fast-growing category of ESOPs.)[110]

Traditional Financing for ESOPs

Companies generally transition ownership into an ESOP using debt of various kinds. ESOP trusts enjoy a special privilege as the only benefits plan that can legally borrow money.

Leveraged ESOP: A large majority of conversions to employee ownership are accomplished through a leveraged ESOP, in which an ESOP borrows money and buys the owner's stock, repaying the loan over time out of cash flow. According to a 2015 survey by the National Center for Employee Ownership, 72 percent of ESOP transactions are leveraged. Because lenders generally prefer to loan directly to the company (since its assets can better secure the loan), the transaction is often accomplished by the company borrowing money and then relending it to the ESOP plan.[111]

Non-leveraged ESOP: In this method, the ESOP uses company contributions to purchase stock each year, rather than to repay a loan. Employee ownership is created by simply contributing stock directly to the ESOP plan (a transaction that is tax deductible). Or companies can make pre-tax contributions of cash to the plan, which the ESOP plan then uses to buy stock from the company (either common or preferred).

A leveraged ESOP sounds simple enough, but the actual transaction is a bit more complex. The company must first set up the ESOP trust and then take out a commercial loan (this is called an outside loan) and/or, very commonly, the seller takes a note. Next the company re-lends the funds directly to the ESOP trust (an inside loan). The proceeds are then used by the ESOP to buy shares of stock in the company, which are placed into a "suspense account," to be released gradually as the inside loan is repaid. To enable the ESOP to repay its loan to the company, the firm makes cash contributions, which are tax-deductible, directly to the trust. Eventually, the loan is repaid, the shares are fully paid for, and the employees own the shares free and clear through the ESOP.[112]

How a Leveraged ESOP Works:

STEP 1
Company ABC sets up an ESOP trust.

STEP 2
Company ABC borrows $ from a lender (called an outside loan) and/or the seller.

STEP 3
Company ABC re-loans $ to the ESOP, usually at a similar interest rate (an inside loan).

STEP 4
The ESOP then uses the proceeds from the loan to buy shares of the company. These could be existing shares or newly issued stock.

STEP 5
Stock purchased by the ESOP is held in a "suspense account," to be released to employee accounts over time, as the loan is repaid.

STEP 6
The company makes tax-deductible contributions to the ESOP so that it may repay the loan. It may also issue dividends (also tax deductible) on shares held by the ESOP.

STEP 7
The ESOP uses those contributions plus any dividends to repay the loan from Company ABC or the commercial lender.

Source: Scott S. Rodrick et. al, *Leveraged ESOPs and Employee Buyouts*, Oakland, CA: National Center for Employee Ownership (NCEO), 2000.

ESOP financing generally employs a combination of these forms:

- **Traditional commercial lenders:** ESOP transactions are often financed with senior debt. Either the ESOP trust or the sponsor company can seek a loan to fund the ESOP's acquisition of shares in the company. If the company takes the loan, it will usually re-loan those funds to the ESOP. There are a number of national and regional banks that have dedicated ESOP lending departments.[113]
- **Seller financing:** The current owners can lend money and take a note, instead of or in addition to a bank loan. Partial seller financing can help smooth the way for a loan, and it allows the seller to enjoy interest income as well as income from the sale itself.
- **Partnering with private ESOP development firms:** A large ESOP advising industry exists, including firms that have helped structure thousands of ESOP transactions.[114] The ESOP Association, the industry trade association, maintains a general directory of firms that work with ESOPs.[115]
- **Mezzanine financing:** This form of financing can supplement capital raised from traditional debt and the selling owners. Mezzanine financing refers to a layer of financing between senior debt (which takes priority in repayment) and owner equity. It may take the form of debt capital that gives the lender the option of converting to equity.
- **Bond market:** Though not a common practice, ESOPs can issue bonds to raise debt capital.

Challenges, Solutions, Opportunities

- **ESOP companies can face challenges with fees or excessive debt.** One ESOP challenge is generating adequate cash to make regular contributions to the ESOP (if unleveraged) or payment on debt service (if leveraged). An additional challenge is that some companies can be too small to afford the fees and annual administration costs of setting up and managing an ESOP. Smaller companies may be better off seeking conversion to a worker cooperative.
- **Challenges to seller financing:** Forming an ESOP with seller financing generally requires strong motivation by the seller. There are challenges that could impact a seller's interest, including:

  Price competition—Legally, an ESOP can purchase shares of a company only at fair market value, as determined by an independent valuation, based on what a financial buyer would pay. Yet, in a fairly small minority of cases, strategic acquirers may be willing to pay a premium. This can create a competitive disadvantage for the ESOP model, if the owner prioritizes maximizing sale price.

  Liquidity—A seller who seeks to immediately and completely cash out of a business may find it difficult to obtain the necessary financing unless he or she is willing to take on a substantial seller note as part of the deal. If the owner is leaving, there also needs to be qualified successor management.
- **ESOPs may not mean employee ownership in perpetuity.** ESOPs are governed by the Employee Retirement Income Security Act (ERISA), which governs pensions and requires trustees to act in the best interests of beneficiaries, which is generally taken to mean selling the company to the highest bidder. In essence, if a trustee receives an offer to purchase the company—for example, from a private equity firm—he or she often feels obligated to sell. Employees themselves also may seek to sell the

company when their shares represent substantial wealth. One example is Full Sail Brewing, once a model ESOP company, until employees and founders voted nearly unanimously in 2015 to sell to a private equity firm. (It's worth noting that the two founders apparently initiated the sale, controlled more than 40 percent of the company, and served as the sole trustees of the ESOP.)[116] Another challenge is the need for the company to cash out employees when they retire; this is called the "repurchase obligation." In particular, when many employees retire at once (say, because of a demographic bulge in the workforce), this can create a cash crunch, which may lead the ESOP board to choose to sell shares to an outside buyer rather than be forced to deplete cash reserves.[117]

- **One solution to the perpetuity problem is employee ownership through a perpetual trust—**similar to the trust that owns the John Lewis Partnership, a large department store and grocery store chain in the U.K. that is 100 percent owned by its employees. The first U.S. company to adopt this innovative model was WATG, an architecture and interior design firm with 365 employees, which created a perpetual trust for employee ownership in 2014. Previous company owners, who were senior company leaders, rejected a handsome buyer's offer, instead opting to create the trust. WATG took a bank loan and used it to make a gift to the trust, which allowed the trust to purchase 60 percent of shares; the ultimate goal is 100 percent ownership. The trust's founding document says its purpose is to hold shares of WATG "as a permanent part of ownership and governance." Employees benefit by receiving a share of annual profits, but do not actually own any shares or benefit from the growth in equity value.[118]
- **Significant tax advantages accrue to both sellers to ESOPs and to ESOP companies themselves.** If owners sell to an outside buyer, they will pay taxes on the net long-term capital gain. But if owners sell at least 30 percent to an ESOP, they can roll over the proceeds into U.S. stocks or bonds and avoid paying tax until that replacement investment is sold. In addition, when companies make contributions to an ESOP to buy a seller's stock, those contributions are fully deductible, which reduces company income taxes. If an ESOP company is an S corporation, it will pay no income taxes on retained earnings that accrue to the ESOP; employees will owe taxes on that income when they terminate their employment (at a time when their taxable income may be lower, due to retirement).[119]
- **Reduced turnover can be a major benefit of an ESOP.** For example, Carris Reels, which makes packaging for the wire and cable industry, is a company with $83 million in annual sales and 450 employees; it is now 100 percent ESOP-owned. CFO David Fitzgerald has said, "Before the ESOP, we had 100 [percent] employee turnover in our Michigan and North Carolina facilities. Now that the ESOP owns the company, turnover is 20 percent companywide."[120]

Innovative Financing for ESOPs

Innovations are emerging in ESOP financing that may offer clues for how to increase the total number of ESOPs as a share of total U.S. businesses. Some examples include:

Small Business Investment Companies

The Small Business Investment Company (SBIC) program of the U.S. Small Business Administration (SBA) increases capital for small businesses by licensing private investment funds as SBICs; these funds then use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses.[121] A few private equity firms now use SBICs to finance leveraged ESOP transactions. In Charlotte, North Carolina, the private equity firm Mosaic Capital Partners raised a $165 million SBIC fund that provides $3 million to $15 million in mezzanine debt and equity to lower middle market companies to fund ESOP buyouts.[122] Working in collaboration with a private credit fund and a bank that provides senior debt, Mosaic Capital Partners has completed four transactions in one year alone, including the leveraged ESOP buyout of the previously family-owned, California-based Hollandia Produce, a leading greenhouse grower of hydroponic lettuce in the U.S.[123]

State employee ownership centers

Employee ownership centers include the Vermont Employee Ownership Center, the Ohio Employee Ownership Center, the Rocky Mountain Employee Ownership Center, the Pennsylvania Center for Employee Ownership (an affiliate of the National Center for Employee Ownership), and the California Center for Employee Ownership run by the Beyster Institute at the University of California, San Diego. They promote employee ownership through information, outreach, and preliminary technical assistance. Both the Vermont and Ohio centers also operate revolving loan funds.[124] Several other state centers are in development.[125]

Public incentives to drive private investment

Governments can offer direct investment for employee ownership, or use loan guarantees and other credit enhancements. One example is the Indiana ESOP Initiative (IEI), created by then-Treasurer Richard Mourdock in 2007. “No group of employee owners has ever, ever, ever, ever moved their company to Mexico or China!” Mourdock once exclaimed.[126] Having participated in an ESOP earlier in his career, Mourdock chose to encourage the creation of ESOPs through a $50 million linked deposit program.[127] The state treasurer purchased CDs at a slightly reduced rate of interest, which served as collateral, allowing reduced interest rates for companies.[128] In its first two years, IEI helped to create more than 900 new employee-owners.[129] IEI remains of interest as a model, though the program may no longer be active; the state website reports the initiative “is currently being reviewed and evaluated by the Treasurer of State’s Office,” and the office did not return calls seeking comment.

ADDITIONAL RESOURCES

- **ESOP Financing Issue Brief,** The ESOP Association, http://members.esopassociation.org/imis/ItemDetail?iProductCode=ISSBR5&CATEGORY=BRIEF
- **ESOP Experts Online Directory,** The ESOP Association, http://www.esopassociation.org/network/esop-experts
- **ESOP Professional Services Directory,** National Center for Employee Ownership, http://www.nceo.org/pages/directory.php
- **Guide to Leveraged ESOPs,** National Center for Employee Ownership, http://www.nceo.org/Leveraged-ESOPs-Employee-Buyouts/pub.php/id/20/
- **SBIC program,** U.S. Small Business Association, https://www.sba.gov/sbic/general-information/program-overview
- **Employee-Owned S Corporations of America,** ESCA, http://esca.us/.

In 2015, GAC Chemical Corporation founder Jim Poure sold his shares to an ESOP trust, in part through a loan from Bar Harbor Bank & Trust, which was helped by a 75 percent loan guarantee from the Small Business Administration's 7(a) program. Every year, this guarantee program generates more than $10 billion in lending.

Photo c/o GAC Chemical Corporation

Case Studies in Financing ESOPs

CASE STUDY

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SBA 7(A) FINANCING: A VALUABLE, UNDERUSED STRATEGY FOR ESOPs

A little-known, little-used form of financing for ESOPs is the 7(a) program of the U.S. Small Business Administration (SBA), which provides a partial loan guarantee to lenders, encouraging them to make loans to companies that might otherwise lack access.[130] Every year, according to Rob Wilson of C7(a) Financing LLC, this guarantee program of the SBA facilitates more than $10 billion in lending. The law offers special incentives for ESOP borrowers by not requiring the same loan guarantees required of other borrowers. Yet Wilson observed that the 7(a) program still remains little known in the financial services and ESOP worlds.[131]

That may be changing, Wilson wrote in the May-June 2016 issue of the *Employee Ownership Report*, published by the National Center for Employee Ownership. He reported that several recent ESOP transactions have used SBA 7(a) financing. One example is GAC Chemical Corporation of Maine. In 2015, founder Jim Poure sold his shares to an ESOP trust, in part through a loan from Bar Harbor Bank & Trust, which was helped by a 75 percent loan guarantee from the SBA.[132]

Another example Wilson discussed was the sale of an environmental consulting firm to an ESOP as an owner exit strategy. The total transaction was $5.1 million. A bank provided $3.1 million, with a 75 percent guarantee from the SBA. The seller was not required to make a personal guarantee, but did find it necessary to loan the ESOP $900,000. The final $1.1 million came from the company's cash reserves.

Because "goodwill" was a large part of the purchase price (meaning no hard assets backed that value), many lenders might have declined this loan. It was an SBA 7(a) lender that eventually agreed to do the deal.[133]

Why is 7(a) financing little used? Partly it is lack of knowledge in parties involved. Also, there are restrictions when two complex federal programs, SBA 7(a) and the Employee Retirement Income Security Act (ERISA), which governs ESOPs, are involved. To meet the "small business" limit set by the SBA, there is a $5 million limit on 7(a) loans. There are also limits on firm size—$7 million in annual revenue for industries like services, retail trade, and construction; 500 employees for firms in manufacturing and mining; and 100 employees for companies in wholesale trade industries.[134]

Wilson noted that a high percentage of ESOP transactions would still fall within the appropriate range. He added that, given the large opportunity represented, the ESOP community would be wise to pay attention to 7(a) loans.[135]

CASE STUDY

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BARCLAY WATER MANAGEMENT: MANY PATHS TO FINANCING EMPLOYEE OWNERSHIP

Corey Rosen, founder of the National Center for Employee Ownership, shares this story:

The story of Barclay Water Management offers a useful illustration of the many ways employees can buy a business: 1) Buying it directly with after-tax dollars. 2) Establishing an ESOP, which uses pre-tax dollars and gives sellers better tax treatment. 3) Funding the ESOP through a combination of loans and annual cash contributions. 4) Becoming fully employee-owned by borrowing commercial loans and seller notes. It's all there in this one story.

The tale of Barclay Water Management dates back to 1932, when the company was established. Today this company provides a complete range of water treatment solutions for industrial, commercial, and institutional clients in the Northeast and Mid-Atlantic states. It was in 1982 that founder Stan Barclay began selling stock to some of the company's managers. That's the first method: direct sale to employees using after-tax dollars. Within ten years, the employees owned 100 percent of the company, with most stock held by key managers and lesser amounts by others.

As some of the managers started to look to sell, Bill Brett, the company's CEO, heard about ESOPs at a conference where Barclay was named one of the country's top small workplaces. It seemed like the perfect fit. The company, which had about 80 employees, would set up an ESOP trust that would buy shares from employees. Now the second method was in play.

To continue employee ownership, the company would need to employ the third method: funding the ESOP with pre-tax profit contributions from the company and debt. This initial tranche enabled the ESOP to buy 22 percent of the business, which was then allocated to employees who had worked at least 200 hours in a year. Employees receive allocations based on relative pay (a flatter formula can also be used] and become vested incrementally over six years. If they choose to leave the company before the age of 65, the company will re-purchase their shares of stock and convert them into cash, which is paid out over a period of time. At each point, the shares are valued through an appraisal by an outside valuation firm.

By 2016, Barclay had about 100 employees and the ESOP owned 29 percent of the shares. At this time, many of the key owners, including Brett, were ready to move on. The next step, then, was for the ESOP to buy out the remaining shares. Additional debt was needed.

First, the trust used a commercial loan, payable over five years, to buy out in full several of the shareholders. The trust gained the access to the capital through the company, which, unlike the trust, has collateral and can more easily access bank loans. The ESOP will repay the debt to the company, and as it does so, shares will be released to employee accounts. The transaction also nets benefits to the company and employees. The company receives a tax deduction for the annual contribution to the trust, and employees are able to become business owners at no cost. With ESOPs, becoming vested in a business is a company benefit.

Left with the task of compensating the largest shareholders, the ESOP needs to do a bit more maneuvering. To complete the buyout, the trust entered into an agreement with the remaining shareholders. The company will issue warrants on behalf of the trust to existing managers and will purchase seller's notes, which are subordinate to the commercial loan, from shareholders as well. This allows the remaining shareholders to be repaid principal and interest, for a period of six to 10 years, plus warrants, which will enable them to participate in gains as the company becomes more successful.

When shareholders eventually cash out their shares, they will get a reasonable return on the notes. Meanwhile, Barclay's former owners can choose to reinvest the income in certain other securities and defer any tax on the gain until they sell those new investments, or they can pay capital gains taxes at the time of sale.

Barclay was always a very good company with a strong pro-employee culture, but since becoming an ESOP, it has created ways for employees to get more involved in generating ideas. After the company began sharing detailed metrics with employees, many innovations in sales followed and profits tripled in one year alone. Employees came up with a whole new line of business, making sure water systems are providing safe drinking water—a key issue for hospitals. The employee-generated approach is more efficient and safer than traditional treatment methods.

While many of its peer craft brewers have been selling to multinationals, New Belgium Brewing of Fort Collins, Colorado—makers of Fat Tire Amber Ale—has chosen to become employee-owned and share wealth with workers. After becoming partially owned by an ESOP in 2000, in 2012 New Belgium transitioned to 100 percent employee ownership.

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CASE STUDY

Click for info

NEW BELGIUM BREWING: STARTING A TREND OF EMPLOYEE OWNERSHIP AMONG CRAFT BREWERS

It was the start of something big when New Belgium Brewing of Fort Collins, Colorado—makers of Fat Tire Amber Ale—became partially owned by an ESOP in 2000. The company transitioned to 100 percent ESOP ownership in 2012. In an industry where other craft brewers were selling to multinationals, New Belgium took a significant step toward remaining independent, toward sharing wealth with employees—and toward sparking a trend among other craft brewers.[136]

When co-founder Kim Jordan and her former husband launched the company in 1991, they took out a second mortgage and used credit cards to achieve an initial capitalization of $60,000. "We then got a brewery equipment vendor to help us get financing from a leasing company and an SBA loan" to open a second brewery, Jordan told *Fortune*. Expansion was done with traditional financing; New Belgium has never had equity investors.[137]

The two founders gave 10 percent of ownership to co-workers in 1996, through a deferred compensation plan. In 2000 they merged that plan with an ESOP, which then owned 32 percent of the firm. When the couple divorced in 2009, the company bought out the shares of Jordan's husband and retired those shares. In 2012, all remaining outstanding shares—held by Jordan, her two sons, and five managers—were sold to the ESOP. A bank provided a loan for much of the purchase, and Jordan financed the rest with a loan to the company. "Now we operate as an ESOP with a B corporation designation," Jordan said. "We disburse a number of shares to all of our owner co-workers every year."[138]

Jordan stepped down as CEO in mid-2015. Will New Belgium remain employee-owned in perpetuity? In December 2015, *The Denver Post* reported that the company had hired an investment banking firm to explore a potential sale for $1 billion or more. Jordan, now board chair, said no deal is pending.[139] One source close to New Belgium reported that there is no intention now to sell, nor an active buyer trying to purchase the company.

CASE STUDY

Click for info

OHIO EMPLOYEE OWNERSHIP CENTER: BRINGING ESOPs TO DOZENS OF INDUSTRIAL COMPANIES

When the owners of Hy-Tek Material Handling in Ohio were nearing retirement, the company chose to transition ownership to an ESOP in 2007. Company income that would have otherwise been taxed instead went to fund worker ownership, helping rebuild the balance sheet. The ESOP proved to be an engine for growth, as well as a boon to employees and a powerful recruiting tool. In the nine years Hy-Tek has been an ESOP, revenue and income have increased more than 200 percent—outpacing growth from any other period in the company's 53-year history.[140]

Hy-Tek is a supplier of material-handling products for industry, such as shelving, pallets, and bins of all kinds—a far cry from the organic bakeries or solar companies often associated with worker ownership.[141] Yet Hy-Tek is typical of the industrial companies the Ohio Employee Ownership Center (OEOC) has supported. OEOC director Roy Messing says he expects more companies will transition to worker ownership in coming years as aging owners face a market filled with many companies up for sale, making sale to employees an attractive alternative. "These businesses are getting grayer, and they are going to have to do something," Messing said.[142]

The OEOC is a nonprofit center established at Kent State University in 1987 to provide information and preliminary technical assistance about employee ownership. It has helped nearly 100 companies convert to at least partial employee ownership, with 15,000 employee-owners created, many of them through ESOPs. Some $350 million in company wealth has been directed to employees—with the average wealth created at around $40,000 per employee-owner. This has been accomplished at surprisingly low cost: around $772 per job created or retained.[143]

OEOC finances some transactions through the Common Wealth Revolving Loan Fund (CWRLF) it operates, which became a certified CDFI in 2013. CWRLF raises capital through social investment notes that offer below-market interest rates and are sold to individuals, corporations, foundations, and religious organizations. Through its specialized underwriting procedures (particularly effective for companies that lack collateral), the fund is able to offer more generous and flexible loan terms than traditional lenders. The fund also works with other partners, such as local financial institutions, to secure financing for small ESOP companies. The powerful combination of financing, specialized underwriting procedures, and technical assistance has demonstrably increased the number of ESOPs in the target footprint.[144]

Social enterprises, broadly construed, are organizations that employ commercial strategies to achieve a social mission.

While definitions of social enterprise vary widely, for the purposes of this report, social enterprises can best be thought of as being divided into two broad categories.

Financing Social Enterprises

One category—which we might informally term *nonprofit social enterprise*—includes nonprofit organizations and their subsidiaries that have a revenue-generating model covering part or all of their operating costs. These nonprofit social enterprises are the ones most likely to call themselves social enterprises, and to belong to social enterprise associations, such as the Social Enterprise Alliance, which has close to 1,000 members. Often, these social enterprises have a primary purpose of employing residents in underserved communities.

Estimates of scale vary widely. The Great Social Enterprise Census, launched by Pacific Community Ventures, found $300 million in revenue and 14,000 employees in 2012. Although modest (and also likely a considerable underestimate), these counts represent more than a doubling of capacity in the preceding six years, since 60 percent of the businesses that responded had been formed in 2006 or more recently.[145]

A second category—which we might term *for-profit social enterprise*—embraces companies that are more traditional in their business models and have a strong social mission, thus may be viewed by investors as social enterprises. These are the kinds of companies most likely to be capable of attracting financial capital and providing a competitive return.

Each category involves different financing mechanisms and is worth looking at separately.

Traditional Financing for Nonprofit Social Enterprises

Foundation funding: Foundations remain a starting point for funding many social enterprises. In essence, nonprofits typically initiate social enterprise as a method by which they can stretch grant dollars further, by generating earned income that can supplement grant and donor funds. The businesses developed often enable nonprofits to do their core mission work better—for example, having a client work at a social enterprise consistently results in job placement outcomes far superior to a simple job training program. Occasionally, fellowships through organizations like Ashoka or Echoing Green—which provide networking, capacity building, and stipends for social entrepreneurs—can help finance social enterprises. Echoing Green's fellowship program is almost three decades old, and its alumni include founders of social enterprises such as Hot Bread Kitchen, which employs immigrant women and helps transition them to long-term careers in the baking industry.[146]

Program related investments (PRIs): Once there is reliable revenue coming into the social enterprise, it may qualify for program related investments. These are typically below-market rate loans, considered part of the foundation's annual 5 percent distribution. To qualify as a PRI, an investment must have a charitable purpose consistent with the foundation's mission. A PRI helps establish a track record of repayments that may help attract other investors in later stages of growth.

SOCIAL RETURN ON INVESTMENT

For nonprofit social enterprises, return on investment is sometimes measured in social terms. A 2015 study, for example, found that for every $1 spent by social enterprise, society nets a 123 percent return on investment. Taxpayers see a quarter of this return, as the reliance on government benefits is lessened and revenues bolster financial independence.[147]

One example is DC Central Kitchen, which reduces prison recidivism through culinary job training and placement. Reporting on its economic impact, DC Central Kitchen notes that by serving up to 5,000 meals a day to nonprofits and schools it saves these organizations around $3.7 million in annual food and labor costs.[148] The organization reports a job placement rate of 90 percent and says that it trains the unemployed for less than half the cost of other organizations.[149] And since it helps ex-offenders graduate and find work, with an average recidivism rate of only 2 percent (compared to a more typical rate of 50 percent), taxpayers are spared the expense of law enforcement, homeless services, and welfare payments.[150] All told, DC Central Kitchen finds that this adds up to a "350 percent return on investment for our community each year."[151]

Challenges, Solutions, Opportunities

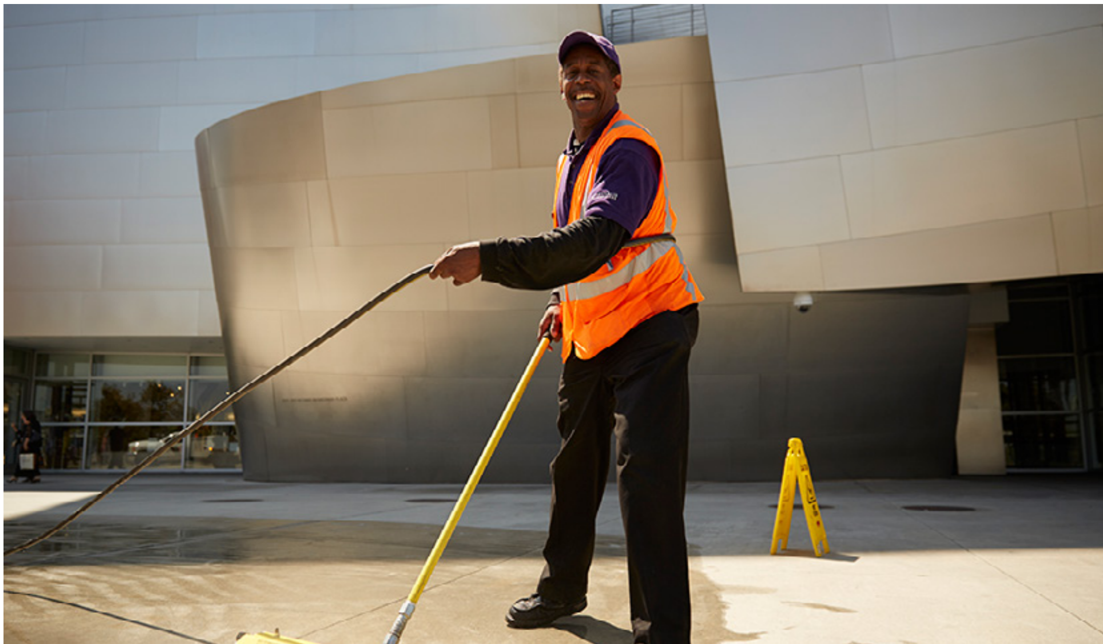
- **Nonprofit social enterprises often make low or no profits,** making it difficult to qualify for loans and investments. Among financing solutions are loan guarantees by foundations or other stakeholders, the growth of specialized nonprofit financing funds, and the ability to make the case for a social return on investment above and beyond financial return.
- **For-profit social enterprises can possess unique advantages in seeking financing.** As Tasha Seitz, chief investment officer of Impact Engine, a social enterprise accelerator in Chicago, said to *Forbes*, "Social enterprises can find sources of funding aligned with their mission that your typical firm doesn't have access to."[152] They also can sometimes combine philanthropic with other forms of financing.
- **New IRS clarifications for mission-related investments** by foundations were issued in 2015. This clears the way for more impact investing for social enterprise development.[153]
- **Growing investment by large players** is another sign of increasing potential for social enterprise investment. Larger financial asset management firms, such as JP Morgan, Morgan Stanley, Deloitte, Deutsche Bank, and Goldman Sachs, have all established impact investing portfolios in recent years to focus on the social enterprise space.[154]

Innovative Financing for Nonprofit Social Enterprises

Mission-related investments (MRIs): Beyond grants and PRI, more innovative is the growing use of mission-related investments in social enterprises. MRIs are made by foundations with the expectation of generating social or environmental benefits, as well as risk-adjusted, market-rate returns. Unlike PRIs, MRIs are made from a foundation's asset base, endowment, or corpus. MRIs, too, are a form of impact investing; some foundations may have engaged in this practice for some time without naming it at all. A 2015 report from Arabella Advisories, a philanthropy consulting firm, reports that only one in ten small foundations is participating in impact investing, but those that are doing it are doing a lot.[155] For small foundations participating in impact investing, the average share of portfolios in impact investments is 40 percent, according to data from Exponent Philanthropy, a membership group of smaller philanthropic organizations.[156]

Combining grants and investments: Some forward-thinking funders—such as RSF Social Finance, the F.B. Heron Foundation, and the Omidyar Network—have reoriented themselves to combine various kinds of capital in support of social enterprises.

Social impact bonds: These bonds, also known as pay-for-success bonds, are an emerging area of finance that is helping social enterprises scale. Social impact bonds create a unique partnership among government, philanthropy, and nonprofit organizations. States issue bonds to private companies and philanthropies that are repayable only if the social enterprise meets its stated social goals. The idea is that government pays only for positive outcomes and investors share the risk of achieving these outcomes. One organization working with social impact bonds is Social Finance in Boston, which brokered an arrangement with the state of New York to bring in $13.5 million to the Center for Employment Op-



One of the nation's most prominent social enterprise accelerators is REDF, which has supported more than 60 social enterprises, helping to create more than 11,000 jobs, particularly for the most marginalized. This San Francisco–based organization has received two multimillion-dollar grants from the Federal Social Innovation Fund, which will allow REDF to expand to regions outside of California, including Seattle; Chicago; Denver; Austin, Texas; and Portland, Oregon.

Photo c/o REDF

portunities (CEO) in 2014.[157] CEO is a nonprofit which prepares the formerly incarcerated for employment, saving $4,100 in criminal justice costs per participant.[158] This social impact bond, paid for by private investors putting in a minimum of $100,000 each, helped CEO provide job training to 2,000 new clients. New York State will repay investors, with a premium, if performance targets are met.[159]

Federal Social Innovation Fund: Created in 2009, this federal grant-making body funds proven social innovations that help low-income communities, with grants that generally require one-to-one matches. One social enterprise organization receiving a grant is REDF (formerly the Robert Enterprise Development Fund), one of the nation's most prominent social enterprise accelerators. This San Francisco–based organization has supported more than 60 social enterprises, helping to create more than 11,000 jobs, particularly for the most marginalized—those with backgrounds of homelessness, incarceration, addiction, or mental illness.[160] REDF has received two large grants from the Social Innovation Fund, for $7.5 million in 2010 and another $7 million in 2015,[161] which will allow REDF to expand to regions outside of California, including Boston; Seattle; Chicago; Denver; Indianapolis; Austin, Texas, and Portland, Oregon.[162] The majority of the funds, 95 percent, will be disbursed as subgrants to 22 social enterprises that aid those with barriers to employment.[163]

Innovative Financing for For-Profit Social Enterprises

Well-established networks and gatherings exist among impact investors seeking to invest in the second category of social enterprises, those that are more like commercial businesses. Most prominently there is the annual Social Capital (SOCAP) Markets Conference, first held in 2008, which draws upwards of 10,000 attendees to its annual Bay Area gathering.[164] The Global Impact Investing Network (GIIN), established in 2009, now counts around 200 members among investors, asset managers, and service providers.[165] While many investors in these networks invest globally, the United States is an increasing focus of these groups.

The financial ecosystem for social enterprises continues to evolve. Public, private, and philanthropic sectors all invest in social enterprises. One of the chief early complaints from early actors in this space was that there were not enough investable social enterprises. Part of this was due to the fact that many investors wished to see substantial social impact, but were unwilling to accept below-market returns, which narrowed the universe of investable options.

Impact investing: Impact investing is debt or equity capital (not grants) that seeks to create social returns along with financial returns. It is generally available only to firms with a proven business model and an established track record of profitable operation. Impact investor capital can come from socially responsible investment firms, most of which are members of the Social Investment Forum trade group. Other impact investors can be local angel investors. New players are emerging continuously. One example is ImpactAssets, which offers philanthropist and individual investors impact investing opportunities through donor advised funds and impact investing notes. Regenerative Finance, which attracts funds from wealthy millennials—who are helping finance the Renaissance Co-op in Greensboro mentioned above—is another example.[166]

Blended finance: Social enterprises with the ability to scale and make a profit can find success in attracting both grants and equity financing. One social enterprise that has accomplished this is Jail Education Solutions, which sells a wireless, tablet-based education system for the incarcerated. Since its launch three years ago, this Chicago firm has raised $1.5 million in equity and $500,000 in grants, including a grant from the MacArthur Foundation, a PRI from the Patricia Kind Family Foundation, and venture capital from Kapor Capital, Serious Change, and SustainVC's Patient Capital Collaborative.[167]

ADDITIONAL RESOURCES

- ***Impact to Last: Lessons from the Front Lines of Social Enterprise,*** REDF, 2015, http://redf.org/learn-category/impact-to-last/
- **Social Innovation Fund,** Corporation for National and Community Service, http://www.nationalservice.gov/programs/social-innovation-fund
- **Social Enterprise Alliance,** http://www.se-alliance.org
- **Social Investment Forum,** http://www.ussif.org/

CASE STUDY

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OMIDYAR NETWORK SEEKS CATALYTIC IMPACT

The Omidyar Network—established in 2004 by eBay founder Pierre Omidyar—consists of both a 501(c)(3) grant-making foundation and a for-profit limited liability company that makes investments. The aim with both sides is to support market-based approaches that have the potential for large-scale, catalytic impact.[168]

Since its inception, the Omidyar Network has invested $461 million, as well as disbursing $508 million in grants.[169] Its first investment in the social accountability space was in SeeClickFix, which builds open-source, customized platforms for individuals to report and monitor non-emergency issues in their communities.[170] The Omidyar Network joined with another impact investment group to make an equity investment of $1.5 million in SeeClickFix in 2011, and joined a second equity investment of $1.4 million with a larger group of impact investors in 2014.[171]

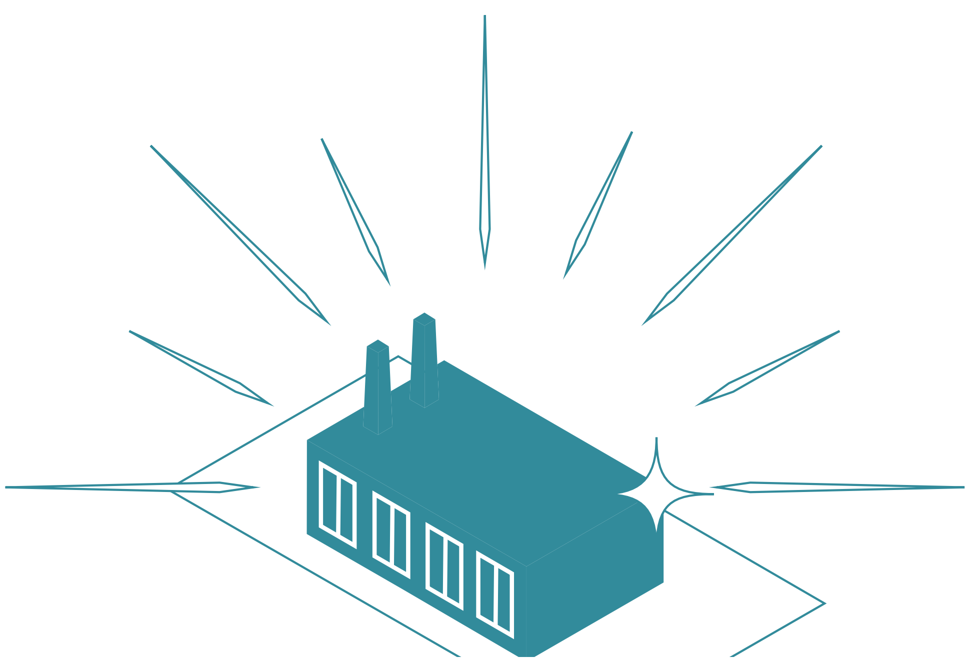
The Omidyar Network also invests in other fund managers that seek to invest in social enterprises, such as Core Innovation Capital, which makes investments in financial services and technology firms that create consumer financial products, particularly for those who have traditionally lacked access.[172] Core Innovation launched in 2010 with $45 million in capital,[173] and has invested in thirteen companies.[174] One firm that Core Innovation invested in is Atlanta-based L2C, which developed tools for lending to individuals with limited credit histories.[175] L2C's tools and models were so promising that it was acquired in 2014 by TransUnion, one of the big three credit rating companies, which sought to provide more data to financial services clients seeking to increase lending to individuals from underserved backgrounds.[176]

Hybrid enterprises are businesses that have adopted legal forms that embed some form of social mission in their articles of incorporation and bylaws.

In the United States, two primary forms of hybrid enterprise have emerged over the past decade: low-profit limited liability corporations (L3Cs) and benefit corporations. An L3C is a limited liability company in which the profit goal is subordinated to a charitable mission. A benefit corporation, by contrast, is a form of corporation whose bylaws outline an express social mission. Nationally, there are now more than 1,300 L3Cs and 1,600 benefit corporations, a remarkable expansion from a baseline of zero a decade ago.[177]

Financing Hybrid Enterprises

Hybrid enterprise has many origins, among which are Jed Emerson's concept of "blended value" (a business blending nonprofit and for-profit approaches), and Heerad Sabeti's concept of "for-benefit" enterprises, which exist for social benefit, in contrast to "for-profit" enterprises, which exist to maximize financial returns.[178] Sabeti envisioned an emerging "fourth sector" of enterprises designed for social benefit, a sector different from the customary three sectors of government, traditional for-profit business, and nonprofit organizations.



Low-Profit Limited Liiability Corporations (L3Cs)

One advantage of the L3C is that, by design, it can raise funds from both investors and philanthropy. The form was in fact created primarily to facilitate the uses of program related investments from philanthropic organizations. As mentioned previously, PRIs are low-interest loans aligned with a foundation's charitable mission. Because PRIs are typically repaid, the money lent out can be recycled to benefit multiple projects.

One of the nation's leading LC3 philanthropic investors is the MacArthur Foundation in Chicago. In 2014, for example, MacArthur made two impact investments totaling $5 million to help launch Commons Energy L3C, which has a mission of helping underserved markets reduce energy and water costs. Commons Energy is a subsidiary of the nonprofit Vermont Energy Investment Corporation. Additional support for Commons Energy included a PRI of up to a $2 million from the Kresge Foundation, in the form of a credit enhancement (i.e., effectively a subsidized line of credit), as well as a $250,000 mission investment from the High Meadows Fund.[179] Commons Energy's status as an L3C may have helped it attract these mission-oriented investments. It is appropriately incorporated as a hybrid, for it is the nation's first public-purpose energy services company (ESCO). It differs from a traditional ESCO in that its goal is not maximum profit but deeper energy savings.[180] Commons Energy provides technical assistance and investment capital to owners of small and medium-sized buildings that are generally left out of the ESCO marketplace, such as schools, health care facilities, and affordable multifamily housing.[181]

Benefit Corporations

Benefit corporations or B corporations can refer to enterprises of many types, including cooperatives, ESOPs, and publicly traded companies. Essentially, being a benefit corporation is a public declaration of intent to serve the public good. An advantage of the benefit corporation model is that corporations of any size—even large publicly traded corporations—can hypothetically adopt this design as a way to help retain the primacy of the social mission over time. Kickstarter, the online crowdfunding platform, became one of the most prominent firms to become a benefit corporation in September 2015. "We don't ever want to sell or go public," cofounder and CEO Yancey Strickler told *The New York Times*. "That would push the company to make choices that we don't think are in the best interest of the company."[182]

The most feasible way for a publicly traded company to incorporate as a benefit corporation is to do so relatively early in its life, and then go public with that design in place. It is also at least theoretically possible for an existing publicly traded firm to re-charter as a benefit corporation, but it would require shareholder approval. One firm that has expressed interest in this path is Unilever, the Dutch multinational which owns Ben & Jerry's, a subsidiary that has been certified as a B Corporation.[183] Kickstarter, which reincorporated last year as a public benefit corporation in order to provide legal protection for its social mission, is one clear example of an organization that set out to solve a social problem that happens to coincide with the non-financial interests of a venture capital firm.

The designation B Corporation refers to a social certification process; this process is independent of the incorporation process that is legally required to become a benefit corporation. To date, 31 states—with five more in the pipeline—have approved legislation that enables companies to formally incorporate as benefit corporations.[184]

The nonprofit organization that certifies B Corporations is B Lab. B Lab has also been a leading advocate of benefit corporation legislation. B Lab points to growing interest among multinational and publicly traded companies committed to the social responsibility standards that are inherent in B Corporation certification. To help ensure ongoing company commitment to the public good, B Lab has created additional transparency and validation requirements for publicly traded companies.[185] It is also in the process of creating a Multinationals and Public Markets Advisory Council, which will help B Lab promote "mission-aligned corporate structures that expand fiduciary duty to include the consideration of societal—not just shareholder—interests."[186]

CHALLENGES, SOLUTIONS, OPPORTUNITIES

- **L3Cs and benefit corporations face many of the same financing challenges that traditional small business faces.** Lending for small business has been in decline since the recession following the financial crisis of 2008.[187] One solution is to approach CDFIs or other lenders or investors with a social mission.
- **Hybrid status can pose additional challenges.** While being a hybrid can enable a business to pursue multiple financing channels, it can also pose barriers. Philanthropy may shy away because the business earns a profit, making it seem inappropriate for foundation action. Traditional finance may shy away because of the link to charitable mission. A key solution may be to present potential lenders and investors with a strong business plan and strong financial position, with hybrid status as a bonus, not the central selling point.
- **Being a benefit corporation or B Corporation can help a business stand out.** Impact investors can see this status as indicating authenticity about social mission.
- **Benefit corporations benefit from having a community of like-minded enterprises.** This can help in improving management practices and making connections to potential investors.

Innovative Financing for Hybrid Enterprises

Initial public offering (IPO): The IPO—selling shares to the broad public—is a traditional way growing firms access substantial capital. Yet for benefit corporations, it remains an innovation. For example, in March 2015, the Brooklyn-based online handicrafts marketplace Etsy became the largest—and one of the few—certified B Corporation to sell shares in an IPO (see case study). Etsy raised $267 million.[188] In its B Corporation certification, Etsy earned a B score of 127, significantly higher than the 80 point minimum necessary to receive certification from B Lab.[189] As a publicly traded company and a B Corporation, Etsy is likely to face pressure to maximize returns to shareholders. To protect social mission for companies like this, B Lab has created additional transparency and validation requirements.

Program Related Investments: L3Cs are specifically designed to attract foundation program related investments. The L3C institutional form was developed by Robert Lang, with the aim of simplifying for foundations the cumbersome task of a seeking a Private Letter Ruling from the IRS, which indicates whether an investment qualifies as a PRI. That process can take up to 18 months and cost $50,000 or more in legal fees. In essence, the statute under which an L3C is organized requires that the business make the same types of commitments that the IRS has traditionally required. For this reason, state L3C laws are typically designed to incorporate all of the federal tax requirements that apply to PRIs. These include stipulations that the enterprises are specifically formed to further charitable or educational purposes, and that production of income or the appreciation of property value is not a major purpose.[190] Thus far, foundations making PRIs in L3Cs are mostly found in the early adopter states such as Vermont, Illinois, and Michigan.

Municipal Support: In the 31 states which allow legal incorporation as a benefit corporation, a small but growing number of municipalities are developing strategies to offer financial support to these businesses. The City of Philadelphia began investigating the impact of Philadelphia-based benefit corporations, finding that nine out of ten are locally owned, and nearly half offer some form of employee ownership. It also found that the city's benefit corporations are three times more likely be owned by women or minorities than traditional companies, and twice as likely to offer health insurance and retirement plans. These findings encouraged the city in 2009 to establish a Sustainable Business Tax Credit, offering up to a $4,000 reduction in taxes for as many as 25 businesses each year between 2012 and 2017.[191] In awarding the tax credit, the city considers a variety of factors, including how the business provides low-income or underserved communities with beneficial products or services, and how it promotes economic opportunities beyond job creation.[192] In 2016, new legislation was introduced to double the tax credit to $8,000.[193] A similar effort to support benefit corporations is under way in San Francisco, where the city in 2012 passed an ordinance to grant benefit corporations a 4 percent bidding preference on city contracts.[194] In Maryland, State Delegate Meagan Simonaire introduced legislation in January 2016 to authorize Anne Arundel County to provide a property tax credit for benefit corporations.[195]

ADDITIONAL RESOURCES:

- **Benefit Corporations,** B Lab, http://www.bcorporation.net/
- **Laws for L3Cs,** Americans for Community Development, http://americansforcommunitydevelopment.org/laws
- ***Impact Investing: A Guide for Philanthropist and Social Investors,*** Social Grant Makers, 2014, https://www.socalgrantmakers.org/sites/default/files/resources/Line%20of%20Sight%20-%20Northern%20Trust%202014.pdf
- **Philadelphia's Sustainable Business Tax Credit,** City of Philadelphia, https://alpha.phila.gov/tax-credits/sustainable-business-tax-credit/

In March 2015, the Brooklyn-based online handicrafts marketplace Etsy became the largest certified B Corporation to sell shares in an IPO; it is one of only a few to do so. Etsy raised $267 million.

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Case Study in Financing Hybrid Enterprises

CASE STUDY

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ETSY: B CORPORATION COMPLETES A $267 MILLION IPO

The work Etsy is doing in generating income and part-time employment for low-income women is one of the modern economy's phenomenal success stories. This online handicrafts marketplace enables craftspeople and artists from all walks of life to sell their crafts on its platform. Some 24 million shoppers come each year to purchase handicrafts from 1.6 million sellers, and 86 percent of those sellers are women, whereas only 30 percent of vendors nationally are women-owned.[196] These Etsy sellers also have lower household income on average than the general population, which means the income generated can be a boon for cash-strapped households.[197] Close to one in three sellers consider Etsy sales a business or their sole occupation; 44 percent use Etsy sales to cover household expenses; and 25 percent use the sales for savings.[198]

How Etsy finances itself is an equally compelling story. Etsy, which in 2012 became a certified B Corporation, in its early stages raised capital from Union Square Ventures (USV). This venture capital firm has invested in other pathbreaking companies such as Twitter, Tumblr, and Meetup—as well as socially responsible firms like La Ruche (which connects farmers with buyers) and CrowdRise (which facilitates crowdfunding for charitable giving).[199] USV also invested in Kickstarter, which recently reincorporated as a benefit corporation under Delaware law.[200]

In March 2015, the Brooklyn-based Etsy became the largest—and one of the few—certified B Corporation to sell shares in an initial public offering, raising $267 million.[201] To expand investment opportunities for Etsy vendors and other non-institutional investors, Etsy set aside 5 percent of shares for retail investors, and it limited investments to $2,500.[202]

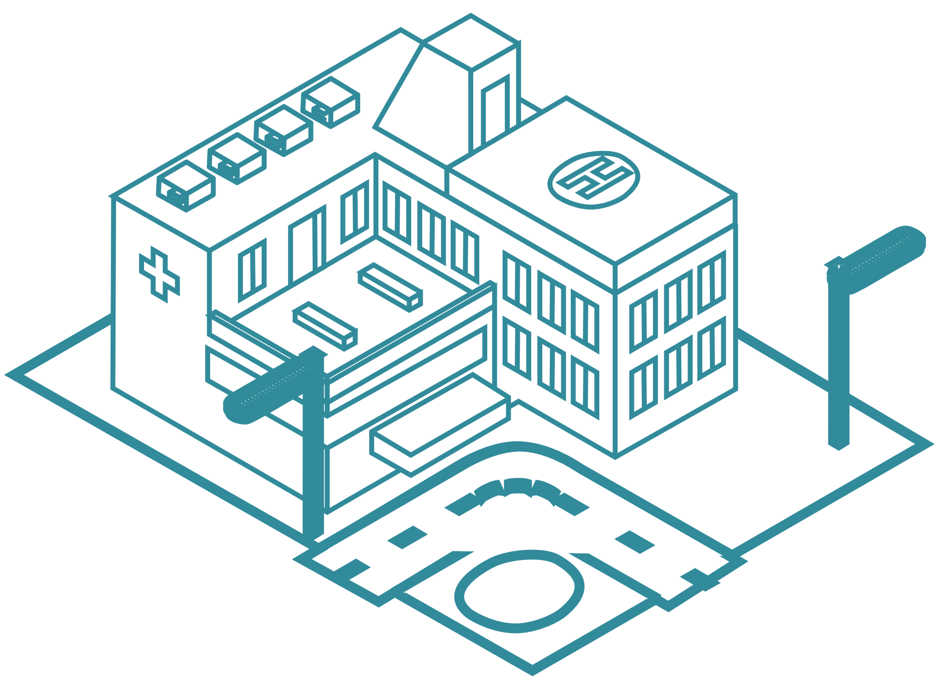
Etsy is well known for its social mission, including commitments to environmental sustainability, to providing a supportive work environment for its 685 employees, and to promoting women-owned businesses. [203] Etsy's mission is to foster a "world in which small businesses have significant sway in shaping the economy, local living economies are thriving everywhere, and people value authorship and provenance as much as price and convenience."[204]

Mayors and city economic development departments are increasingly a locus of experimentation and innovation in creating inclusive local economies.

As Bruce Katz and Jennifer Bradley wrote in their book *The Metropolitan Revolution*, "Cities and metropolitan areas are the engines of economic prosperity and social transformation in the United States."[205] One potential element in play as local leaders innovate is the set of substantial local assets held by municipally owned enterprises.

Financing Municipal Enterprises

Municipal enterprises—businesses owned or chartered by local public authorities that provide services and generate revenue—include water and sewer systems, electric utilities, waste management, broadband internet networks, hotels and convention centers, public transportation, golf courses, ports, airports, and land and real estate. Also included are municipal financing of economic development and public pensions. These various municipal assets hold the potential to be used as engines for local job creation.



Traditional Financing of Municipal Enterprise

Municipal bonds: Traditionally, the financing of municipal economic activity has been done substantially through the issuance of municipal bonds, a robust part of the U.S. bond market. In 2015, $403 billion in new municipal bonds were issued, bringing the total outstanding to $3.7 trillion—roughly nine percent of the nation's total bond market.[206] As Charles Schwab analysts Cooper Howard and Rob Williams observed recently, municipal bonds outperformed all other bond categories in 2015, as well as outperforming stocks. Municipal bonds are attractive to investors for their stable returns and low risk, as well as the fact that interest income is exempt from federal income tax, and often from state income tax as well.[207]

CHALLENGES, SOLUTIONS, OPPORTUNITIES

- **Growth is stalled in some areas of municipal enterprise,** such as municipally owned electricity, a sector where creation of new enterprises is politically and financially difficult today.
- **While privatization once proved a challenge for municipal water, that trend has reversed.** Around 87 percent of all U.S. water systems in the U.S. are publicly owned at the local level. Attempts at privatization of water in recent decades have generally been disastrous, due to poor service and rising rates; many have been reversed amid public pressure. Between 2007 and 2014, the number of privately owned systems fell seven percent and the number of people served by private systems fell 18 percent.[208] Efforts at privatization now are often met with opposition—as in 2013, when residents of Bethel, Connecticut blocked a proposal to sell the town's water utility to Aquarion, with more than 70 percent of residents voting against the sale in a referendum.[209]
- **Municipal enterprises are more inclusive than private employers.** For decades, women and African-Americans have been employed in the local and state public sectors at rates higher than in the private sector. People of color in public sector employment also face smaller wage disparities across racial lines.[210]
- **Economically targeted investments (ETIs)—socially oriented investments by public sector pension funds—are on the rise** thanks in part to the U.S. Department of Labor's recent guidance that says pension fiduciaries can consider the social and environmental impacts of ETIs, so long as they are financially equivalent to competing investment choices.[211] This Labor Department action is helping broaden support for ETIs as an economic development strategy. Though most public pension funds are regulated at the state and local level, many states model their standards after federal rules.[212]
- **Four particular areas represent current opportunities for municipal enterprise growth and job creation:** municipal water, transit-oriented development, high-speed internet, and hotels.

AREAS OF JOB GROWTH IN MUNICIPAL ENTERPRISE

Municipal water systems: These systems represent enormous assets for localities. The Los Angeles Department of Water and Power, for example, is the country's largest publicly owned utility, supplying water and electricity to the city's 3.9 million residents and 450,000 businesses.[213] Each year, it transfers about seven percent of its gross revenues from electricity ($261 million in FY 2014–2015) and five percent of its gross revenues from water to the city's General Fund, helping finance city operations and support public sector jobs.[214]

One city using its municipal water system for economic development is Chicago. In March 2016 Mayor Rahm Emanuel announced the launch of a new public-private research partnership called Current. The Metropolitan Water Reclamation District of Greater Chicago and the nonprofit business group World Business Chicago are working together to increase efficiency, improve wastewater treatment, and increase water industry employment. Chicago's water economy—today the fourth-largest in the nation—accounts for $14 billion in gross regional product. Regional water enterprises employ close to 100,000 workers. The city projects that the research and investment that the Current partnership is projected to undertake will support more than 400 businesses, creating $250 million in economic value over ten years.[215]

Transit-oriented development: Another set of growing assets for cities is local transit systems, which provide the opportunity for transit-oriented development as an approach to economic development. Transit-oriented development aims to develop compact, walkable, mixed-use communities around public transportation nodes. Often this form of development focuses substantially on real estate. But it also represents an opportunity for job development. That's the idea behind Jobs to Move America, a growing movement being promoted by advocates like Madeline Janis, national policy director for the Los Angeles Alliance for a New Economy (LAANE). This ambitious plan envisions bringing tens of thousands of manufacturing jobs back to America using the public dollars already pledged to mass transit development.

One project that Janis has her eye on is the $40 billion allocated to improve Los Angeles's mass transit with new light-rail cars. This project is financed by a half-cent tax increase over 30 years. Janis notes that there are virtually no American rail car manufacturers in the U.S. today. She and a coalition of advocacy groups in major cities are seeking to substantially increase the number of such companies. Robert Puentes, senior fellow with the Brookings Institution's Metropolitan Policy Program, said that LAANE's plan potentially represents a "permanent shift in the American economy."[216]

High-speed internet: More than 450 communities have already established publicly owned networks, including more than 50 in 19 states offering super-fast networks with at least 1 GB service. These publicly owned systems commonly provide higher speeds, better service, lower costs, and updated infrastructure in communities often neglected by large for-profit cable companies. In addition to providing a locality with revenue, these public broadband networks create the opportunity for locally owned businesses to flourish, and for residents to establish in-home businesses.[217] For example, the Chattanooga Electric Power

Board (EPB), a municipally owned utility, in 2007 announced a ten-year plan to build a fiber network serving all of Chattanooga. Chattanooga became the first city in the country to make commercially available 1 GB high-speed broadband service. Today, the city-owned service serves 60,000 residential and 4,500 business customers.[218]

Municipally-owned hotels: Hotels owned by municipalities can be found in communities as different as Austin, Texas; Overland Park, Kansas; Chicago; Omaha, Nebraska; Denver; and Sacramento, California. Robert Nelson, chair of the Department of Hotel, Restaurant, and Institutional Management at the University of Delaware, notes that many publicly owned hotels are constructed to support another prominent sector of municipal ownership—convention centers.[219] The Vancouver Hilton Hotel & Convention Center in Washington, for instance, is owned by the Vancouver Public Facilities District and leased by the Downtown Redevelopment Authority. Together, the hotel and convention center employ nearly 200 people, 80 percent of whom live in the area.[220] The tax laws were changed in 1996 to allow the use of tax-exempt municipal bonds to finance hotels, which fueled the increase in this sector.[221] Another financing mechanism is public pension funds. For example, the Retirement System of Alabama pension fund owns eight upscale hotels across the state.[222]

Innovative Financing of Municipal Enterprise

Mini-Bond Program: The Los Angeles Department of Water and Power has created a Mini-Bond Program that enables its active and retired employees to purchase tax-exempt bonds without paying brokerage fees or commissions, providing a wealth-building mechanism for employees not able to reach the $5,000 minimum investment level of its regular bond program. LADWP expects to raise $15.9 million through Mini-Bond investments in a future bond offering.[223]

Green bonds: Institutional investors are increasingly attracted to green bonds, which address environmental challenges by channeling money to green projects. For example, Massachusetts in June 2013 floated the first municipal bond labeled green by its issuer, as part of a $670 million general offering. The Office of the State Treasurer said it would use proceeds from the $100 million bond to back environmentally sound infrastructure projects.[224] In another example, municipally owned utilities have banded together to float bonds for wind energy development. One example is the $65 million raised in a 2010 bond issued by the Berkshire Wind Power Cooperative Corporation, a cooperative composed of fourteen municipally owned utilities in Massachusetts that are seeking together to finance local wind development.[225] Worldwide, green bond issuance reached a record $41 billion in 2015.[226]

Financing partnerships: The City of Denver helped create a collaborative fund—the Denver Transit-Oriented Development Fund—now totaling $24 million, for residential and commercial development around transit areas. The city provided $2.5 million for the fund. Another $15 million was provided by the national nonprofit Enterprise Community Partners. Other investors and multisector partners include private banks, CDFIs, the County of Denver, the Colorado Housing and Finance Authority, and the Colorado Division of Housing.[227] Program related investments came in from the Ford Foundation, the Denver Foundation, and the Gates

Family Foundation.[228] Since 2010, nearly $200 million has been leveraged from public, private, and nonprofit sources. To date, 700 jobs have been created and eight properties acquired, helping to preserve and create more than 600 homes and 120,000 square feet of commercial space.[229]

Economically Targeted Investments: In 2014, public sector pension plans held close to $4 trillion in assets and increasingly, portions of these funds are invested for social impact.[230] A recent Deloitte survey found that 64 percent of the country's pension funds intend to make an impact investment in the future.[231] ETIs provide an opportunity for municipalities to finance inclusive economic development. ETIs are not an asset class themselves, but are distributed over fixed-income securities, private equity, and real estate.[232] One prominent ETI investor is the New York City Retirement System (NYCRS), comprised of the pension funds of municipal workers and teachers, with $165 billion in assets. NYCRS aims to invest 2 percent of assets into low- and moderate-income areas in New York City.[233] At the end of 2014, NYCRS's ETI portfolio yielded a ten-year net return of 6.3 percent, 1.4 points above its benchmark.[234]

ADDITIONAL RESOURCES:

- ***Steps to Avoid Stalled Equitable Transit Oriented Development Projects,*** Living Cities, April 7, 2014, https://www.livingcities.org/resources/259-steps-to-avoid-stalled-equitable-tod-projects
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Seattle has embarked on an ambitious $73 million project, the MarketFront, to expand Pike Place Market, which was chartered by city government and is one of the country's leading public markets. MarketFront will add 47 rooftop day stalls for farmers and artists. The project also includes 40 new units of low-income senior housing and a new neighborhood center with expanded social services.

Photo c/o Pike Place Market Foundation

Case Studies in Financing Municipal Enterprise

CASE STUDY

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PIKE PLACE MARKET: FINANCING THE EXPANSION OF THIS SEATTLE ICON

Seattle has embarked on an ambitious $73 million project, the MarketFront, to expand Pike Place Market, one of the country's leading public markets.[235] In so doing, it provides a valuable demonstration of how municipally chartered enterprise can finance and support local community wealth building.

Since 1973, Pike Place Market has been governed by the Pike Place Market Preservation and Development Authority (PDA), a nonprofit corporation chartered by the city "to increase the opportunities for farm and food retailing, support small and marginal businesses, and provide services for low-income individuals."[236] By charter, the PDA is governed by a 12-member council that has four mayor-appointed representatives, four publicly elected representatives (any state resident can pay $1 a year to join the "constituency" group), and four appointed representatives. The directors serve staggered four-year terms and must be confirmed by the Seattle City Council.[237]

Pike Place currently serves 80 farmers, 220 small business, and 250 artisans. With the expansion, MarketFront will add 47 rooftop day stalls for farmers and artists. The project also includes forty new units of low-income senior housing and a new neighborhood center with expanded social services.[238] The expansion financing plan is illustrated below:[239]

Financing the Expansion of Pike Place Market

Source	Amount	Notes
City of Seattle general obligation bonds	$34,000,000	Debt
Low Income Housing Tax Credits (& related low-income housing finance)	$9,200,000	Equity
Pike Place Market Preservation & Development Authority (PDA) bonds	$8,500,000	Debt, amortized over 20 years at 4 % interest
WSDOT Alaska Way Viaduct parking mitigation funds	$6,000,000	Equity
Pike Place Market Foundation capital campaign	$6,000,000	Equity
New Market Tax Credits	$4,000,000	Equity
PDA	$3,000,000	Equity
State of Washington grants	$2,500,000	Equity
Total	**$73,200,000**	

As can be seen, the City of Seattle provides nearly half of the funds, which come from general obligation bonds. This support covers a portion of construction and the full cost of the land.[240] The PDA will also, for the first time in its history, issue its own bonds (raising at least $8.5 million, but authorized to go as high as $18 million if needed), amortized over 20 years, with a 4 percent coupon.[241] The PDA will also contribute $3 million in equity.[242]

The Washington State Department of Transportation awarded the PDA $6 million as a grant. It is tied to Pike Place Market parking fees, so, in theory, Pike Place "pays back" the $6 million by entering into contracts (restrictive covenants) that limit what it charges the public to park. But no cash needs to be paid back.[243]

Of the $9.2 million needed to finance the on-site senior housing, PDA has already raised $1.4 million from the Seattle Housing Levy.[244] The PDA procured a New Market Tax Credit allocation from Morgan Stanley, and has, with the support of the Pike Place Market Foundation, raised more than half its $6 million capital campaign goal.

Denver is a leading innovator with its first-in-the-nation Transit-Oriented Development (TOD) Fund, the result of a collaboration between the local government, public and private lending institutions, CDFIs, philanthropy, and a community development corporation.The fund helped to finance the $32 million Avondale Apartments, which includes a new public library, commercial space, and affordable housing.

Photo c/o studiotrope Design Collective by David Laurer

CASE STUDY

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DENVER TOD FUND: FIRST-IN-NATION LOCAL FUND FOR TRANSIT-ORIENTED DEVELOPMENT

Denver is a leading innovator in transit-oriented development finance through its first-in-the-nation Transit-Oriented Development (TOD) Fund, the result of a collaboration between nonprofit developers, local government, foundations, and financial institutions. Transportation costs today devour a rising share of the budgets of low-income families in the Denver region, many of whom live in outlying areas. Making sure these families benefit from transit-oriented development is the aim of the new fund, which seeks to make development affordable and equitable as the transit system expands over the next two decades, building 122 miles of rail transit, 18 miles of bus rapid transit, and 57 new stations.[245]

The TOD Fund was launched in 2010 with $15 million in capital and has leveraged close to $200 million from other partners. Those investments have funded 626 affordable homes as well as mixed-use commercial spaces. To build on that success, the fund is today expanding regionally and has grown to $24 million.[246]
Helping to conceive the fund were the nonprofits Enterprise Community Partners and the Urban Land Conservancy (ULC), which partnered in launching the fund with the city, public and private lending institutions, CDFIs, philanthropy, and a community development council. The aim was to purchase and develop real estate around planned transit corridors. Enterprise Community Partners is the fund manager and the ULC is one of the borrowers. To date the fund has invested in 13 TOD projects, with ULC completing nine of the transactions.

One notable TOD site is the Avondale Apartments at Mile High Vistas. The $32 million development, led by the ULC as the master site developer, includes a new public library, 10,000 square feet of commercial space, and 80 units of permanently affordable housing. It has helped to create 195 jobs—65 of them permanent—and spur an economic renaissance along the Colfax Avenue corridor.[247] A 2013 study found that without the $2.35 million from the TOD Fund, the project likely would not have been completed.[248]

Financing the Denver TOD Fund[249]

Source	Amount	Notes
Colorado Housing and Finance Authority & Colorado Housing Authority	$10,500,000	2% interest (CHFA) 1% interest (CHA) Top loss outside of city of Denver
Enterprise Community Loan Fund, Mile High Community Loan Fund, & banks	$5,500,000	6.65% interest Senior debt
Rose Community Foundation & MacArthur Foundation	$4,500,000	2% interest Third position
City of Denver	$2,500,000	0% interest Top loss within city boundaries
Enterprise Community Partners	$1,000,000	2% interest Second position
Total	**$24,000,000**	

Finance has a vital role to play in advancing broad-based enterprise as a tool for job creation and reducing wealth inequality.

CONCLUSION

This survey of the various models shows key areas poised for growth and social impact, indicating where finance can play a leadership role.

- **In financing worker-owned cooperatives, CDFIs have a potentially powerful role to play.** These financing organizations can be particularly effective in entering new territory when they form working groups—like the group of co-op lenders formed in 2014 by Capital Impact Partners—exploring together how to more effectively finance cooperatives.

- **Impact investors have a potentially vital role to play in financing transitions to worker ownership.** There has been surprisingly little attention to worker ownership among impact investors, who tend disproportionately to focus on publicly traded firms. The baby boom entrepreneur transition offers a large opportunity to learn to invest in ways that more directly benefit workers. An illustration of this approach is the Regenerative Finance group of millennial impact investors who supported the startup of the Renaissance Community Co-op in Greensboro, North Carolina. Similarly, a group called the Southern Grassroots Economy Project is piloting the development of a Southern Reparations Loan Fund to jump-start worker cooperative development in marginalized southern communities.[250]

- **Financial service providers can increase their ESOP lending, including making greater use of the SBA 7(a) program.** At present, commercial lenders issue more than $10 billion in SBA section 7(a) loans, a program that enables businesses to qualify for 75 percent federal guarantees on loans. ESOPs have been eligible for such loans since 1979, but relatively few ESOP loans of this type have been made.[251] Growing expertise in this area to finance more conversions of existing businesses to ESOP ownership could be a critical strategy for both preserving existing small businesses and reducing income inequality.

- **Institutional investors of all kinds can continue to advance green bonds to support a host of needed infrastructure investments in energy, water, and elsewhere.** Bond instruments like the Berkshire Wind Power Cooperative Corporation—funding wind development by fifteen municipally owned utilities in Massachusetts—show how these environmentally oriented bonds can be an important tool for a sustainable and inclusive economy.[252]

- **Local governments are poised to advance both worker ownership and benefit corporations as engines for job creation.** A small but growing number of municipalities are developing strategies to offer financial support to these businesses. Philadelphia began offering tax credits for benefit corporations because it found they were effective tools of economic inclusion, fostering employee ownership, and are much more likely be owned by women or minorities than other businesses. Another policy intervention is support for employee ownership technical assistance centers. As noted above, in Ohio, this low-cost policy (state funding has never exceeded $1 million) has helped create 15,000 employee-owned jobs and generated $40,000 in wealth per employee-owner.[253]

- **Transit-oriented development provides plentiful opportunity to support community wealth building.** As seen above, Denver, Colorado's transit oriented development fund provides a model for how to do this, combining municipal bonds, public and private lending institutions, CDFIs, and philanthropy to create a $24 million land acquisition fund. The fund supports affordable housing, improves transit access for low- and moderate-income residents, and increases the access of these residents to employment and wealth-building opportunities.

It is clear that community wealth building approaches centered in broad-based ownership of business are poised to grow and can be important tools for addressing the economic inequality challenges that we face. Finance cannot do it alone. Yet it is an essential partner, and potentially a powerful force in leading this work. The models highlighted here—be they cooperatives, ESOPs, social enterprise, benefit corporations, or municipal enterprise—shine light on diverse ways to build the partnerships between development and finance. And, by forging these connections, finance and community development can work together effectively to build community wealth and a truly inclusive economy.

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