Hybrid EDM Investment Model

Step One – Assessment and Evaluation

Existing Models: Review and summarize key elements of existing investment models that use financial and/or community intermediaries.

The purpose of this exercise is to identify key elements of each model. During discussions, Advisory Group Members will have an opportunity to evaluate how one or more of these components can be brought together to offer new insights in providing private finance in emerging domestic markets.

Reaching the underserved markets and finding the untapped investment opportunities in urban and rural communities is a specialized process that requires an in-depth understanding of the market and an ability to break through market barriers such as high information and transaction costs. Research shows that overcoming these barriers requires investment intermediaries that can aggregate investments to scale, making them viable for large public-sector pension funds.[1]

Model 1 – Community and Economic Development Corporations

A community development corporation (CDC) and an economic development corporation (EDCs) are nonprofit community developers, which have the local insight that can help, transform neighborhoods and promote companies that are both economically viable and benefit the community. CDCs and EDCs bring relationships with local government and key community leaders. In doing so, these organizations help get investments to scale—allowing for neighborhoods to be significantly improved in the interests of the community, which helps current and future business investments. These organizations also serve to ensure that private investments are undertaken in a manner that incorporates the needs of the community and realizes social returns.

As an example, The Community Preservation Corporation (CPC), a not-for-profit community developer in New York City, was created to fill the gap left by traditional bank lenders in the 1970s and has since expanded its base of capital providers with permanent financing from public-sector pension funds such as the New York City Retirement System (NYCERS). In this example (Hagerman et al. 2005), NYCERS makes forward-rate commitments (commits to buy a loan up to 24 months at a long-term lock-in interest rate) to the originator, a private lender such as CPC. CPC then has the certainty to make the construction loan as the guaranteed take-out financing is in place, and after construction CPC converts the loan to permanent financing and sells it at par to NYCERS. CPC is the entity that has the track record and understands the neighborhood, developers, and operating costs of the project. NYCERS makes the commitment subject to the State of New York Mortgage Agency (SONYMA) insuring the loan.

CPC organizes and produces scale in its ability to nurture development specialists. Before CPC came into being, no one thought of specializing in converting dilapidated buildings into rentals on a larger scale. With the help of CPC financing, and community development expertise, subcontractors often become general contractors and sometimes even owners of these community development projects (Community Preservation Corporation 2005).

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[1] Investment Intermediaries in Economic Development: Linking Public Pension Funds to Urban Revitalization, *Lisa A. Hagerman, Gordon L. Clark, and Tessa Heb, University of Oxford, School of Geography at the Centre for the Environment Harvard Law School, Pensions & Capital Stewardship Project, Labor and Worklife Program*

Model 2 – Economic Development Consultants and Nonprofit Community Partner

Economic development consultants can be instrumental in bringing the community into the transaction. The consultant can serve as a connector between investors and the local community organizations. As a result, they help formalize the role of the community partner to ensure that the social returns embedded in the project are realized.

An example of such a consultant is Economic Innovation International Inc., known as a "fund builder" in the community-based investing industry. The firm was founded in 1971 to identify and build market solutions to social problems. Since 1997, Economic Innovation has been building "triple bottom line" private equity funds and has built more than $2 billion of these funds, which have both a financial and a social objective (www.economic-innovation.com).

Economic Innovation International structures the fund so that the not-for-profit sponsor is embedded in the operating agreement and shares in the fund's management fee and carried interest. The sponsor is considered a "special limited partner" (in a Limited Partnership legal framework) or "special member" (in a Limited Liability Company legal framework) of the fund depending on how the fund is organized. This not-for-profit sponsor can often be the "community development catalyst" that may identify the development site, seek out the joint-venture developer, or provide technical assistance (Flynn et al. 2007).

Economic Innovation has built several regional families of funds often working in partnership with economic development consultants (Strategic Development Solutions, Sustainable Systems, and Economics Research Associates). The firm contributes to feasibility studies for assessing the level of market demand in the region in order for an investment to achieve risk-adjusted market rates of return. The first private equity fund incorporating a not-for-profit sponsor model in a contractual arrangement with the for-profit fund manager was Genesis LA. The Bay Area Family of Funds is another example of the not-for-profit sponsor model in a contractual arrangement with a for-profit fund manager.

Model 3 – Local Government and Community Activities

Investment funds can join with other community partners, which can include state or city housing or economic development agencies and departments. An example of this is the partnership that includes the City of New York's Department of Housing Preservation and Development, national housing advocacy groups, joint-venture developers, and economic development organizations. Developers of significant projects negotiate with neighborhood community groups to form partnerships through Community Benefits Agreements (CBA)—contracts that include concessions such as a day-care center, a new park, and even cash that are directly administered by the community group (New York Times, June 14, 2006).

CBAs provide a mechanism for the community partner to leverage its position and ensure that development decisions deal with a wide range of social and economic issues (such as transportation, jobs, and housing). Community partners also have access to unique funding opportunities from foundations and government, which can help ensure that that the investors "triple bottom line" results can be achieved.

Model 4 – Local and State Government Incentive Zones

California has two primary economic development incentive zones, the California Community Redevelopment Project Area and the California Enterprise Zone. Within these areas, local governments and the state provide enhanced technical assistance and special incentives to businesses. Every city and county has the authority to establish a redevelopment agency and approve a redevelopment project area. Redevelopment agencies primarily focus on land development and infrastructure as they have extra-ordinary powers of eminent domain for private purposes and the ability to issue tax increment-backed revenue bonds. Redevelopment agencies also form project area committees where community members actively advise on development issues. In most cases the redevelopment agency is also the local legislative body, which can help in streamlining land use and permitting issues within the project area.

California law authorizes 42 enterprise zones through a competitive application process administered by the Department of Housing and Community Development. Over 20 zones were awarded designation by the department last year; another 10 zones will be designated early next year. Once as area meets certain low-income economic criteria, Enterprise Zone applicants' are ranked on the community's economic strategy, including identification of specific resources the local government will make available to businesses within its boundaries. Businesses within Enterprise Zones also have access to a variety of state tax incentives including a hiring credit ($32,000 per employee over five years), a manufactured investment credit, and an investor's credit. Further, businesses that wish to engage in state government procurement receive special consideration in the state procurement process.

Redevelopment agencies and enterprise zones can help investors reach scale and achieve broad community impacts because of the strong correlation of economic interest and the ability to aggregate wide ranges of government resources for infrastructure and workforce and business development.

Model 5 – Government Funded Nonprofit as Conduit to Venture Investment

JumpStart, Inc. is a non-profit organization subsidized by the State of Ohio to develop and support technology start-ups in northeast Ohio. JumpStart provides education, business counseling and technical assistance to businesses seeking acceleration through early stage capital. Investment is made in business ideas that have the potential to attract a Series A investment of $3 to $5 Million within two to three years.

JumpStart manages its own fund that is public/private. They invest as convertible debt in early stage companies. This strategy avoids placing a value on the early stage company and focuses their attention on getting the business up and running. The loan is guaranteed by traditional means - patents, property and equipment. The principle payments are made but interest is accrued until the business is ready to receive an equity capital investment. At that point, the debt is converted to equity.

This interesting model facilitates investment, reduces risk and creates a pipeline for venture capital firms. It also is a powerful economic development tool.

Model 6 – Angel as Conduit to Mainstream Angel

The Venture Farm is an early stage investor that focuses on investments under $500,000 in companies with valuations of $1 to $1.5 million. While this has historically been a space for moneys from family and friends, The Venture Farm believes that this has led to wasted experimentation.

The Venture Farm helps these small size companies develop effective organizational structures, product strategies, and access to network of related businesses and customers.

The Venture Farm's initial funding and exist comes from other angel investors. At the close of 12 to 18 months with company's valuation is expected to have increased 2 to 4 times. This brings the businesses to the size and scale where traditional investors are comfortable working ($3 to $5 million). These second round investors benefit from the expertise provided by The Venture Fund, which in turn reduces their transaction costs and risk in bringing the business into their portfolio. The Venture Farm also helps in reducing dilution by selling 50% of its share in the company to the next round of angel investors.

Model 7 – Foundation and Venture Partnerships

Good Capital is a Bay Area investment firm that uses a hybrid approach to accelerate the flow of capital to ventures and initiatives that have double-bottom line returns. Their initiatives and funds address a wide range of social issues ranging from social enterprise financing, community and economic development, brownfield development, and healthcare financing. Their first financial product, a $30 million Social Enterprise Expansion Fund, will provide equity and "equity-like risk-taking" capital for expansion-stage social enterprises.

The company was launched in 2006 and strives to be a bridge between traditional philanthropy and traditional investment. According to Good Capital, traditional philanthropy often does not address the funding needs of the most risk taking, innovative approaches to solving social challenges. Traditional investment vehicles such as venture capital and lending, on the other hand, are built upon calculations that demand a level of financial return that often cannot be supported when working in the complex and challenging social arena. This is even true of mainstream socially responsible investment, which primarily seeks market rate returns or is relatively risk averse.

Good Capital's approach is to lead the development of the emerging social capital market. The company relies on a unique host of partnerships which help to underwrite the risks and other capital needs of its portfolio, including Calvert Giving, Criterion Ventures, and RSF Social Finance.

Further Discussions

- Considering the above models, could any of them be used to increase the flow of equity capital into EDMs? Are there any that could reduce risk and transaction costs?

- How do financial institutions fit in the role as a financial intermediary? Are their examples where lenders have formal or informal relationships with private equity investors? Beyond SBA, can lenders bundle guaranteed small business loans?

- How do university-based entrepreneurial organizations fit within the role of the financial or community intermediary? Do universities serve as both community development advocates and workforce trainers?

- How do workforce training programs and the local workforce investment board fit within the role of the financial intermediary? Collectively, do investors use these services?