

# Report of the NCBA Cooperative Capital Task Force January 2007\*

## I. The Cooperative Capital Task Force -- Background

At NCBA's Annual Meeting in 2004, the membership articulated the position that developing capital resources for cooperative development was a top priority for NCBA and the cooperative community. In response to this and other concerns, in March of 2005, NCBA brought together representatives from the various cooperative sectors at the Policy Forum on Cooperative Development. The group identified a list of priorities for NCBA, first among them was to develop new and innovative methods to promote capital investment in co-ops. The NCBA Cooperative Capital Task Force was established in early 2006 to determine how to carry out this priority and was directed to report back to the NCBA Board within a year.

The objective of the Task Force was to identify the capital needs of cooperatives and the potential sources of capital for cooperatives. In this report, the term capital refers to both equity (at risk capital with an ownership interest) and debt (loans provided by creditors). Throughout the report, we have tried to specify equity or debt where appropriate and relevant. With respect to debt, the Task Force focused largely on subordinated debt -- that is, debt that acts in many ways like equity. The Task Force did not consider the issue of conventional debt financing.

The Task Force included sixteen NCBA members and was chaired by Margaret Lund of Northcountry Development Fund (NCDF) and vice-chaired by Rich Larochelle of National Rural Utilities Cooperative Finance Corporation (NRUCFC). A list of members is attached. The Task Force met via conference call in March of 2006 and January 2007 as well as in person in March, May, July and November of 2006 and January 2007. As part of its research the Task Force heard presentations from a number of experts in cooperative finance, capital markets, government programs, socially responsible investing and the community development worlds. See list of presenters attached.

The Task Force agreed on the following tasks:

- provide recommendations to the Board on new sources of capital for NCBA and its members to help implement and related public policy initiatives for NCBA staff;
- consider both public and private initiatives;
- complete a document and its work by the end of 2006 or early 2007; and
- support and help implement recommendations agreed upon by the group.

\*Updated February 2007

## **II. The Vision of the Task Force**

The vision is to see cooperatives create mechanisms to mobilize resources by and for cooperative enterprise; develop a clear and simple way to present opportunities for anyone to invest in cooperatives; and promote cooperative enterprise as a flexible and efficient tool enabling people to meet their needs and aspirations.

## **III. The Need**

Member contribution of equity is at the heart of cooperatives but it is often limited, especially if the members have low incomes or manage their own businesses. Since some co-ops have to pay taxes on retained earnings, they are more inclined to allocate and return those earnings to members, particularly if there is pressure from members for a return of equity. But if the co-op is in need, it may require that equity back for operations. Funding equity redemption from operations puts co-ops at a competitive disadvantage.

Capital is not the only challenge facing cooperatives, but it is critically important. Co-op equity capital comes from three sources – members, retained earnings and outside investors and partners. There are opportunities and limitations with each source. Member contribution of equity is at the heart of cooperatives but it is often limited, especially if the members have low incomes or manage their own businesses. The co-op structure requires that earnings are allocated to members. Frequently those earnings are returned to members, particularly if there is pressure from members for a return of capital. But if the co-op is in need, it may require that capital back for operations. Funding equity redemption from operations puts co-ops at a competitive disadvantage.

Some co-ops offer preferred stock or other options such as non-co-op subsidiaries to obtain equity from outside investors. But this has limitations because co-ops may not offer the high rate of returns some investors seek or the business model may confound or confuse outsiders. But there should be a way for sympathetic outsiders to invest in cooperatives, especially where the benefits of the cooperative extend beyond its members.

Some co-op sectors are well capitalized. Rural utilities have access to funds from government agencies as well as their own finance organizations to fund large projects and have no capital needs that cannot be addressed. Electric and, to a lesser extent, telephone co-ops also have a ready-made market for their products as long as there are people living in their service areas. Credit unions are well-capitalized and have only one type of capital – retained earnings. Credit unions cannot seek equity from their members nor can they return equity in any form other than interest or dividends on accounts, but they have managed to attain a well-capitalized state through the one source available to them – retained earnings.

Though access to equity capital is a problem for cooperatives, it is also symptomatic of a greater challenge faced by the cooperative community – making the case for co-ops. We heard repeatedly that investors do not understand the financial structure of cooperatives, which

hinders access to some types of financing. If we cannot demonstrate the benefits of cooperatives, we will continue to face the threat of demutualization and struggle to find new sources of capital.

The Task Force agreed that part of the community's job is to promote the cooperative model as the preferred, better model. Finding ways to identify and communicate our strengths is essential to give co-ops a strategic, competitive advantage in the marketplace. Explaining how pooling represents economic power, how we reinvest capital in the community, and how we exist to meet the needs of members will help demonstrate the co-op advantage. Part of this effort must be focused on explaining our financial structure in a simple and standardized way to attract investors (including members) who need to understand the value of investing in cooperatives. Only when we can explain our value can we unlock it.

What is the value of co-ops? We need to look to our principles to help define and explain why we are better.

- Voluntary and open membership
- Democratic member control
- Member economic participation
- Autonomy and independence
- Education, training and independence
- Cooperation among cooperatives
- Concern for community

How are we different? How are we better? Here are six specific ways:

- Cooperatives distribute capital widely among average Americans, while stock companies concentrate it.
- Cooperatives keep capital in the community, while stock companies export it elsewhere.
- Cooperatives exemplify the Ownership Society, while stock companies concentrated ownership among the investor class.
- Cooperative governance is open and democratic, while stock company governance is closed.
- Cooperatives have both economic and social goals, while stock companies are motivated solely by a return on investment.
- Cooperatives largely police themselves while government must provide extensive oversight and control over stock companies.

#### **IV. Capital Needs of Individual Sectors**

The Task Force conducted an informal survey to determine the capital needs of each sector. The Task Force agreed that traditional debt financing is generally available to cooperatives but that equity, and in some cases flexible subordinated debt, was needed to support and foster the development of the cooperative enterprise. The Task Force concluded that the food, worker, purchasing, agriculture and housing co-op sectors were in need of equity capital for start up

and expansion activities. The utilities and credit union sectors, however, reported adequate capitalization for their projects, much of it available through their earnings, government programs or finance organizations.

Also of interest was where the deals for the equity capital would come from. From discussions with representatives from the various sectors, it was clear that the deals were there but they needed patient, at-risk capital – equity -- to move them forward, especially in the food, housing and worker co-op sectors. Potential sources to identify deals included sector groups or networks, the Cooperation Works group of co-op development centers and the Community Development Financial Institution (CDFI) network. The Task Force agreed that there were other additional types of consumer co-ops and consumer-owned businesses that probably needed equity for start-up and expansion deals but the Task Force did not have the time or resources to explore these in depth.

### *Food Cooperatives*

For start-ups, equity capital is needed for predevelopment, feasibility, business planning, market analysis, and legal costs. The estimated amount of equity needed to start 200 stores is \$225,000 per store, or \$45 million, for a 10-year period. Additional money for technical expertise may increase this estimate by 30-40 percent. Current sources for start-up capital are grants, member loans and equity, some public financing, and donations. The NCB Food Co-op 500 program, with a goal of increasing food co-ops from 300 to 500 over the next 10 years, is a source of some financing for this sector, but the question of where capital for growth and expansion of its start-up co-ops is still a concern.

For expansion activities (including adding stores), the estimate is \$800,000 per store for 50 stores, or \$40 million, for five years. The financing for existing stores is 25 percent from reserves, 25 percent member loans and 50 percent other debt. The New Markets Tax Credit (NMTC) program has been tapped for at least one new deal and inventory guarantees from other co-ops have also been used to support growth. But access to patient capital would allow more co-ops to leverage more money and meet their growth targets for the sector much faster.

There are many potential deals in this sector if equity financing were readily available. Approximately 25 percent of capital needs are available from within the sector but co-ops report a need for more equity to leverage much more money, especially for expansion activities. The New England Fund is looking at NMTC as a potential funding source for an equity fund for northeast co-ops.

### *Housing Cooperatives*

Developers of housing cooperatives have need for short term equity to initiate development. Equity during the acquisition and rehab period can leverage significant debt to build new co-ops or acquire large multiple building rehab and conversion projects. That equity can be taken out when the co-op is ready for occupancy, through share purchases by its members. One

potential source of capital is the NMTC program but co-ops may have to get changes in the program to clarify that housing co-ops are eligible.

Many existing large co-ops need capital for rehab and expansion at the level of \$5 million to \$10 million per project. But this activity can be financed through existing sources of debt refinancing. Creating affordability in housing beyond what is economically feasible is a highly desirable goal but is a matter of public investment and subsidy. A new program offered by the Federal Home Loan Banks (FHLB) to assist members purchase shares is an example of such public subsidy. See below in section VI for discussion of program.

### *Worker Cooperatives*

This sector identified both hard assets like equipment and also working capital as needs of start-up worker co-ops (low-income). While start-ups can afford some debt, equity is needed for the remainder. The estimated equity need is \$1 million over a period of one to three years. This money could be placed immediately as there are projects currently in the pipeline, e.g., Alexandria, Virginia Taxi Cab co-op. The funding for such projects includes member equity (limited) and funds from specialized community loan funds, but such sources are extremely limited.

Worker co-ops also need money for capital equipment, and for growth and expansion initiatives. The estimated need is at least \$1 million per year, but varies greatly depending on the type of firm. Because worker co-ops typically start out over-leveraged, many are challenged with maintaining an acceptable debt/equity ratio, even as they grow and gain success. There is currently no equity source that addresses the needs of existing worker co-ops.

The demand for funds would be much higher if other worker-owned businesses such as ESOPs were included in the mix. ESOP funding is, however, easily available in the current finance market. For purposes of this report we will exclude ESOPs from consideration. One underused financing tool for worker cooperatives is the 1042 rollover, discussed in more depth in section VIII, Task Force Recommendations, subsection on Private Sector Action.

### *Agriculture Cooperatives*

Agriculture cooperatives have an ongoing need for capital to retire member equity. Many small- to medium-sized cooperatives struggle to pay members who may be retiring or interested in taking out some of their equity. These cooperatives probably face the greatest pressure to convert to another form of business to secure capital from outside investors. For some agriculture co-ops, the lack of capital management and planning to address capital needs has led to these problems. To meet the demand from members, some agriculture co-ops have resorted to discount mechanisms to redeem equity more cheaply. Co-ops could take greater advantage of the use of nonqualified patronage refunds, an option that delays distribution of refunds to members but provides more capital for the cooperative to use for growth and expansion initiatives.

Another significant need for this sector is for capital projects, e.g., new distribution or processing facilities. The 20 percent growth in the organic food industry has triggered a need for capital for expansion and conversion projects. Organic Valley, (the brand name for Cooperative Regions of Producer Pools CROPP) is an organic agriculture co-op that produces and markets organic dairy and meat products. It identified both equity and debt financing needs for processing facilities and its program to assist farmers to convert to organic, which takes around three years.

### *Purchasing Cooperatives*

Purchasing cooperative members are small businesses that band together to enhance their purchasing power and lower costs. They operate in many sectors of the economy and their capital needs often depend upon the strength of the member-businesses and the relevant market at any given time. NCBA estimates that they have doubled in the last decade to more than 300 nationwide. This is a growing sector of cooperatives and would benefit from more equity investment. Purchasing cooperative often want to give back as much equity as possible to their members to allow them to grow or expand their individual businesses.

Some of the capital needs for the purchasing cooperative itself may be to revolve member equity, to return equity to a member business that is leaving, or to purchase or build facilities. The amounts needed vary dramatically depending on the size of the purchasing cooperative. Seeing a need for equity, Amarak, a drywall distributor cooperative with over 170 member owners, put together Cooperative Capital Partners to explore various ways to purchase cooperative member companies when they want to sell. See discussion in Section VI.

### *Credit Unions*

According to the sector, most credit unions are well capitalized. The level of capitalization required to meet regulatory levels is nine percent, credit unions average net worth is approximately 11 percent of their net assets. Credit unions have one form of capital – retained earnings. Credit union share deposits account for 85 percent of their assets. While assets in the sector exceed \$700 billion, credit unions are limited in how they can use their retained earnings. Credit unions tried to change the law to allow equity contributions from their members but Congress would not allow it.

The Task Force discussed ways in which the credit union sector's robust capitalization could be tapped for uses by other co-op sectors. Though many credit unions cannot invest in funds or engage in certain types of commercial lending, community development credit unions and credit union service organizations have a broader range of powers that allow them to participate in co-op investing activities. Also, the National Credit Union Foundation (NCUF) has a Community Investment Fund (CIF) for credit union development activities. Credit unions that invest in the CIF through their corporate credit unions receive 50 percent of the dividend and the other 50 percent of the dividend goes into the Foundation for development initiatives.

## *Rural Utilities Cooperatives*

The rural utilities reported that they have no need for capital because they have their own finance companies such as CFC for the sector and access to the USDA's Rural Utilities Services (RUS) loan programs. As of year end 2005, these programs provided more than \$20 billion in loans and guarantees to members in 47 states. On an annual basis, RUS provides \$4 billion in direct loans and guarantees; private finance organizations provide an additional \$1.5 billion to \$2 billion.

Utilities projects tend to be large scale, capital intensive e.g., \$222 million RUS direct loan for Kauai Island Utility Electric Cooperative, but risk is low because there is an income flow from ratepayers. The USDA and CFC programs are sufficient to fund these large scale projects. CFC makes loans to individual cooperatives for their projects. This funding, combined with RUS, supports overall co-op development. See Section VI – Innovative Programs, Government financing Programs - for discussion of a USDA utilities loan and grant program that Task Force members identified as potential source of equity capital for co-ops.

## **V. Current Sources of Capital**

Though it is difficult to estimate the amount of debt versus equity in the cooperative sector as a whole, most cooperatives rely on debt for the bulk of their financing. Member equity plays a significant role in some sectors and cooperatives, e.g., purchasing cooperatives, but it is nominal for other types of cooperatives, e.g., food co-ops or credit unions.

### *Equity*

Co-ops can obtain equity through direct investment from members and non-members; retaining a portion of their net margins; and retaining a portion of the proceeds from sales of member's products. The following are various ways co-ops hold equity:

- Common stock: Co-ops can issue several classes of common stock as a source of initial equity. One of the classes will be assigned voting rights. For example, Class A, Membership rights, with one share/member/vote; Class B, investment portion, e.g., purchase of acreage, Class C, provides rights to share in the patronage based on participation in co-op. Each member can have all three classes, which represents his/her interest in the co-op.
- Preferred stock: Nonvoting, dividend paying stock. It can be issued to members, the general public, institutional investors or targeted non-patron groups.
- Membership fees: Initial equity capital provided by members in a non-stock company e.g., food co-op that requires an initial \$100 membership fee, that entitles them to vote and to share in patronage, either discounts or refunds/dividends.
- Capital certificates: Similar to preferred stock, these may be issued by non-stock co-ops and may bear interest, have no voting rights and can be issued to members and non-members.

- Deferred patronage refunds: Co-ops can defer patronage refunds and use them to accumulate capital to finance operations or new facilities and then redeem them under a revolving capital plan. Some co-ops must redeem 20 percent of the net margins but can defer 80 percent until a later date.
- Retention of unallocated reserves: Capital reserves that are retained on an unallocated basis (not allocated to members) can be used for losses or may be held as required by state law.
- Per-unit capital retains: Co-ops deduct a certain amount from sales proceeds of members' products based on a percentage of sales or on a physical unit basis.
- From subsidiaries or parents: Co-ops may have subsidiaries or parents from which they receive equity investment financing.

### *Debt/Borrowed Funds*

- Specialized banks and lending institutions
  - Cooperative banks, such as NCB, specialize in providing loans and other services to cooperatives.
  - National Rural Utilities Cooperative Finance Corporation (CFC): Established in 1969 to make long-and short-term loans to rural electric cooperatives.
  - Farm credit banks: Federally chartered and regulated Farm Credit Banks provide loans and other products and services primarily to agricultural cooperatives. CoBank is a federally chartered and regulated Farm Credit Bank created in 1916 and serves primarily agricultural and rural cooperatives.
- Government programs: e.g., government loan and grant programs, RCDG grants, VAPG grants.
- Municipal bonds: Sometimes available to stimulate local economy by financing projects.
- Private market:
  - Private debt placement
  - Commercial paper
- Commercial banks and insurance companies: These are good sources of financing for debt and for insurance companies, as institutional investors.
- Revolving fund loans: Private and public revolving loan fund programs.

**Co-op Funds:** There are several regionally based co-op revolving loan funds that provide some equity subordinate debt financing. These funds are supported by and provide funding for cooperatives. They receive funding from a variety of public and private sources, e.g., cooperatives, CDFI funds, grants, socially responsible investors. See discussion below in Section VI.

**Subordinated debt:** While subordinated debt may be categorized as debt, it has characteristics of equity -- the loan/investment is a lien but has rights junior to the senior lien holder yet ahead of shareholders -- and is considered risk capital. Collateralized sub debt allows deposits to be used as the security interest for the debt.

## VI. Innovative Programs for Accessing Capital

One of the benefits of the Task Force was the sharing of information among the various sectors and individual co-ops about how they address their capital needs. A number of innovative programs have been developed by cooperatives that could be replicated by others. Task Force members also were impressed with the success of models employed by other countries, many of which illustrate the benefits of cooperation and financial support among cooperatives and their members.

Some of the programs or models the Task Force expressed an interest in pursuing:

### *The REED Fund's Use of USDA's REDLG Program*

In addition to providing financing through low-interest loans for co-op utilities projects, USDA offers opportunities for investing in cooperative and non-co-op businesses in the community through its Rural Economic Development Loan and Grant (REDLG) program. The loan program offers RUS borrowers zero-interest loans that they are required to re-lend, at zero-percent, to finance job creation projects and sustainable economic development in rural areas. The co-op must repay the loan if the third party defaults. The program gives out approximately \$15 million to \$25 million per year.

The purpose of the grants program of REDLG is to promote sustainable rural economic development and job creation projects through a revolving loan fund. Any utility co-op can apply and is required to provide a 20 percent match. The program has been budgeted at \$8 million to \$10 million for the past few years.

The Rural Electric Economic Development (REED) fund, a revolving loan/equity fund run by a consortium of 21 South Dakota and Minnesota electric cooperatives, is an example of an innovative use of government financing to grow a fund to spur economic growth in a region. Over the past 10 years, the REED Fund has been awarded \$7 million in grants from the REDLG program and leveraged another \$10 million. This non-profit debt/equity fund has made more than 133 loans for over \$26 million to small communities, businesses and agricultural projects in the region.

What makes this fund unique is the way it revolves the initial loan proceeds into community investing and its ability to leverage more financing from a broad array of private and public sources. REED obtains funding from CDFI, CFC, Basin Electric Power Cooperative, intermediary lending USDA programs, and the Calvert Foundation. It is in the process of applying for New Market Tax Credits and it has used some of the earnings to invest in a private equity fund in the region, helping to promote more economic development. The director attributed REED's success to the leverage gained from pooling resources among co-ops and its regional focus (95 percent of loans made were to locally owned projects, assisting in the creation of 3,600 jobs). She also said that they had developed in-house expertise essential to grow and manage such a fund.

## *Preferred Stock*

A number of cooperatives have raised capital by issuing preferred stock to both members and outside investors. Preferred stock is non-voting, dividend sharing stock that has claims senior to member shares. Several large agricultural cooperatives such as CHS, Inc. and Dairy Farmers of America (DFA) have successfully raised millions in capital through preferred stock purchases. DFA attracted institutional investors and CHS started with its members and expanded its offering to outside investors. Though some co-ops are SEC registered, public companies, most offerings come under an exemption to SEC registration. Even under the exemption, however, the disclosure requirements can be quite costly and burdensome, leading some cooperatives to consider the SEC registration route to get access to brokers and a broader investor market.

Organic Valley raised \$11 million through its preferred stock offering to non-institutional investors mostly in five states, including Wisconsin and California. Equal Exchange is a fair trade worker co-op that offers organic coffee, tea and cocoa products grown by co-op farmers around the world. Preferred stockholders have provided a source of equity for the co-op for 17 of its 20 years. The worker-owned cooperative has paid on their class B shares on average 5 percent annual dividend.

Small cooperatives such as the Viroqua Food Cooperative in Wisconsin also have taken advantage of this option. The co-op raised funds through a preferred stock offering to expand into a new building. Through these offerings to members, some co-ops have realized “less is more” -- fewer committed members willing to invest more dollars can result in more capital raised than many members contributing small amounts.

The elimination of the dividend allocation rule, a triple tax on co-op earnings that made dividends on capital cost-prohibitive, presents a great opportunity for co-ops to pursue this option. But the amount that can be raised and the returns are limited for a variety of reasons, including state and federal laws that cap dividends at eight percent. Most of these offerings are private and demand a great deal of administrative, legal and marketing work. Non-cooperative competitors can raise more capital more quickly in the capital markets.

## *Cooperative CDs*

Equal Exchange partnered with Wainwright Bank to offer CDs backed by loans to Equal Exchange. The fixed rate of return on the CDs depends on the performance of Equal Exchange on the loans but is sufficient to attract purchasers interested in investing in fair trade business or worker-owned cooperative. If the bank fails, the CDs are insured by FDIC but if Equal Exchange defaults on the loans, CD holders would absorb the loss. This is a form of collateralized sub debt where the CD deposits serve as collateral for the loan to the co-op.

The Davis Cooperative Development Fund (DCDF) partnered with two banks and a credit union that agreed to direct a certain percentage (.25 percent to 1 percent) of account balances, including CDs, of DCDF depositors to the fund. DCDF encourages local co-ops and non-profits to deposit their funds with these institutions through a variety of marketing tools. The DCDF depositors use a code when they set up an account that lets the financial institution know they want a portion of funds directed to DCDF. This relationship also gives DCDF depositors at one institution preference for the Federal Home Loan Bank Board's Affordable Housing Program (AHP) grants, which has helped bring \$1.5 million to the DCDF groups.

The Task Force discussed the opportunity for credit unions to offer CDs to members interested in investing in other co-ops. Certain types of credit unions are allowed to offer investments. As reported in a November 13, 2006 New York Times article, "Putting Your Money Where Your Heart Lies," more people are investing in their communities through non-profit, community-based institutions like Community Development Credit Unions. The Credit Union Foundation, corporate credit unions and Credit Union Service Organizations may be other avenues to explore for offering and marketing these products.

A related way to raise capital is through short term commercial paper. National Information Solutions Cooperative (NISC) is an information technology cooperative that develops and supports software and hardware for utility co-ops and companies. The co-op raised \$20 million from their 500 members to develop new software through the sale of commercial paper with fixed payback terms (three, five or seven years) and adjustable interest rates tied to a benchmark. It developed the paper through its legal department; it required no SEC or state registration because it was only offered to members.

### *Cooperative Funds*

One source of funding that some cooperatives may not be aware of comes from within the co-op community – co-op funds. Though they have different organizational structures, these funds provide financing, mostly debt, to co-ops and other community-owned businesses to foster economic development. They also advance the cooperative enterprise by providing support services to the self-help enterprises they lend to. The Cooperative Fund of New England and Northcountry Cooperative Development Fund (NCDF) serve as financial intermediaries between co-op, institutional, religious, and financial institution, individual and other investors and the co-ops that need loans in their geographic communities. The Local Enterprise Assistance Fund (LEAF) works closely with the non-profit ICA Group to provide business consulting and technical assistance as well as debt and equity financing to worker cooperatives and other community based businesses with the goal of creating and saving jobs.

Another way co-ops help co-ops is through the Cooperative Community Fund program. Begun in 1998 by the Twin Pines Cooperative Foundation (TPCF), the program encourages food cooperatives to set up their own Cooperative Community Fund (CCF) within TPCF. The CCFs are endowments where the interest earned is donated by each of the funds to local nonprofits and cooperatives and the principle is invested in cooperative development. Twenty-five food

co-ops now sponsor local CCF's enabling TPCF/CCF to invest \$1.6 million in 10 different organizations involved in cooperative development.

Together these funds help create a vibrant cooperative and community-building economy throughout the country. These funds have grown over the years into significant sources of financing, particularly for some sectors. And they help co-ops and other community-based enterprises leverage much more capital. For example, the \$3 million LEAF has invested in worker-owned businesses leveraged another \$27 million. Every dollar put into the TPCF/CCF program generates at least four dollars of conventional financing leading to \$6.4 million of lending to food cooperatives, housing co-ops, community development organizations and nonprofits.

These funds demonstrate how individual cooperatives can contribute to and grow the cooperative enterprise as a whole. And, it can be done in a cooperative way. The NCDF, for example, is member-owned and member-governed. It recently set up a community development credit union, a further demonstration of how the cooperative enterprise can be used to finance the development and promotion of cooperatives.

### ***Socially Responsible Investing in Cooperatives – the Calvert Foundation Example***

Over the past few years, there has been a great deal of money invested by individuals, institutional investors and organizations that want to integrate certain values and societal concerns with their investment decisions. This practice is referred to as Socially Responsible Investing (SRI). According to the Social Investment Forum, there are four SRI strategies: Screening, Shareholder Advocacy, Community Investment and Social Venture Capital. The Forum's 2005 report identified \$2.29 trillion in total assets under management using one or more of the investment strategies. Community investing, the smallest but fast growing portion of SRI, went from \$5.4 billion in 2000 to \$19.6 billion in 2005.

The growth in community investing stems in part from the 1% or More for Community Campaign, a campaign to encourage investors to direct at least 1% of their managed assets to community investing. In 1990, the Calvert Social Investment Fund's shareholders voted to place 1% of the Fund's assets in below-market investments in local non-profit financial intermediaries to support micro-credit, low-income housing, small business and other community development initiatives. Calvert did the same with five more of its funds. Though Calvert Fund is a leader in SRI investing, there are now 144 individual SRI funds (several offered by the same mutual fund company).

In 1995, Calvert established the Calvert Foundation as a non-profit to help promote community investment here and abroad. The Foundation developed a new investment instrument called *Calvert Community Investment Notes* through which individuals and institutions can invest in non-profit intermediaries. The Calvert Fund has put \$25 million into the CIN as part of the 1% Campaign. Though the Notes are offered through an SEC registration exemption, they do require a laborious process to meet other federal and state registration requirements. They pay

investors a below-market fixed rate of interest and investors can choose a region or a type of project in which they want to invest.

The Foundation provides only debt financing to the intermediaries, which include co-op funds. Over 10 years, it made \$82 million in loans to 195 organizations and has more than \$122 million in assets. Calvert also developed the Social Return on Investment tool, which allows investors to see what their investments produce for the community, e.g., units of housing or jobs created. The Foundation staff has developed research and analytical tools about the performance of non-profit lenders that Calvert makes available to those interested in investing. They hire out their credit analysis, etc. expertise and will be a good resource for co-ops.

### *Using FHLB for Limited Equity Housing Co-op Share Purchase*

There is a new source of capital for member share purchases in housing cooperatives through the Federal Home Loan Bank (FHLB) system. The FHLB offers forgivable loans of up to \$15,000 per household to purchase homes, including shares in limited equity and mobile home park cooperatives. Few cooperators know about this national program that allows co-op members to use the funds to purchase shares in the co-op. The program is available (at various levels) through the 12 regional banks that comprise the FHLB system.

Each regional FHLB sets up its own program, offering matching funds (at different ratios) of \$5,000 to \$15,000 to the individual/household participant. To be eligible, a household must be at 80 percent or less of local area median income. The funds are forgiven over 5 years at the rate of 20 percent per year.

This program could provide needed financing to build new or convert existing buildings into cooperatives. Organizers could work with their local credit union to get all eligible applicants into the FHLB programs. Depending on how the program is structured, this could give co-op developers access to \$250,000 to \$750,000 in funds to develop a 50 unit co-op building. If planned well, the FHLB program is a great source of capital and a tremendous source of wealth building for the members.

### *Investor Cooperative Laws*

Five states have enacted laws to allow for the formation of cooperative associations that permit nonpatron members to participate in governance and financial rights of the association. In addition, the National Conference of Commissioners of Uniform State Laws has been developing a model cooperative association law and expects to adopt a final version in 2007.

According to a report issued by USDA Cooperative Services in 2006, approximately 22 organizations have been formed under these statutes. Some of them are not yet operating and many are traditional cooperatives that formed under the laws to have two classes of voting stock--patron member and investor member – for use at some time in the future. Entities formed under these laws are unincorporated associations and, like LLC's, are eligible under the IRS check-the-box regulations to be taxed as a partnership under Subchapter K of the Internal

Revenue Code.

The intent of these laws is to attract equity from investors who do not patronize the cooperative. Each law sets slightly varying limits for governance and financial rights permitted to be held by the non-patron investors.

While the goal of getting more equity into co-ops is a good one, many in the cooperative sector oppose these laws because they let outside investors help run and take much of the income from a cooperative. Allocating financial and voting rights to non-patron and outside investors violates long-standing cooperative principles, which say cooperatives are owned and run by their members.

### *Co-op Buying Group*

Amarok, the drywall distributor purchasing co-op with over 170 member owners, established Cooperative Capital Partners to explore various ways to purchase cooperative member companies when they want to sell. The co-op is exploring either a private equity fund or buying group option to purchase member companies before they are sold outside to investors or stock companies outside the cooperative. Members would get together and purchase the for-sale member through a buying group in which all the members contribute some level of equity and assist in the management of the member company. A purchase by the co-op or a co-op fund creates added value for members, protects the co-op against loss of members, and helps attract new members.

### *Incentives to Invest in Cooperatives – Success in Other Countries*

- **Quebec—Facilitating Investment in Co-ops** 7.3 million out of 7.5 million Quebec residents are members of cooperatives. There is an integrated, public/private, multi-tiered cooperative system that includes government financial support for the co-op sector. The system includes investment support for co-ops, tax benefits for investing retirement funds in co-ops, and tax credits for investing in co-ops.

The Desjardins Group represents the largest diversified financial services cooperative in the province. In 2001, the *Capital regional et cooperatif Desjardins* (a member of the Desjardins group) was set up by legislation as an investment company whose main objective is to promote investments in resource regions and meet the capital needs of cooperatives. People can invest up to \$2,500 per year and receive a 35 percent (previously 50 percent) tax credit taken over seven years. The first offering was sold out quickly and thus far, there have been six issues of shares, the latest for \$150 million.

Through 2005, the company had invested more than \$300 million in Quebec businesses, more than \$30 million in cooperatives. The Desjardins system, with thousands of members, hundreds of branches and service centers throughout Quebec and Ontario, represents a

perfect vehicle for marketing and selling investment shares in a fund that support co-op development.

- **The Italian Model – Three percent and no tax on indivisible reserves** Cooperatives in Italy are organized through three national federations, and at the provincial and sector levels. Though cooperatives grew in popularity after WWII, by the 1970s they lacked coordination and were losing market share. Mergers and closings led to fewer co-ops with increased efficiency and profitability. The Lega Federation transformed itself into a diversified society of consumer co-ops that now has more than 17 percent of the country's grocery volume. Co-op Italia serves as a national buying agency for 175 of the consumer co-ops and source for the COOP label, which accounts for 30 percent of all private label products.

The success of co-ops in Italy was assisted by two laws that promote co-op development and intergenerational solidarity. The first law, passed in 1992, requires all co-ops to transfer three percent of their net profits to one of three national cooperative development funds established for each federation. The Lega's Coopfund, the largest, had a cumulative balance of over \$300 million in 2005. The fund is used to make loans and help new cooperatives with their capital needs. Though 76 percent of the fund comes from northern Italy, 27 percent of the fund goes to the South, which remains Italy's poorest area with the fewest cooperatives. In addition, the Coopfund requires that assets from liquidated co-ops must go into the fund, providing the mechanism to support future generations of co-ops.

The second law promotes the concept of indivisible equity by making tax exempt a portion of the net profits that are assigned to indivisible reserves. These tax-exempt, indivisible reserves must be transferred to the co-op fund if the co-op closes or sells. This allows individual co-ops to reduce their tax burden and have more capital for operations while helping to ensure the continuing viability of the co-op sector.

The co-op sector in the region of Emilia Romagna accounts for 30 percent of the region's gross domestic product, the most successful of co-ops in the Italian economy. While the laws that promote co-op development helped fuel this success, the clustering of co-op economic activity and reciprocity among cooperatives in the region is at the heart of it. For example, a food co-op that expands may use a co-op for the real estate transaction, another to finance the property and another to manage it.

### *Government Financing Programs*

The Task Force heard from several presenters about various government programs that may be available for cooperatives to use as seed money for a fund or to leverage funding from other sources.

- **USDA Loan Programs** In addition to the REDLG program discussed above, USDA's Business and Industry Loan Guarantee program not only offers guarantees up to 80 percent

of loan with commercial lender but also provides guarantees for co-op stock purchases. The stock purchase program is limited to producers who want to join new value-added cooperatives. Though it is a rural program, up to 10 percent of the loan amount (maximum \$25 million) can go to urban area.

- **New Market Tax Credits** The NMTC program permits investor/taxpayers to receive a credit against Federal income taxes (over 7 years) for making qualified equity investments in Community Development Entities (CDEs). The CDE invests in a qualified business in the form of a loan located in a low-income area or that creates jobs for people with low incomes. The credits can be used for mixed use housing and real estate but it is more difficult to use it for working capital.

This program is deploying funds to low-income areas much faster than predicted. Forty percent of the credits have gone to non-real estate projects, e.g., child care, health care centers. NCB has used NMTC and gets fees up front from the projects. Apparently one recipient used the NMTC to set up a pool for small business lending.

It is also very inefficient to disburse in small amounts (anything under several million dollars); making it of only very limited potential use for direct investment in most cooperative enterprises. A more applicable use of this program for cooperative equity might be to encourage tax credit recipients to target some portion of their (substantial) project fees toward a special fund for making smaller equity investments in co-ops.

- **SBA Programs** SBA has loan and grant programs for small businesses. Though some types of co-ops and non-profit entities have not been eligible for SBA programs, the definition of small business includes some types of cooperatives. NCBA is working to clarify whether co-ops could be eligible for their programs.

In addition to its loan and grant programs, the SBA administers investment programs, the Small Business Investment Company (SBIC) and the New Market Venture Capital (NMVC) Program. The SBIC program, developed in 1958, provides guaranteed debentures to serve as additional capital for privately owned and managed venture capital funds that invest in small businesses. The NMVC program, which also provides guaranteed debentures, was set up in 2001 to help invest equity capital to small businesses in very low-income neighborhoods. NMVC must come up with a minimum of \$5 million in private capital. The appropriation included \$30 million for operational assistance grants to the start-up entrepreneurs. Six NMVCs were funded before the program was rescinded in 2003 as a result of across the board budget cuts.

- **Rural Business Investment Company (RBIC)** This USDA program, modeled after the SBIC program and administered by SBA, was established with a one time appropriation of \$300 million in the 2002 Farm Bill to promote investment in rural businesses. The program uses federal funds to finance guaranteed debentures for up to 300 percent of the private capital raised. The program also provides money for technical assistance to the companies it invests

in. The program's funding also was rescinded but the program's sponsor, Senator Tom Harkin (D-IA), the Chairman of the Senate Agriculture Committee, may seek a new appropriation.

## VII. Findings of the Task Force

***Co-ops must Lead the Way*** Having co-ops play the leading role in addressing this problem is a necessity. The Italian example makes clear co-ops can be the primary source for funding new co-op development and growth. The Task Force expressed an interest in showing early success with the fund to help get support for and investment in the fund. It was suggested that two immediate sources of equity can be developed through a fund without requiring statutory or regulatory changes or going outside the cooperative community – collateralized sub debt and the purchase of preferred shares.

The Task Force agreed that relying primarily on public financing for cooperative development was a mistake. The cooperative community can and should deploy its resources to support co-op development. Though government programs should not be the focus for meeting co-op capital needs, the REED fund illustrates how small amounts of government money can be turned into significant private investment capital. And we should make sure any restrictions on co-ops' accessing government programs, e.g., SBA, are explored and, if possible, removed.

***More Cooperation among Cooperatives*** The cooperative enterprise has equity capital but it has not been deployed throughout the various co-op sectors in an efficient or effective way to meet the needs of other cooperatives/sectors.

- Cooperatives need financial services cooperatives, e.g., credit unions, to finance initiatives or innovations such as a CD that supports cooperative enterprise.
- Accessible equity financing is a necessary part of the infrastructure of our community – other successful co-op development systems in the world do this (Quebec, Italy and Spain's Mondragon). We have seen success on a sector-by-sector basis when equity needs have been addressed (rural electricians).
- The large co-op sectors and entities that have sufficient capital need to critically evaluate the real benefits of being a source of equity for other sectors.
- Automatic reinvestment of co-op net margins/profits is a good idea, even on a voluntary basis. Task Force members suggested that a 1% of net margin annual contribution from all cooperatives into a special equity fund would not be unrealistic or burdensome. Incorporating part of individual co-ops' net earnings (equity) into a funding mechanism for use by the all co-ops is consistent with cooperative principles and helps ensure the viability of the community, and each enterprise within it.
- Indivisible equity -- equity that is held by the co-op and not allocated or distributed to members and remains within the co-op community upon dissolution -- is a key driver in the formation of a successful cooperative system.

***Small Amounts can be Leveraged*** Equity leverages debt and other investment from outside, so a little equity goes a long way. Co-ops need not get hung up on creating a mechanism to provide large quantities of equity capital when smaller amounts go a long way and could be a start. The success of the Co-op funds that provide loans and some equity financing to co-ops that then leverage four or more times the amount illustrates how effective small amounts can be.

***Small and Large Cooperatives need Equity*** The informal survey of co-op sectors revealed a wide range of equity needs, from a small food co-op needing \$30,000 to seal the deal to \$15 million facility for value-added agricultural co-op. Any fund should address the equity needs of all types and sizes of cooperatives.

***The Cooperative Model can Meet Some Capital Needs*** Sources of equity within the co-op structure may be limited but have been used effectively to meet the needs of individual co-ops. The use of nonqualified allocations that defer payment of patronage refunds; preferred shares for both members and outside investors; instituting capital management plans to plan for future redemption policy to address needs, are good tools though limited in what can be raised and may be costly to pursue.

***The Simpler the Better*** Developing a simple, standardized way to capture the unique value and financial structure of cooperatives is essential to attract investors, especially those not familiar with the model. There is an appetite for individual investors to invest in co-ops (e.g., Calvert and Equal Exchange); mechanisms should facilitate such investing and avoid expensive and cumbersome processes. The socially responsible investment movement presents great opportunities for cooperatives and may provide a way to make it simple to invest.

***Innovation Works*** Innovative ways to attract capital to co-ops can help the enterprise become more vibrant and prevent demutualization. The Equal Exchange CD, Amarok Fund's buying group in which the group purchases co-ops that may be for sale, the Davis Co-op Fund's partnership with financial institutions are all innovative approaches that show how cooperatives can support each other.

***The Cooperative Enterprise needs Incentives against Demutualization*** Cooperatives are often at risk of being demutualized or converted because they have excess capital, high retained earnings or carry high value, long-held assets at a low cost. The impact of demutualization on the cooperative enterprise is significant – less capital and fewer cooperatives to sustain the sector's infrastructure, to prevent the conversion of individual co-ops and to support cooperative development. The most effective response to demutualization is to alleviate financial incentives for management and CEOs and to retain the assets within the cooperative sector. Some European countries do this by requiring that any net assets remaining upon dissolution or conversion go to cooperative development organizations or community foundations.

## VIII. Task Force Recommendations

Recognizing the need for capital for cooperatives and the resolve of the community to mobilize its resources, the Task Force reached consensus about the development of a co-op equity fund with great enthusiasm and support. The group agreed that if individual co-ops and co-op groups cannot contribute to the cooperative community as a whole, the cooperative enterprise will be at risk. The Task Force divided its recommendations into public policy initiatives for the Board to choose from to direct NCBA staff and private sector action for the Board and NCBA members to consider.

### *Public Policy*

- **Ensure access to government programs** While co-ops should not rely primarily on federal funding, we should work to get co-ops access to programs where they are under-represented. Specifically, SBA should make it clear to banks that co-ops are eligible for certain programs; NMTC should make it clear that co-op ownership housing is eligible etc. The investment programs offered through SBA such as RBICs and NMVC should be easily used by cooperative enterprises.
- **Public support for investing in co-ops** Federal and state legislatures should consider ways to encourage investment in co-ops. Some possibilities include one-time appropriation in a private equity fund, federal guarantees for investors in co-ops and state or federal tax breaks for investors in co-ops in general or certain types of co-ops.
- **Restrictions on demutualization** Federal and state laws and regulations should support the cooperative enterprise by taking away financial incentives that promote its demise. Legislation or regulations should require adequate disclosure and due process to ensure member voting rights; protect against unjust enrichment by management and CEOs; and require the net assets remaining at dissolution/conversion be directed to fund cooperative development.
- **Pursue innovative public solutions** The cooperative community should also pursue the idea of giving co-ops the option to not have some of their retained earnings taxed by keeping them as “indivisible.” We could also pursue this idea without tax law changes by creating a 501(c)(3) investment fund that had the mission to invest in job creation in underserved areas so co-ops could donate their retained earnings and in exchange receive shares owned by the non-profit fund.

### *Private Sector Action—An Investment Fund for Co-ops*

Part of the vision of the Task Force is to mobilize resources for and by the cooperative enterprise. The Task Force agreed that the best way to bring resources together to meet the capital needs of co-ops was an equity investment fund. This fund would be designed to provide a return of the investment and a return on the investment.

While there may be a role for some government financing, cooperatives have the resources and commitment to start and grow a fund. How the fund is set up and its specific features have to be determined with equity fund and other experts but the Task Force agreed that a cooperative fund should include the following:

- **Meet needs of co-ops at all stages** While the bulk of funds may be invested in mature, successful co-ops, the fund would be committed to meeting needs at all levels. The fund may include a minimum amount designed to help small co-ops, start-ups, and ones serving disadvantaged populations. These would be higher risk, lower return investments, but would be an investment in the cooperative community itself. The fund would be structured in such a way as to ensure these investments would have a minimal impact on the overall yield of the fund.
- **Meet investor demand** The fund would need to offer different investment opportunities to address different investors' appetite for risk, return, liquidity and social impact. This can be achieved by including a diversity of risk within the fund portfolio or developing several funds within the fund to address the needs of different investors. Calvert allows investors to direct their investment according to the level of return and risk they want.
- **Provide technical assistance** Link developing co-ops with technical assistance resources through cooperative development centers that are part of the CW network, CDFIs, ICA-Group, co-op to co-op mentoring, etc. High risk investments would have a designated source of technical assistance, and perhaps the fund would include rules and standards of operation to increase chances for success.
- **Potential debt financing to fill gap** Though the intent of the Task Force is to develop an equity fund that provides a return to investors on and of their investment, some of the capital of the fund could be in the form of subordinated debt and in the few instances where other debt financing is not available, ordinary first lien debt. The fund should not replace any available sources of debt financing.
  - Another form of debt financing involves the use of IRS Code Section 1042, which allows owners of a company to defer capital gains tax when they sell to an ESOP or worker cooperative. Section 1042 has proven to be among the most important factors in the growth of the ESOP movement, but it was used for the first time by a worker cooperative in 2005. The fund could provide loans that would be used by buy shares from current owners and transfer them to a worker cooperative. Section 1042 has the potential to finance the conversion of existing non-cooperative companies to cooperative status, primarily in circumstances where there is sufficient advanced warning about the potential sale of the company.
- **Wide array of potential investors** The Task Force agreed that if investing in co-ops was made easy and profitable, there would be as many opportunities as there are investors.

Examples of specific types of investors to target include cooperatives and their members, investor co-ops (commitment of 1-3% per year of net margin/profit), cooperative financial institutions such as CFC, credit union centrals, CUNA, etc., other community members/groups who want to invest in a local co-op, and socially responsible investors.

- **Targeted marketing efforts** The fund would develop a marketing program to attract those investors, such as socially responsible investors, who are interested in an adequate return but also interested in stability, supporting cooperative enterprise, community investing or other social values.
  - Use the cooperative sector to the greatest extent possible to market and sell the investment. The Desjardins public offerings are so successful in part because of their thousands of member's affinity for co-ops and the hundreds of branches and centers all over Quebec where residents can go to invest.
- **Standardize and simplify** The fund should make it as easy as possible to invest in cooperatives:
  - Standardize investment forms and other information about the fund and its portfolio businesses to make it easy and accessible for outsiders to understand and invest in cooperative enterprise.
  - Use technology and internet to promote easy investing and access to fund wherever possible.
  - The cost of registering in each state may be high (\$100-\$200K total) but may be worth it to make it easy to attract investors nationwide. It has been done by others like Calvert and would be worth investigating.
- **Clarification of disclosure and registration rules** The costs/benefits of SEC registration requirements for a public offering must be compared with those SEC exempt offerings. Task Force members involved in preferred share offerings indicated that the exempt process can be quite burdensome and limits the marketing channels available for the investments. It is clear that research needs to be done to identify the relevant disclosure and registration requirements and determine how best to proceed.
- **Restrictions on demutualization** The fund should incorporate restrictions on demutualization for those cooperatives participating in the fund. Though there may be rare instances in which demutualization is called for, taking away financial incentives to demutualize is essential to maintaining the cooperative enterprise. Participating co-ops should agree to rules that prohibit management and CEOs to be paid for a conversion and to direct any excess equity back to co-op development when the co-op dissolves or demutualizes.
- **Develop and use expertise within the co-op community** The more expertise we can develop within the cooperative enterprise the more efficient and successful the fund will be.

As we learned from Italian cooperatives, reciprocity is key to growing the sector. We should look for cooperative services, resources and experts whenever possible.

- **Develop way to access the relevant sector expertise to oversee the investing**  
The more expertise to analyze and gauge the proposed investment, the better. REED fund's low loss ratio demonstrates how important it is for people to know the market, the type of risk involved and the players. NCDF has been lending to food co-ops for over 28 years and has an exceedingly low loss rate. Calvert has developed expertise and tools to help analyze financial performance or investor organizations; its staff is available to help.
- **Develop tool to gauge return for investors** Calvert's SROI tool available on its website not only lets investors know how their investment fares but also allows potential investors to gauge how their investment will be put to work. A similar tool to measure success is key to getting investors and support for the fund.
- **NCBA membership** To show commitment to the cooperative enterprise, the fund should include a mandatory requirement that all recipients be NCBA members. The fact that you are reading this report is a tribute to others who saw the need for co-ops from all sectors to come together so that we may all benefit. Support for a strong cross-sector national organization is critical to see that these proposals as well as the needs of co-ops in the future are met in the most effective manner.
- **Owned by and for co-ops** The ownership structure of the fund would need to be researched more but the goal is to have co-ops own their fund.

## IX. The Consequences of Inaction

Tackling the cooperative capital issue will not be an easy task. Cooperatives with excess capital will have to justify to their membership the use of funds in ways that may not yield the highest rate of return to those members, but instead will have a broader and longer term impact by promoting and supporting the cooperative enterprise. Interested investors will need to acknowledge a timeline that, at least for new and developing co-ops, may exceed that of other financial investments. They will also need to embrace a measure of success that goes beyond financial return to an individual co-op, and is instead based on the economic value of strengthening the whole cooperative sector. Cooperatives of all kinds will be challenged to articulate more succinctly and forcefully and to a much broader audience what it really means to be a co-op and why ours is a superior form of human enterprise.

It is clear that without some kind of targeted, appropriate, and cross-sector, cooperative-specific source of equity, new co-op development will continue to be stunted, growing co-ops will continue to suffer relative to their investor-owned competitors, and larger co-ops will continue to be plagued by demutualization. Certain sectors that have solved their capital needs through industry and sector-specific government assistance may move through the 21<sup>st</sup> century with

ease, but other sectors and co-ops will not. If we are to emerge at the other end of this century as a vibrant and healthy sector of the economy, we must act boldly and decisively to ensure the future we chose for ourselves. Building an equity fund that offers a reasonable rate of return provides a great opportunity to create more cooperative successes.

To those who may be unsure about the need to confront this issue, who may be reluctant to take a lower than market-maximizing return on their funds, or who may feel that their own co-op is financially secure and that is all that matters, we must ask: What is the legacy the cooperative movement wants to leave? What is the future our members want to pass on to the next generation? Do they want to be offered the opportunity to proudly help build something substantial that will serve their communities and those like it for generations? We think they do.

Interested cooperators unable to adequately finance their needs and aspirations cooperatively will look to other business models. And we know that for existing co-ops a few self-interested members are only too happy to take down what generations of other cooperators have built under the banner of “improving access to capital.” If we don’t take action to meet the legitimate financing needs of cooperatives across size and across sector we will lose those co-ops to the investor-owned world, to the detriment of those members – past, present and future – as well as to the detriment of our own. Our predecessors helped ensure the success many co-ops enjoy today. We share that obligation and opportunity.

## **X. Next Steps**

***Public Policy Initiatives*** NCBA Board to decide and prioritize public policy recommendations for NCBA staff related to this effort.

***Planning Group*** The next step should be to form a smaller planning group to analyze the creation of a fund. The group should provide detailed feasibility study, analysis of the ownership structure, identification of potential investors and interviews with specific investors to gauge level of interest. This will require some resources and should result in a recommendation about whether we should move forward with the creation of a co-op equity fund and, if so, how to proceed with its development.