



Cooperative Equity Fund Feasibility Report

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I. Introduction	3
II. Regulatory Considerations	4
Exempt Entities.....	4
Private Offering	5
Consultant Recommendation	5
III. Comparison of Legal/Tax Structures	6
Corporations	6
Limited Liability Company (LLC) or Limited Partnership (LP)	6
Cooperatives	7
IV. Governance	9
Consultant Recommendation	12
V. Management	12
Consultant Recommendation	15
VI. Capital Considerations.....	16
Public Sources of Capital	16
<i>New Markets Tax Credits ("NMTC")</i>	16
<i>Small Business Investment Company ("SBIC")</i>	17
<i>USDA Building & Industry ("B&I")</i>	18
<i>Community Development Financial Institutions (CDFI)</i>	19
Private Sources of Capital.....	21
<i>Retail Investors</i>	21
<i>Institutional Investors</i>	22
Capital Structure of the Fund	23
Consultant Recommendation	25
VII. Demand, Investment Targets and Phase-In of Investment Types.....	25
VIII. Preliminary Products	28
IX. Summary of Recommendations	28
X. Scorecard Comparison and Conclusion.....	30
Scorecard	30
Conclusion	31
Appendix.....	32
Financial Discussion	33
Preliminary NCEF Financial Model	36
NCEF Model Assumptions	38

I. Introduction

The Calvert Social Investment Foundation, (the “Consultant” or “Calvert Foundation”) was engaged by the National Cooperative Business Association (“NCBA”) on June 18, 2009 to complete a Feasibility Study on the concept of a national equity fund for cooperative businesses (the “Fund”). Our task was to:

1. establish the feasibility of legal and regulatory compliance,
2. suggest fund structure options,
3. identify potential investors (public and private, institutional and retail),
4. identify entities that may be interested in managing a national equity fund for cooperatives, and
5. develop the preliminary business plan.

In preparing for this assignment, we utilized The Report of the NCBA Cooperative Task Force (the “Task Force Report”) and an earlier feasibility study prepared for NCBA by The Praxis Strategy Group (“Praxis”). NCBA further asked us, as a part of our assignment, to compare our recommended outcome to the Goals of the Task Force Report. Those goals are:

- Meet the needs of co-ops at all stages
- Meet investor demand
- Provide technical assistance
- Potential debt financing to fill gap
- Wide array of potential investors
- Targeted marketing efforts
- Standardize and simplify
- Clarification of disclosure and registration rules
- Restrictions on demutualization
- Develop and use expertise within the co-op community
- Develop way to access the relevant sector expertise to oversee the investing
- Develop tool to gauge return for investors
- NCBA membership
- Owned by and for co-ops

We were further asked to consider additional goals that were not detailed in the Task Force Report, but that are also important potential outcomes. These additional considerations are:

- Provide for retail investment
- Provide annuity income to NCBA, if possible
- Self-perpetuating fund

At the conclusion of this study, we will return to these goals and compare the Consultant’s recommendations to them.

II. Regulatory Considerations

There are essentially two Acts that govern the regulatory issues of concern to this study. They are Investment Company Act of 1940 (“the ’40 Act”) and the Securities Act of 1933 (“the ’33 Act”), collectively, (the “Acts”). Given the options and constraints of these regulations, we identified options for creating the Fund.

Exempt Entities

Praxis correctly concluded that the costs of becoming a regulated company under the ’40 Act would be substantial, (in excess of \$500,000) and that the Fund would need to be extremely well-capitalized (a minimum of \$100 million). This structure is not feasible given the start-up nature of the Fund and we did not explore it further. Instead, we have focused entirely on available exemptions to registering under the Acts.

We examined the creation of the Fund as an organization exempt under the ’40 Act. The ’40 Act applies to the issuance of securities by companies substantially all of whose assets are financial assets. These organizations can be either for-profit or nonprofit. In order to qualify for an exemption from registration requirements under the ’40 Act, the Fund must refrain from general solicitation and advertisement, and also limit its investor base to 99 or fewer investors. This is primarily for statutory reasons, but it also serves to reduce the overall costs associated with operating the Fund – for both investors and the Fund itself. Additionally, organizations must exclusively gear their investment opportunities to only “Qualified Purchasers.”¹ Private equity funds almost universally establish themselves as organizations that operate under this exemption. This structure allows for multiple entities to be formed, if necessary, without registering each entity with the SEC. This could be useful if the Fund found it necessary to create separate vehicles for regional or industry sector reasons.

Additionally, 501(c)(3) nonprofit issuers of securities are exempt from federal registration under Section 3(a)(4) of the ’33 Act, and also under Section 3(c)(10) of the ’40 Act. These exemptions can be claimed on a self-executing basis, i.e., no filing or notice is required. At the state level, approximately 20 of the state securities commissions offer the same self-executing exemption as the SEC; the remaining 30 states require either straightforward notice filings, applications for exemption, or full registration.

¹ Rule 2a51-1 of the ’40 Act, as well as Section 3b and 3c of ’40 Act govern exemption provisions. See also Rule 501(a) of Regulation D of the ’33 Act.

Private Offering

The proposed Fund would raise debt and equity via a private offering conducted under Rule 506 of Regulation D of the '33 Act. The terms of such exemption are as follows:

- The issuer may raise an unlimited amount of funds.
- The issuer may not use any general solicitation or advertisement in selling the securities.
- The issuer can only sell securities to accredited investors (an unlimited number) and up to 35 non-accredited investors, so long as such non-accredited investors are sophisticated investors with sufficient knowledge of and experience in financial and business matters.
- The securities cannot be resold for at least one year from the date of issuance.
- The Fund may need to make audited financial statements available to investors (though there is some flexibility with regard to this requirement).

Exempt Entity	Private Offering
Pros	
<ul style="list-style-type: none"> - Reduced fund capitalization - Reduced overall costs - Exemptions can be claimed on a self-executing basis - Allows for multiple entities to be formed without SEC registration 	<ul style="list-style-type: none"> - Exempt under Regulation D of the '33 Act - Unlimited offering size
Cons	
<ul style="list-style-type: none"> - Limited to 99 or fewer investors - Only "Qualified Purchasers" - Constant vigilance to avoid non-compliance 	<ul style="list-style-type: none"> - May not solicit or market broadly - May only sell to accredited investors and 35 non-accredited investors - Securities cannot be resold for at least one year - May need to make audited financial statements available

Consultant Recommendation

We recommend that the **Fund should be organized as an entity that will be exempt under the Investment Company Act of 1940** ("the '40 Act") because it will have fewer than 99 investors. Additionally, we recommend that **the Fund raise its capital via private offerings that will be exempt from regulation under the Securities Act of 1933.**

III. Comparison of Legal/Tax Structures

Corporations

Corporations can either be stock companies or non-stock companies (profit or nonprofit). On the for-profit side, a corporate structure combines highly-defined governance with limited liability for investors. For-profit corporations can tap all the traditional sources of capital, providing more flexible financing options. On the downside, profits are taxed at a corporate tax rate, and dividends paid to shareholders are taxed at a separate rate. Such a system is sometimes referred to as "double taxation", because any profits will eventually be taxed twice. Another disadvantage of the for-profit corporate structure is that a for-profit has a harder time tapping some sources of social capital such as Program-Related Investments ("PRIs") from foundations, which can often be less costly than traditional sources.

The nonprofit tax-exempt charitable corporation structure may be best suited to the somewhat below-market financing that may be required of the Fund. This charitable purpose would be a key rationale for the Fund to be organized as a non-profit. Another key benefit of this structure is that the income from the Fund would not be taxable, thereby allowing a greater accumulation of reserves. Nonprofits can also receive grants and PRIs — capital sources that are not usually available to for-profit corporations.

On the downside, the nonprofit structure limits the financial incentive for investors to participate in the Fund as there can be no outside ownership of a 501(c)3. Investors could only make loans or other debt investments as a means of financing the nonprofit. Another hurdle is the time and expense of seeking and receiving tax-exempt status, which can take as long as 9 to 12 months. This structure requires a board of directors - recruiting, management, ongoing meetings and reporting. In addition to the limitations on profits, there are limitations on the types of business that a charitable nonprofit can engage in (i.e. museum gift shops are contested as nonprofits given that they are explicitly seeking to make profits). However, certain below-market financing activities that would not be pursued by for-profits, especially those that benefit disadvantage or underserved communities, have generally been an acceptable charitable purpose to the Internal Revenue Service.

Limited Liability Company (LLC) or Limited Partnership (LP)

The Limited Liability Company structure combines the benefits of corporate governance associated with corporations with the limitations on liability normally associated with limited partnerships. In both of these structures, interested investors become Limited Partners (in an LP) or Members (in an LLC) for the purpose of investing in the Fund, with each investor owning a beneficial interest in the Fund through their involvement in the newly-formed entity. The Managing Member of the LLC or the General Partner of the LP would then guide the Fund, acting on behalf of the member-investors. In both structures, the Members (in an LLC) or Limited Partners (in an LP) can lose their limited

liability status in they do not maintain a clear distinction between the roles of manager and investor.

Both LLCs and LPs avoid the double taxation of income to which corporations are subject. This is because these are “pass-through” entities for tax purposes, meaning that the financial activities within them are not taxed at the entity level, but rather at the investor level. Like LLCs, LPs allow equity investors who do not actively participate in management to have limited liability for the activities of the LP. However, the General Partner (sponsoring organization) has management responsibility and also unlimited liability for the activities of the LP. LLCs differ from LPs in that the sponsor (Managing Member) is also allowed limited liability along with the equity investors.

Given the attractiveness of this legal structure to sponsors, it has become the preferred organizational vehicle for certain special purpose business entities, such as real estate ventures and private equity funds. LLCs generally have a governance structure similar to corporations, being led by a professional management team under the guidance of a board of directors. However, administrative costs are typically lower for an LLC than a corporation because of relatively simple accounting for income and profit allocation to investors. Another attraction is that an LLC is very easy to create. LLCs can also receive PRIs from foundations — although an LLC may have a harder time doing so than a non-profit.

Cooperatives

A key NCBA requirement is to create a structure that would encourage cooperatives to invest in the Fund. The most obvious way to accomplish this would be for the Fund to be a cooperative. Cooperatives combine the best of corporate governance with greater ownership democracy. Because the co-op functions solely for the benefit of the members who are also the primary customers, there is no conflict between serving the customer and serving the owners as typically would exist in a corporate legal structure. Managers of cooperatives are keenly aware of their member’s needs and have great incentives to produce outcomes that the members desire.

Whether and how the fund can be organized and function as a cooperative depends on many factors, including whether investors or the beneficiary co-ops that receive the investments own it and how patronage is defined and distributed. If the investors own the fund as a cooperative, it would be difficult to define the services or purpose for which the investor/members own the fund other than as a mechanism to make profit/returns. It would make more sense if the cooperatives that received the services (equity investments) of the fund were the owners, similar to a cooperative loan fund owned by the borrower members, which is the closest analogy.

Some of the key questions that need to be addressed in the implementation phase:

- Whether the fund will be owned by investors or the cooperatives in which the fund invests?
- Whether and how the fund defines and pays “patronage” or dividends?
- How the fund would structure the financial participation of the cooperatives it invests in, e.g., should a portion of the investment be retained by the fund as an equity contribution by the cooperative/member? Should an upfront equity investment be required?
- How to determine dividends and redemptions, e.g., the amount the cooperative receives as an equity investment from the fund?
- How would the outside investors invest in the fund? Should the fund be organized under a traditional cooperative law where outside investors are given shares of nonvoting stock or would it be better to organize under one of the new co-op association laws that allow for non-patron voting members?
- Should the fund be set up in a state with generous or nonexistent caps on dividend payments?
- Should the fund require ongoing participation, e.g., 1% of earnings, on the part of the cooperative member after any equity investment is returned to the fund?

A cooperative ownership model that allows the co-op beneficiaries to govern and own the fund would enhance the goals of the fund to promote and support cooperative development and the cooperative business model. Structuring the fund as a cooperative may involve challenges but the benefits of demonstrating how the co-op model can work as a vehicle to invest in cooperatives would probably outweigh the additional work that may be needed. It would also be helpful as a model for future efforts to establish other cooperative funds.

Corporation	Cooperative	LLC or LP
Pros		
<ul style="list-style-type: none"> - Flexible financing structure - Limited liability 	<ul style="list-style-type: none"> - Member affinity - Democratic decision-making - Management incentives align with members needs 	<ul style="list-style-type: none"> - Limited liability - Flexible financing - Not double taxed - LLC combines corporate governance with limited liability for investors and managers - LLCs are easy to set up
Cons		
<ul style="list-style-type: none"> - Higher administrative costs - Double taxation 	<ul style="list-style-type: none"> - Limited capital options - Difficulty in establishing patronage relationship for an investment fund 	<ul style="list-style-type: none"> - LLCs may have difficulty getting PRIs (slightly less favorable for social investors) - LP general partners have unlimited liability

Consultant Recommendation

The Consultant understands the desire of NCBA and the cooperative community to establish a fund for cooperatives that is itself a cooperative. The decision depends on who will own the fund. The cooperative structure could be implemented more easily if the fund were owned by the cooperatives that receive the services (equity capital) of the fund. If the preference is for the investors to own the fund, then we would recommend an LLC because it would be difficult to ascertain the benefit or service provided by the cooperative other than to make a profit for the investor. However, the consultants recognize that the ownership structure is critical; the legal and structural requirements should be more fully assessed and compared in the next phase to determine the structure that best meets the needs of the investors and co-ops in which the fund invests. Please note, the LLC structure is assumed where such an assumption is needed and appropriate in subsequent parts of the report since we have more experience with that model.

IV. Governance

Private equity partnerships typically organize two governing bodies to guide the investment and management activities of the Fund. They include the Advisory Committee and the Investment Committee.

The Advisory Committee is often composed of the largest investors in the Fund and this group serves to resolve conflicts of interest between the Managing Member and the Fund, approve distributions authorized by the Managing Member and confer on the general conduct of the Fund's business.

The Investment Committee has the day-to-day responsibility and limited liability for the Fund's operation. Because of this responsibility, the individuals who are principals of the Fund's Managing Member are typically the sole members of the Investment Committee. Members of the Advisory Committee are not involved in the day-to-day decisions of the Fund in order to retain their limited liability status. If limited partners begin to insert themselves into Fund decisions, they would be deemed to have engaged in the Fund's principal operating activity – investment decision making – and might compromise their legally protected status should any legal disputes arise with the Fund.

While these standard practices well serve the private equity industry, adjustments to them may be in order to better serve a fund aimed at cooperative businesses. A key opportunity for the Fund is to engage and leverage the vast expertise among NCBA members to prudently source and complete Fund investments across multiple cooperative sectors. However, potential limited liability constraints create specific considerations to weigh around Fund governance and advisory boards.

Additionally, we have determined that the Limited Liability Company has the benefits of corporate governance associated with corporations, combined with the limitations on liability normally associated with Limited Partnerships. The Fund should operate with a

Board of Directors, perhaps initially chosen by NCBA. These individuals should provide policy guidance to the Fund. In considering various options, this governance structure could prove decisive.

We have considered three options for Fund governance. They are:

- 1) *The Fund creates an Advisory Board that also serves as the Investment Committee:* In this governance structure, a group of investors would serve in both roles.

Fund institutional investors (such as the NCB) and the Fund's Managing Member would serve on an Advisory Board that operates both as the Advisory Committee and as the Investment Committee.

- Advantages: a) strengthened involvement in the direct investment and management activities of the Fund; b) cooperative expertise is maintained; and, c) all decisions are vetted by key limited members of the Fund.
- Drawbacks: a) Any investor serving as a member of the Advisory Board may forfeit their limited liability status, and assume greater liability alongside the Managing Member; b) The Fund may be unable to attract the money it needs to execute its investment thesis, since institutional investors will likely be unwilling to forfeit their limited liability status to represent their disproportionate share of committed capital in the Fund; and, c) Speed and flexibility in investment decision-making may be hindered, given the potential conflicts of interests that may arise among the investors.

- 2) *The Fund creates an Advisory Committee and an Investment Committee to preside over their traditional activities, but selects its initial investments by a majority vote of the Investment Committee and Advisory Committees.*

In this governance structure, the Fund would establish an Advisory Committee and an Investment Committee in a traditional private equity model. The difference would be that the Fund's decision on initial investments would be determined by the majority consent of the above committees.

- Advantages: a) All limited members will maintain representation in the Fund; b) the key decisions surrounding investment decisions will be decided by the votes of both the Advisory Committee and the Investment Committee together; c) Institutional investors will likely be attracted to the Fund governance structure, given the opportunity for increased involvement; and d) cooperative expertise is maintained.
- Drawbacks: a) Investors may feel a loss of direct control over the Fund's subsequent investment activities; b) Speed and flexibility in deciding upon the initial investments may be hindered, given the number of approvals that will be necessary; and c) greater risk of limited liability forfeiture.

- 3) *The Fund creates an Investment Committee of the Board of Directors and an Advisory Committee composed of “industry experts.”*

This example is an attempt to gain the valuable outside expertise and perspective of the Advisory Committee, combined with the benefits of managed liability. In this governance structure, the Fund would establish an Investment Committee of the Board composed of individuals with specialized knowledge and skills. It will also form a flexible advisory group of individuals (many drawn from NCBA members) with a wide range of cooperative-relevant knowledge. All final investment decisions would rest with the Investment Committee. While speed of decision-making may be impaired, this loss should be more than offset by the gain of expertise provided by the Advisory Committee. It should be noted that it will probably be necessary for the Fund to take steps to protect the Investment Committee, Advisory Committee and Board of Directors from legal risk.

- Advantages: a) Institutional investors would feel comfortable with such a model; and, b) Investment Committee retains control over this activity of the Fund; and, c) Liability is appropriately managed by the Board of Directors; and, d) cooperative expertise is maintained.
- Drawbacks: a) Some investors may feel they have less control over the Fund’s operating activities, and thus chose not to invest in the Fund; b) the Fund may need to take additional steps to mitigate risk and protect Investment Committee members; and c) Speed of decision-making may be impaired.

Governance Considerations		
Structure	Pros	Cons
Advisory Board and Investment Committee as One	<ul style="list-style-type: none"> - more involvement - all decisions are vetted by key partners - maintains co-op expertise 	<ul style="list-style-type: none"> - higher risk of loss of limited liability - more difficult to raise funds - speed and flexibility may be impaired
Majority vote of both the Investment and Advisory Committees	<ul style="list-style-type: none"> - decisions made by both entities - maintains co-op expertise 	<ul style="list-style-type: none"> - investors have some, but not perfect control over investment decisions - speed and flexibility may be impaired - greater risk of limited liability forfeiture
Investment Committee of the Board of Directors and Advisory Committee composed of industry experts	<ul style="list-style-type: none"> - more attractive to investors - appropriate liability mgmt - maintains co-op expertise 	<ul style="list-style-type: none"> - investors have less control of operating activities - may require add'l liability protections - speed of decision-making may be impaired

Consultant Recommendation

We recommend that the Fund adopt Option 3. This is a modified governance structure that preserves investors’ limited liability status, draws on broader knowledge available among NCBA members, while also maintaining appropriate control over the Fund’s important decisions. This recommendation will require the review and comment of legal counsel when and if the process for establishing the Fund moves from this feasibility stage into implementation.

V. Management

There are two models for fund management. The first is to create the necessary skills in-house (Build-Your-Own) and the other to hire those skills by engaging a fee-for-service manager (Rent-From-Outside). The cost of Build-Your-Own can vary considerably, but is generally not believed to be a viable model for a single stand-alone fund. Fees for private equity fund management in the Rent-From-Outside model range from 1% - 3% depending on the size of the fund, with larger fees associated with smaller funds.

A Fund focused primarily on cooperatives would lack some of the attractive investment features that draw private equity fund managers. For instance, NCBA has an absolute commitment to avoiding forced exit strategies, such as demutualization. This will limit the timing and potential upside for a manager. Cooperative structures will further limit

additional fund manager returns from the ownership of company equity. Given these limitations and the potentially complex (but smaller) transactions that the Fund would require, we eliminated for-profit private equity funds from consideration for the fund management role. We determined that the economics of the Fund would not be attractive to those entities.

We also investigated a number of potential non-profit fund managers, including Good Capital, Non Profit Finance Fund (“NFF”), Low-Income Investment Fund (“LIIF”), Calvert Social Investment Foundation and the Enterprise Community Investment (“Enterprise”). Our investigation focused on each organization’s:

1. experience with equity or debt fund management,
2. stated willingness to manage funds on behalf of others,
3. reputational quality of underwriting and due diligence, and
4. mission or business fit with NCBA’s diverse members.

Each organization is summarized below:

Good Capital is a San Francisco-based investment firm that invests in the most promising social enterprises. Their first financial product, the \$6 million Social Enterprise Expansion Fund (“SEEF”), provides equity and equity-like growth capital to social enterprises that are ready to expand. Good Capital targets social enterprises (both for profit companies and nonprofit organizations with earned income) with scalable business models that have the potential to create systemic and large-scale social change and generate an attractive return for investors who have the right kind of human and financial capital. SEEF is overseen by an investment committee with decades of experience in venture capital, investment banking, operations, and social entrepreneurship. The Social Enterprise Expansion Fund is closely managed and applies the same rigor to due diligence and the bottom line and exit strategies of its portfolio companies as would a traditional venture capital firm.

Nonprofit Finance Fund (NFF) is a national leader in financing nonprofits, strengthening their financial health and improving their capacity to serve their communities. With NFF's help, nonprofits build and renovate facilities, fund growth needs, and expand and sustain operations over time.

NFF serves both nonprofits and their funders, offering an integrated package of financial and advisory services, including facilities and working capital loans and lines of credit; asset-building programs; intensive workshops; Nonprofit Business Analyses, and other consultations to help nonprofit management understand the impact on their finances of management and program decisions. A newly launched entity, NFF Capital Partners, helps nonprofits attract equity-like growth capital.

Nonprofit Finance Fund's financial consulting services provide nonprofits with tools to assess financial health, communicate financial needs and understand the financial impact of decisions on programs and mission.

The Low Income Investment Fund (LIIF) is driven by its goal of poverty alleviation. LIIF pursues this aim by providing capital and technical assistance to help low income communities finance and build facilities for education, affordable and supportive housing, child care, and other community revitalization programs. LIIF lends capital through its Revolving Loan Fund (RLF) for predevelopment needs, acquisition lines of credit, construction financing and mini-permanent loans. While the RLF funds projects in each of LIIF's program areas, LIIF's other loan fund, the ABCD Fund, is specifically dedicated to loans for child care centers in California. ABCD Fund loans are made for centers' feasibility planning, acquisition, construction and long-term real estate financing needs.

For over 10 years, Calvert Foundation, a nonprofit 501(c)(3) organization, has been working to make community investment a safe and logical option for all investors seeking to make a positive social impact. It focuses on using investment capital, rather than conventional philanthropy, to create a sustainable, scalable model that enables nonprofit organizations and social enterprises to address critical social problems. Through the Community Investment Partners (“CIP”) program, Calvert Foundation works with foundations, nonprofits, CDFIs and investors to set up and manage investment programs that earn a modest return yet have an enormous social impact on underserved communities. CIP provides asset management services to help organizations effectively place capital, manage risk and maintain professional relationships with their borrowers and investment organizations. As of June 30, 2009 CIP managed approximately \$90 million of outside investor capital. The CIP program leverages the experience and knowledge from Calvert Foundation’s own investment program, which has attracted over 5,000 investors and raised over \$170 million for 240 groups.

Enterprise Community Partners, Inc. (“Enterprise”) is a leading provider of capital and expertise for affordable housing and community development. Enterprise works with partners – developers, investors, government, community-based nonprofits and others – to reach common goals. Enterprise is one of the leading providers of Low-Income Housing Tax Credit (LIHTC) equity in the country. Their investment portfolio reflects a consistent resolve to tackle the toughest challenges, the most at-risk populations and the most complex projects to provide community solutions. Through the LIHTC program, Enterprise has financed \$6.5 billion in capital for the creation of 1,400 affordable housing developments. They have also been among the most successful applicants for New Market Tax Credits and offer fund management assistance through their Enterprise Community Investments subsidiary.

The following table describes the major finding and outcome of our investigation.

Manager Considerations				
Name	Management Experience with Debt / Equity	Willingness to Manage Funds for Others	Reputational Quality	Mission / Business Fit with NCBA
Good Capital	One of the few equity mgrs in social investing arena beyond tax credits	Yes	Good staff, but little track record	Staff experience points to ability to analyze equity investments in diverse businesses
Nonprofit Finance Fund	Very capable debt manager	Not at this writing	High	Focused exclusively on Non-profits
Low Income Investment Fund	Very capable debt manager	Not at this writing	High	Focused on underserved communities
Calvert Foundation	Very capable debt manager	Yes	High	Focused on underserved communities, but has broad experience with social enterprises, both nonprofit and for-profit.
Enterprise Community Investments	Very capable debt and equity manager	Yes	High	Limited to affordable housing and New Market Tax Credit investment in distressed communities. Has broad experience with nonprofits and for-profits.

While all of these entities are high quality organizations, we eliminated NFF, LIIF, and Enterprise from consideration. Enterprise and LIIF have a primary focus on low-income and distressed communities. NFF is limited to Community Development Finance Institutions. While Enterprise has recently created a consulting business to provide fund management expertise to outside entities, this practice is limited to tax credits. Lastly, At this writing, NFF and LIIF have not expressed an interest in managing external funds.

As a result of this investigation, the most viable managers for the Fund are Good Capital and the Calvert Foundation. Neither organization is a perfect fit for the Fund. Good Capital has a very short track record, but is one of the few managers of equity for social investing. Calvert Foundation has extensive experience and a well organized business for managing outside investment funds, but has not ventured into equity investing.

Consultant Recommendation

We recommend that NCBA seek proposals from Good Capital and Calvert Foundation for management of the Fund. Given that both organizations have distinct

skills and experiences that could benefit the Fund, NCBA might consider proposing a joint venture management arrangement between Good Capital and Calvert, thereby drawing on the best of each.

VI. Capital Considerations

Capital for the Fund could be provided by private or public sources, as either debt or equity. The following discussion summarizes our investigation of the most appealing public and private sources of capital. Lastly, we discuss the appropriate mix of debt and equity given the likely risk profile of the ultimate investments and also considering the goals and other considerations of NCBA.

Public Sources of Capital

New Markets Tax Credits (“NMTC”)

The NMTC provides a credit against Federal income taxes for investors that make Qualified Equity Investments (QEIs) into Community Development Entities (CDEs). CDEs in turn use the proceeds of these investments to make Qualified Low-Income Community Investments (QLICIs). QLICIs include, among other things, investments in businesses and real estate projects in low-income communities. \$3.5 Billion of NMTC investment authority is available for 2009.

We investigated cooperatives that used the NMTC to finance the development of new facilities for food production and administration space. NMTCs were used to fund the development project through a special purpose LLC, as opposed to funding the cooperative itself. The projects ranged in size from 17,000 square feet to 32,000 square feet and ranged in cost from \$8 million to \$10.5 million. Although they were able to receive the benefit of below market interest rates through the NMTC program, each cooperative contact interviewed found their projects to be lengthy, complex and very expensive from a legal and accounting perspective.

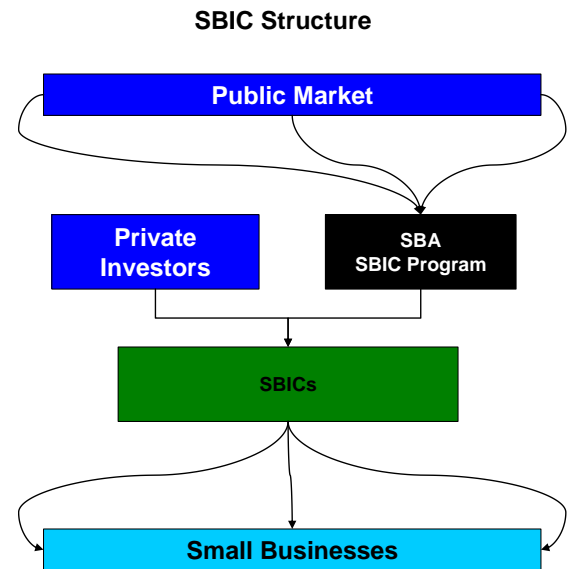
Additionally we spoke with consultants and a syndicator with significant experience in the NMTC program. They stated that while it would be possible to use the credits as a part of a pool, it would be impracticable to do so. The NMTC program has very stringent requirements regarding the location of businesses and projects that they fund. Including tax credit equity in a pool would require that the entire equity fund meet the narrow locational criteria in order for the NMTC regulations to be met. Thus all of a pool of equity would need to be targeted to low-income census tracts that are eligible to receive credits. In addition, in order to receive NMTC funding, the equity fund would need to create an infrastructure in order to become eligible and competitive for the award of credits. The fund would need to apply to become a CDE, the only type of entity to which tax credits are awarded. The fund would also in all likelihood need to partner with an organization with a history in the allocation, management and compliance of NMTC projects in order to be competitive in a NMTC application process.

Our investigation of NMTC leads us to conclude that while it would be difficult to use NMTC with the Fund, the credit is a very attractive, if complex, source of capital. The Fund should seek opportunities to support co-ops that wish to utilize NMTC.

Small Business Investment Company (“SBIC”)

Dating from 1958, the SBIC program has provided over \$50 billion of funding to finance smaller American businesses. A Small Business Investment Company is a privately owned and operated company (the “Company”) that makes long-term investments and that is licensed by the United States Small Business Administration (“SBA”). SBA regulations define a small business as one with net worth (excluding goodwill) of less than \$18 million and average after-tax income (exclusive of loss carry-forwards) for the prior 2 years of less than \$6 million.

The principal reason for a firm to become licensed as an SBIC is access to financing (“Leverage”) provided by SBA. This leverage principally comes in the form “Debentures” and “Participating” Securities. The focus of this discussion will be on Debentures since the Participating program is no longer functioning. Debentures are unsecured loans issued by the SBIC that have interest only payable semi-annually and a ten-year maturity.



Attractive features of the SBIC program include:

- Investor funds and SBA Debentures are taken down by the Company in “lock step”, thereby delaying investor capital calls and increasing investor returns.
- The Company is required to have total paid-in capital plus (which can include unfunded binding commitments from “Institutional Investors”) of at least \$5 million, of which only \$2.5 million needs to be paid-in prior to issuance of the SBIC License.
- This paid-in capital must be equity, not debt.
- Once at least 50% of this \$2.5 million is invested, the SBIC will be eligible to use SBA Leverage prior to having another capital call from investors.
- Once a management team files its formal SBIC application, it may hold a closing, form its fund and begin operations.
- However, it may not obtain Leverage until it receives its license, a process that historically has taken from 6-10 months. Ratio of SBA Leverage to investor capital is 2:1.
- Once licensed, most SBICs fund their operations solely by using SBA Leverage until the ratio of outstanding Leverage to paid-in capital from private

- investors (called “Leverageable Capital”) reaches two-to-one, and they then coordinate capital calls from private investors with the use of Leverage to maintain a two-to-one Leverage ratio.
- Current Community Reinvestment Act (“CRA”) regulations present banks (other than certain “small banks”) with a continuing need to make investments that qualify for CRA purposes. Investment in an SBIC is specifically identified in the CRA regulations as a type of investment that will be presumed by the regulatory agencies to be a “qualified investment” for CRA purposes.
 - The SBIC Act specifically authorizes banks and Federal savings associations to invest up to 5 percent of their capital and surplus in SBICs.

Our investigation determined that SBIC is an attractive program that could be utilized by an equity fund for cooperative businesses. One serious constraint is the requirement that a fund’s capital (to be paid-in before the awarding funding of the SBIC license and SBA Leverage funding) must come from equity. This eliminates any fund from consideration of an SBIC license that hopes to add debt to its capital structure in addition to the SBA Leverage. Based on this, we believe the SBIC program may be a very important vehicle for a subsequent equity fund. The subsequent fund would probably be composed of cooperatives that have been convinced of the concept due to the successful deployment of the initial fund. With successful proof-of-concept, it may be possible to raise a subsequent fund with equity-only investors.

USDA Building & Industry (“B&I”)

The B&I program is designed to encourage the commercial financing of rural businesses, thereby creating rural jobs and improving the economic and environmental climate of rural communities. The program provides 80% guarantees on loans up to \$5 million (and 70% on loans of \$5-10 million). While there are no minimum loan sizes, loan under the program typically begin at Small Business Administration maximum of \$750,000.

The B&I program is lender-driven and lender friendly. The guaranteed portion of the loan does not count against lending limits and the B&I guarantees help lenders satisfy Community Reinvestment Act (CRA) requirements. There is an active secondary market for B&I guarantees (e.g., Farmer Mac II and SBA markets) and lenders use their own forms, loan documents, and security instruments. Any federal or state chartered bank, or bank-holding company’s mortgage company; credit union; or insurance company which is subject to government credit examination and in good standing are eligible. Other lenders with commercial lending experience and financial strength, such as Community Development Financial Institutions (“CDFI”), may also be approved.

Most types of enterprises qualify as borrowers-- manufacturing, wholesale, retail, service -- new or existing. Project must be in a rural area -- beyond any 50,000+ population city and its urbanized periphery. Cooperatives, proprietorships, partnerships, corporations, LLCs, trusts, nonprofits, tribes and public bodies are all allowed legal structures for borrowers, as long as the proposed operation has a realistic repayment ability and a

tangible balance sheet equity position at loan closing/project completion of 10 percent or more (for existing businesses) or 20 percent or more (for new businesses). Additionally, there must be adequate collateral.

The B and I program's new provision authorizing loans for the purpose of purchasing equity securities in cooperatives or funds that invest primarily in cooperatives makes the program an attractive credit enhancement tool that is cooperative-friendly. We continue to research ways to integrate this program directly into the Fund but there are hurdles. An obvious need would be for B&I guarantees of loans made to start-up cooperatives in rural areas. However, given the high credit hurdles in the program, it is not clear that start-ups would qualify for the guarantee. Another constraint is the rural focus of the program. While the definition of "rural" is broad enough to accommodate many investments, this constraint may mean that the Fund would have to segregate rural investments using the program in some fashion. Further investigation will be required to determine the highest and best use of the B&I program in relation to the Fund.

Community Development Financial Institutions (CDFI)

The sole aim of the CDFI Fund is to strengthen the ability of financial institutions to offer credit, capital, and financial services to underserved communities and populations in the U.S. in order to promote economic revitalization and community development.

In order to qualify for CDFI funding, an applicant must first obtain certification as a Community Development Financial Institution from the CDFI Fund. The CDFI Fund defines a CDFI as an entity that is a specialized financial institution that works in market niches that are underserved by traditional financial institutions. With this definition, currently the CDFI Fund has certified over 784 financial institutions as CDFIs. To meet the eligibility requirements of CDFI certification, an organization must fulfill all of the following requirements:

- Be a legal entity at the time of certification application
- Have a primary mission of promoting community development
- Be a financing entity
- Primarily serve one or more target markets
- Provide development services in conjunction with its financing activities
- Maintain accountability to its defined target market; and
- Be a non-government entity and not be under control of any government entity

Once certified as a CDFI by the Treasury Department, the Fund would apply to the CDFI program for funding (one of four programs through which the Fund disperses awards). Since its establishment by the Riegle Community Development and Regulatory Improvement Act of 1994, the CDFI Fund has awarded more than \$864 million to community development organizations and financial institutions. Award sizes vary significantly in amount, ranging from as low as \$400 to the maximum award ever given of \$162 million. In line with the mission of the CDFI Fund, stressing the underserved

qualities of the cooperatives to which an NCBA-related organization would provide loans would be a key component in securing funding from the CDFI Fund.

Although the certification process for becoming a CDFI is not complicated, the Fund would have to primarily serve “one or more target markets”, which may hinder the greater investment strategy of the Fund if it does not plan to focus on such target markets. However, this potential constraint may be manageable within the CDFI application process as the Fund would serve many areas of interest to the CDFI program, such as rural business development. Given the outstanding potential benefits of becoming a CDFI, we recommend that the Fund pursue CDFI status.

Public Sources of Capital			
NMTC	SBIC	USDA B&I	CDFI
Pros			
- Tax benefits from business investment - Could benefit co-ops	- Leverage from federal government	- 80% guarantee from federal government	- Leverage from federal government - Grants from federal government
Cons			
- Limits lending to a particular segment - Very difficult to use within fund structure - Limited to low-income communities	- Appears to require all equity funding before SBIC license issued.	- While financial entities other than banks can participate, not clear how to do so - Rural focus may limit deals and cause difficulty structuring Fund	- Limits lending to a particular segment - May have some reporting requirements attached to financing from CDFI Fund

It should be noted that these public resources can be combined in creative ways to fund cooperative activities. An example of such a deal might be a facility being built in a rural area that not only may qualify for B&I loans, but could benefit from NMTCs and possibly state tax credits, where they exist.

Private Sources of Capital

Retail Investors

A part of the NCBA assignment was to investigate how to make investing in the Fund available to retail investors. Retail investors are generally thought to be comprised of two distinct marketing segments. They are the High Net Worth (“HNW”) segment, which can be further subdivided, and the Mass Affluent segment. High Net Worth investors have investable assets of \$2 million or more, while Mass Affluent investors have assets greater than \$100,000 but less than \$2 million. Both segments contain investors who are drawn to social investment. The primary distinction between the two is the threshold amount of money they are able to invest.

The two primary vehicles for retail investing are registered securities and securities offered by nonprofits under certain exemptions to registration. Registering a security for public solicitation under an exemption such as what Equal Exchange and Organic Valley have done, is a costly and complicated endeavor. Despite these hurdles, such registration has proven to be a successful strategy for these organizations and has opened investing in cooperatives to a broader array of investors.

Nonprofit issuers of securities (501(c)(3) organizations) are exempt from federal registration under Section 3(a)(4) of the Securities Act of 1933, and also under Section 3(c)(10) of the 1940 Act. These exemptions can be claimed on a self-executing basis, i.e., no filing or notice is required. At the state level, approximately 20 of the state securities commissions offer the same self-executing exemption as the SEC; the remaining 30 states require either straightforward notice filings, applications for exemption, or full registration. The cost of offering an exempt security is approximately \$ 35,000 upfront, plus annual costs of \$ 35,000. Approximately \$15,000 of the estimated upfront costs are assumed to be legal fees, which can vary significantly.

Self Executing States

**AK, CT, DE, FL, HI, IL, MA,
ME, MS, NE, NH, NJ, NM,
RI, SD, TX, UT, VT, WV, WY**

Registering an offering at the state level by a nonprofit affiliated with NCBA would thus be a cheaper and simpler option for NCBA to access retail investors. The distribution of these exempt retail investment notes could be accomplished by any validly registered broker-dealer, such as CUNA Mutual, or by direct solicitation on the part of the nonprofit's officers and directors. Essentially, a nonprofit, such as Cooperative Development Foundation ("CDF"), can be the platform through which the Fund can take investments (however indirect) from retail investors. The nonprofit itself would then count as just one of the 99 or fewer investors in the Fund. Another attractive feature of this approach is that CDF could use the proceeds from the exempt notes to provide financing to a broad array of cooperatives, in addition to the Fund.

Based on the acceptance of Calvert Foundation's note program, with over \$170 million outstanding, a well-designed Co-op note distributed nationally through credit unions should be appealing to HNW and Mass Affluent investors.

Institutional Investors

There are several sources of institutional capital that may be available to the Fund. These include large cooperatives, banks, credit unions, foundations, mutual funds and insurance companies. With the exception of cooperatives, most of these investors are more inclined to provide debt financing over equity. The terms provided by these investors will also vary.

Foundations typically provide the most favorable financing terms with rates usually falling between 1% and 6%. These are debt investments and would need to qualify as Program-Related Investments (PRIs). They often come with certain reporting requirements on the borrowers. If the Fund is organized as an LLC, it is possible that foundations would make a PRI investment. However, most foundations have recently suffered losses in their own investment portfolios and have fewer resources available for PRIs. Examples of active PRI lenders are the MacArthur, Ford, Rockefeller, Annie Casey and Gates Foundations.

Banks and credit unions will often lend at market rates, which will fluctuate depending on the interest rate environment. Some of the larger banks, especially those seeking CRA

credit, will lend through their community development corporations at more favorable rates. Examples are Wells Fargo, Bank of America, JP Morgan and Citibank.

Credit Unions are fully discussed in the Praxis study. We agree with the Praxis findings that it may be difficult for credit unions to be direct investors in the Fund. Further investigation is needed on this issue. However, we believe that credit unions will become indirect investors through the creation of a program whereby insured certificates of deposit can be offered to credit union members, who in turn donate a portion of the interest earned to CDF. Participating credit unions can match the member donation. CDF can then contribute those donations to the Fund as part of its senior debt or as equity. This is hereafter described as (the “CD Donation Program”). Based on our discussions with credit unions there may be interest in such a program.

Mutual funds and insurance companies may also provide financing at market rates. Both types of organizations are highly regulated and neither have CRA obligations. It may therefore be more difficult to structure a direct investment in the Fund from these entities. However, occasionally, more favorable terms can be negotiated if there is already a business relationship between the company and the borrower.

Capital Structure of the Fund

Based on our review of the Task Force Report and of the Praxis study, we agree that the Fund will be making investments of patient capital in various types of cooperatives. This equity-like and equity capital will be somewhat riskier than collateralized senior lending. Therefore the capital structure of the Fund must minimize capital risk to offset the operating risk of the Fund. This would argue for a low-cost and patient (or at least stable) source of primary capital. Additionally, we have considered the need to appeal to retail investors, different investor appetites and cooperative ownership. We have determined that the above goals can be best accommodated by a capital structure that combines low-cost retail capital for patient senior debt with subordinated debt from institutions and common equity from cooperatives.

Low-Cost Retail Capital: We have assumed that approximately \$2.5 million of senior debt could be raised over the first two years of the Fund’s operations. This debt will have a current-pay coupon of approximately 3% and generally have a term of five years. Senior debt will be raised primarily from retail investors (e.g., through the sale of CDF Co-op Investment Notes through CUNA Mutual brokers and through the CD Donation Program being developed by credit unions through the Filene Institute). The funds raised by CDF would then be lent to NCEF as a senior tranche of debt capital. Once the funds are fully deployed in the Fund, CDF could earn an estimated 1% margin above average cost of funds, or in this example approximately \$25,000 (1% of \$2.5 million). These funds could be available to pay the ongoing costs of the registration and could potentially provide NCBA with an annuity income.

The retail note is a simple offering. The notes could be made available in denominations of \$1,000 each. Investors could be offered a choice of interest rates and terms, for

instance 0% to 2.5% for 3, 5 or 7 years. The experience of Calvert Foundation, who pioneered the Community Investment Note concept, is that investors tend to choose in the middle ranges. Investors in Calvert's note also tend to renew their notes at a high rate (>90%). Another benefit of the retail investment note is that marketing materials can be standardized for use by CUNA Mutual brokers nationwide.

Subordinated Debt & Equity: The balance of the capital structure of the Fund could be comprised of subordinated debt and equity. Subordinated debt of \$2.5 million at 5% for five years would come from a variety of institutional investors, including cooperatives, banks, credit unions and foundations. Most importantly, approximately \$1 million of common equity would need to be raised from other cooperative organizations in order to launch the Fund. While the subordinated debt will have a current-pay structure like the senior debt, the common equity will only realize its return from available Fund cash flow. We have assumed that a target equity yield of 7%, plus the benefits of helping build the cooperative movement, will be sufficient to draw equity investors to the Fund. Once assembled, this capital structure will meet the needs of a wide array of potential investors.

Investor Commitments: Another consideration for the capital structure of the Fund relates to the funding of investors commitments. When investors make capital commitments, they typically enter into a pledge or subscription agreement with the Fund for the amount specified in the agreement. In some cases, this pledge is evidenced by a promissory note signed by the investor. Typically the Fund takes its first draw from the investor at the "first close" of the Fund. These initial funds are then used by the Fund manager to cover the startup and initial operating costs associated with the Fund; to fund management & administration fees; and, to allow for the quick execution of the first few investment transactions planned by the Fund. When the Fund makes a capital call to pay for an investment transaction, the investor usually submits payment to the Fund via wire or bank draft. In certain cases, the Fund should use the investor's promissory note as collateral to arrange a "bridge" loan with a commercial bank that will allow the investor to delay payment. Subsequent capital calls are typically made either on an "as needed" basis, or in accordance with the draw schedule delineated in the Fund operating agreement (e.g. equal amounts over a three year period).

Quantifying Social Outcomes: Finally, it will be important to develop a tool to show outcomes important to investors beyond the financial returns. A key consideration for many investors, both retail and institutional, will be how the Fund assists the growth of the cooperative movement, along with other data on jobs, economic development, etc. It is strongly encouraged that if NCBA approves the concept, those charged with implementing the Fund should work with the outside fund manager to design processes to routinely capture and report such outcomes.

Private Sources of Capital	
Retail Investors	Institutional Investors
<ul style="list-style-type: none"> - High Net Worth - Mass Affluent 	<ul style="list-style-type: none"> - Cooperatives are likely participants - Banks are likely participants - Credit Unions are likely participants - Foundations are possible participants - Mutual Funds are unlikely participants - Insurance companies are unlikely participants
<p>} Likely to participate in a Co-op note and CD Donation Program at Credit Unions</p>	

Consultant Recommendation

We recommend that the Fund be capitalized with a combination of debt (senior and subordinated) and equity. While the debt should have a current pay coupon structure, we recommend that common equity receive its return from net cash flow as available for distribution. The Fund could arrange the some of the debt to be drawn as capital call, thereby reducing the debt service requirement. Lastly, tools to measure outcomes for cooperatives beyond the Fund’s financial return should be developed at the outset of Fund operations and used to satisfy investor’s social motivations.

VII. Demand, Investment Targets and Phase-In of Investment Types

Demand

Based on the Praxis study and interviews conducted for this report, we have concluded that there will be sufficient demand for a moderately sized (< \$20 million) equity fund aimed at various cooperative businesses.

It will be desirable for the Fund to initially focus on companies that are mature enough to make current interest payments on the Fund’s investment, so that in turn the Fund can meet its interest obligations to its investors. Initially, this will probably preclude the funding of start-ups in the Fund but that depends on the level of risk presented by the potential investee.

The Report of the NCBA Cooperative Capital Task Force detailed sectors where transactions for the Fund (and the attendant capital needs) are likely to originate. They are:

- Food Cooperatives – start-ups and expansion of current facilities.
- Housing Cooperatives – “bridge” equity during acquisition and rehab phases.

- Worker Cooperatives – hard asset (equipment) funding, member equity loans and start-up working capital.
- Agriculture Cooperatives- retiring member equity to maintain coop status, capital projects and assistance to farmers for conversion to organic farming or to cooperative status.

In order to generate sufficient transaction volume and to better manage risk, it may be desirable to co-invest with regional funds, such as The Cooperative Fund of New England's ("CFNE") Cooperative Capital Fund ("CCF"). Below is sampling of potential deals that have been identified for CCF. These potential transactions are not an exhaustive list of the types of investments open to the Fund but a sample of current deals that could benefit from patient cooperative-friendly capital.

- A large food co-op store expansion and housing development. The funds from CCF will probably take a deeply subordinated debt position since the co-op is a consumer co-op with no place for outside equity at this point.
- A blueberry farm conversion from a single-owned farm to a cooperative structure. Since they are in formation stage, the corporate structure will allow for outside equity or preferred shares.
- A farm where the owner wants to retire and turn over his property to a cooperative farming organization. This organization will require technical assistance to structure the co-op, but this is another opportunity to allow for preferred shares with limited or nonvoting rights for CCF.
- A start-up solar energy worker(engineer)-co-op that is trying to launch a pilot project of installing solar panels on a school or YMCA. CFNE has provided a small working capital loan, but the start-up needs an equity infusion to go to scale.
- A current worker co-op borrower of CFNE that does photovoltaic installation and is starting to expand and may purchase their building.

The ability of cooperatives to accept preferred investors, pay dividends (and at what level) or take on different types of debt will vary from co-op to co-op. Such items are regulated by the states, but are also determined by the by-laws of the coop. There will often be variability in the ability of co-ops to accept certain types of capital, often within the same state and same industry. Since it is nearly impossible to pre-determine the correct structure of an investment, flexibility in deal structuring will be a key factor in meeting the varying needs, regulatory regimes and governance constraints of cooperatives.

Investment Targets

It will be desirable for the Fund to initially focus on companies that are mature enough to make current interest payments on the Fund's investment, so that in turn the Fund can meet its interest obligations to its investors. Once proof of concept has been achieved, a subsequent fund or sub-fund can be raised with the ability to pursue a range of investments, including additional risk classes.

We concur with the initial Investment Strategy for the Fund suggested by Praxis (page 18, Praxis Study):

Investment Strategy:

- A fund should invest in established high growth, solidly performing cooperatives, particularly in the first three to four years.
- For medium sized and smaller investments the fund should focus on cooperatives with a business model that has been proven or is essentially operating as a “franchise.” Cooperatives in the grocery and purchasing sectors are examples.
- Some form of credit enhancement may be necessary particularly if a portfolio strategy is followed that includes startup or early-stage co-ops.
- A national fund could work hand-in-hand with regional funds that would 1) provide deal flow that has already been vetted, 2) co-invest in smaller deals that may then be monitored more efficiently by the regional funds, and 3) work with and invest in early stage cooperative businesses that may be unique or have localized business models.

The strategy outlined by Praxis of investing in high growth later stage co-ops and in small but growing co-ops with positive cash flow is appropriate and would meet the needs of co-ops at all stages of organizational development. Co-investing with regional funds, where feasible, will maximize available cooperative expertise and potentially provide for technical assistance.

Phase-In of Investment Types

While the Fund should strive to meet the needs of different types of cooperatives, it will be necessary to demonstrate initial proof-of-concept and minimize the risk exposure of the Fund. We therefore recommend that the order of investment acceptance be as follows:

1. high growth, solidly performing cooperatives,
2. medium sized and smaller investments in cooperatives with a business model that has been proven, and
3. start-up or early-stage coops.

This phasing in of investment targets will allow the Fund to become operational, while delaying the introduction of more resource intensive activities, such as coordinating with technical assistance providers for start-ups, until later. This strategy also allows for more targeted marketing and for the simplification of marketing material in the early stages of the Fund’s life. The exact period of time for this phasing should be decided by those responsible for implementation of the concept.

VIII. Preliminary Products

(See Appendix - NCEF, LLC Indicative Term Sheet)

IX. Summary of Recommendations

Regulatory/ Legal/Tax Structure:

We recommend that the Fund entity have fewer than 99 investors to qualify for the exemption under the Investment Company Act of 1940 (the '40 Act). We recommend that the Fund raise its capital as private offerings that will be exempt from regulation under the Securities Act of 1933. With regard to the corporate structure of the fund, we recommend that either a cooperative or LLC structure be pursued. We will provide more information and analysis to allow the NCBA to make the decision as the process moves to implementation phase.

Governance:

The Fund should be governed by a Board of Directors and an Investment Committee of the Board, along with an Advisory Committee composed of outside “industry experts” with cooperative experience and knowledge.

Management:

Transaction analysis, negotiation, structuring, documentation, closing, servicing and monitoring should be delegated to an outside management firm chosen by the Fund’s Board of Directors. Perhaps a joint venture could be arranged between Good Capital and Calvert Foundation.

Capital Structure:

The Fund will be capitalized at \$6 million with a combination of debt (senior and subordinated) and equity. While the debt and preferred stock will have a current pay coupon structure, common equity will receive its return from net cash flow. The targeted returns to equity are 7%.

A critical component of the capital structure will be the ability to raise \$2.5 million from retail investors at Credit Unions using a Co-op Investment Note offered by CDF (and sold by CUNA Mutual brokers) under the non-profit exemption from the '33 Act.

A vital part of the Fund will be the development of security enhancements appropriate to the scope and scale of the Fund’s work that will be targeted by the Fund’s Board of Directors. These enhancements should include (but not be limited to) risk capital of \$1,000,000 (minimum) and subordinate debt of \$2,500,000.

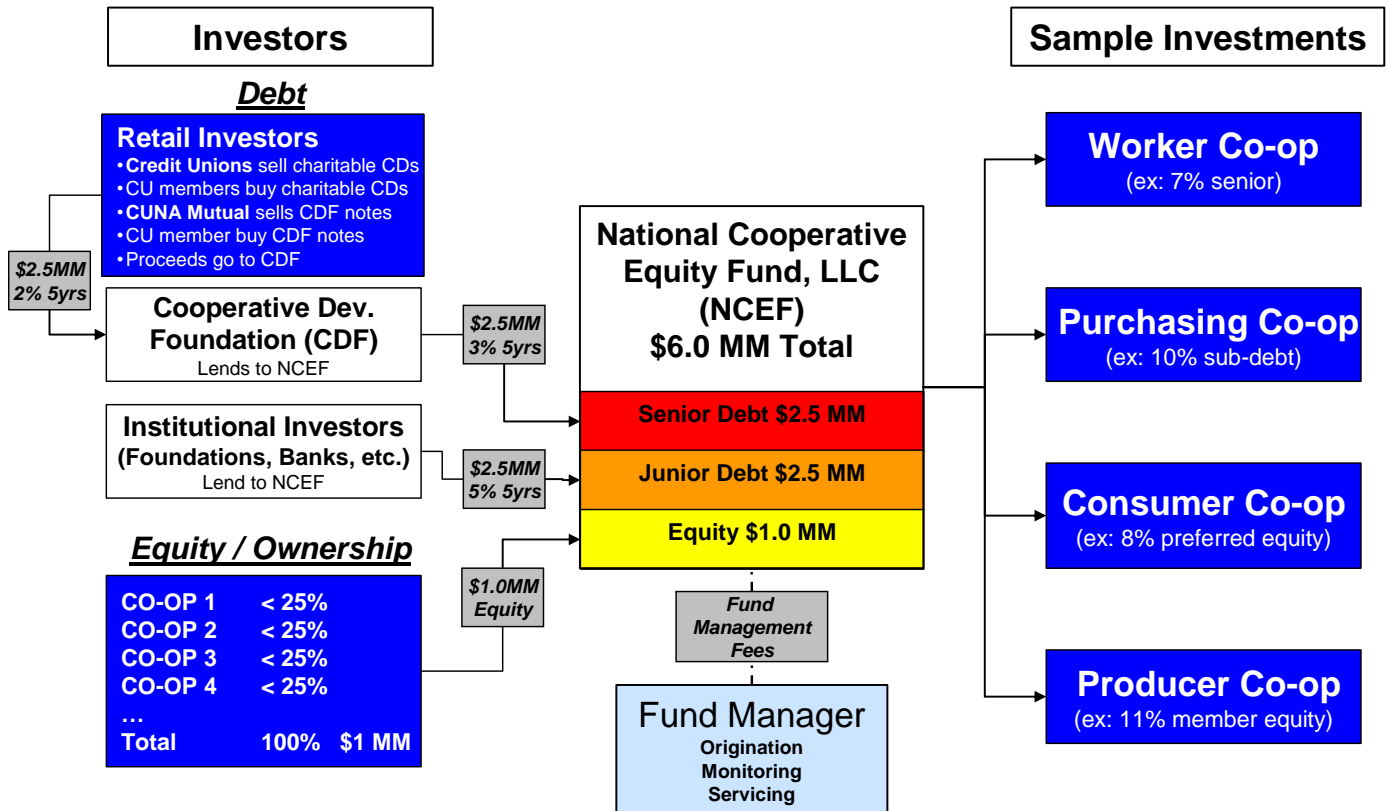
See Illustration 1 below for the capital structure and funding mechanism for the Fund.

Demand, Investment Targets and Phase-In of Investment Types:

The Fund should invest in high growth, solidly performing cooperatives, medium-sized and smaller investments in cooperatives with a business model that has been proven and start-up or early-stage co-ops, in that order. It will be important to work with regional funds to identify co-investment opportunities.

Illustration 1 – Fund Structure (with CDF retail funding option)

Cooperative Ownership of Fund Example with CDF-issued Co-op Investment Note



X. Scorecard Comparison and Conclusion

Scorecard

The following is a summary of how the Consultant’s recommendations compare to the Task Force Goals and to Other Important Considerations.

Scorecard	
Comparison of Consultant’s Recommendation with Task Force Goals	
Goal	Addressed?
Meet the needs of co-ops at all stages	Satisfied
Meet investor demand	Satisfied
Provide technical assistance	Not Satisfied
Potential debt financing to fill gap	Satisfied
Wide array of potential investors	Satisfied
Targeted marketing efforts	Satisfied
Standardize and simplify	Satisfied
Clarification of disclosure and registration rules	Satisfied
Restrictions on demutualization (See Term Sheet)	Satisfied
Develop and use expertise within the co-op community	Satisfied
Develop way to access the relevant sector expertise to oversee the investing	Satisfied
Develop tool to gauge return for investors	Satisfied
NCBA membership (See Term Sheet)	Satisfied
Owned by and for co-ops	Satisfied
Other Important Considerations:	
Provides for retail investment	Satisfied
Provides annuity income to NCBA	Satisfied
Self-perpetuating fund (once established, fund equity revolves)	Not Satisfied

While it is contemplated that the Fund will be able to invest in start-up co-op at a later stage, technical assistance for those organizations cannot be provided by the Fund. Developing relationships with regional fund partners, consultants and Cooperative Development Centers will be required to effectively assist these later stage investees.

Given the long-term nature of the Fund’s investments combined with the difficulty of predicting when certain investments will be repaid, it will be very difficult to create a self-perpetuating (revolving) financial structure. What is more likely to occur is that once the Fund has achieved proof-of-concept and successful initial investment, the ground will be prepared for subsequent funds. These could include all equity funds that gain an SBIC license and SBA Leverage.

Conclusion

It is the Consultant's opinion that there is sufficient demand to justify an investment vehicle aimed at providing patient capital to cooperative businesses nationally. That investment vehicle must serve a number of potential investor demands and provide a reasonable return, albeit potentially a below-market one. The investment products offered by the vehicle must be flexible in order to accommodate the diversity of operating, governance, legal and regulatory environments that cooperatives operate within. Due to the small scale of an initial vehicle, it will be essential to seek standardization where possible and utilize the skills of industry experts combined with an entity or entities with experience in social and business debt and equity investing. With appropriate structuring, this investment vehicle could be financially viable without external subsidies.

Appendix

**National Cooperative Equity Fund, LLC
DRAFT Term Sheet Example**

Size of Investments:	No single investment shall represent more than 10% of the total fund. The minimum investment will be \$100,000.
Rates of Return to Fund:	Depending on the type of investment, rates will range from 6% to 15%, exclusive of additional equity kickers, if allowed and available. Target fund return of 7%.
Term: Working Capital Loans	1- 3 years
Member/Share Loans	5 years
Bridge Equity	Expected exit within 5 years from initial investment
Equipment Loans	7 years
Real estate Loans	7 years
Preferred Shares	Expected exit within 7 years from initial investment
Interest Payments:	Interest on loans and preferred stock dividends to be paid semi-annually in arrears on the fifteenth day of June and December of each year.
Return on Equity:	Equity may require interim cash flow payments, but deferral until exit capital event allowed where appropriate.
Principal Repayment Schedule:	To be determined
Authorized Purposes:	<ul style="list-style-type: none">• Expansion of current facilities.• Bridge equity during acquisition and rehab.• Hard asset (equipment or real estate) funding.• Member equity loans.• Working capital.• Retiring member equity to maintain coop status.• Assistance to farmers for conversion to organic farming or to cooperative status.
Security/Collateral:	Loans will be subordinated or uncollateralized, while equity will be evidenced by share certificates.
Investment Eligibility:	Cooperative organizations only.
Additional Requirements:	<ul style="list-style-type: none">• Depending on fund legal structure, a portion of the investment may be retained by the fund as an equity contribution by the cooperative/member.• 1% of earnings may be required on the part of the cooperative member after any equity investment is returned to the fund.• Restrictions on demutualization required of all cooperatives receiving investments through fund.• NCBA membership required of all cooperatives receiving investments through fund.

Financial Discussion

Based on the consultant recommendations addressed above, Calvert Foundation has prepared a hypothetical financial model for the fund. The following discussion addresses the assumptions — and the deficiencies that may exist in some of those assumptions — that Calvert Foundation has used in the model as well as the outcome.

Capitalization

Over the first two years of operation, the Fund will need to raise \$6 million dollars in debt and equity to capitalize the loan portfolio of the Fund. Roughly \$1.0 million will come from equity investments, which will need to be raised in the first round of financing since cash flows to finance debt investors will be limited in the early years. With the exception of equity, all investments are expected to have a term of five years.

Senior Debt will reach \$2.5 million after two years with inflows of roughly \$1 million each year. Senior debt will come in the form of a loan from the Cooperative Development Foundation which will be funded through the sale of investment notes. Depending on the volume of note sales, senior debt may need to be augmented by investments from institutional investors such as foundations, banks, credit unions, etc. The rate on this senior debt is assumed to be 3.0%, but it could be higher or lower depending on the mix of capital coming from retail note investors (at a lower rate) and institutional investors (usually at a higher rate).

Junior Debt will reach \$2.5 million after two years with inflows of roughly \$1 million each year. Junior debt will come from institutional investors such as foundations, banks, credit unions, etc. The rate on junior debt is assumed to be 5.0%, but could be higher or lower depending on the mix of institutional investors and the ability of the Fund to negotiate and secure favorable terms.

The model assumes a target dividend of 3.0% of paid-in equity capital and caps the amount of net income that can be paid out at 50%.

Setup & Operating Costs

The cost of the retail notes program will be born by the Cooperative Development Foundation and is, therefore, not included in this model. The spread between the 2.0% notes due to retail investors and the 3.0% note to the Fund should be enough to cover the costs of registering notes, administering investors and paying CUNA Mutual commissions.

One-time setup costs for the Fund are estimated to be \$75,000 — the majority of which would include legal fees for setting up the fund and would also include staff time and other costs. Ongoing operating costs are assumed to be \$5,000 for servicing the funds investors and \$5,000 for legal, board and other expenses. In the model, these expenses are inflated at a rate of 3.0% annually.

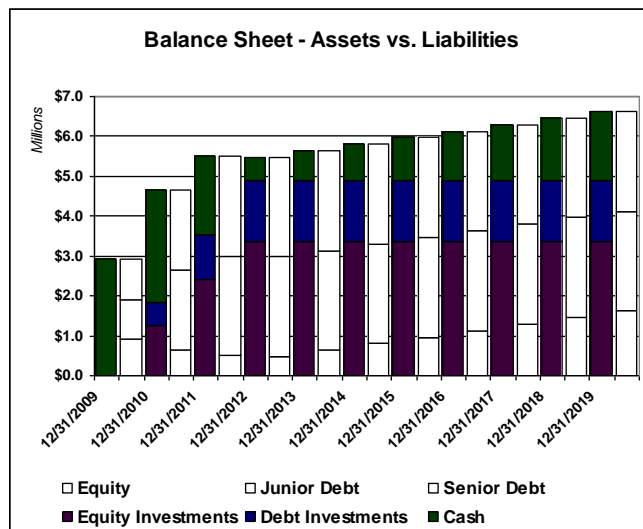
Portfolio

By the end of the third year of operations, the Fund’s portfolio will be fully deployed with roughly 10% of the fund in debt investments, 20% in sub-debt investments, 50% in preferred equity investments and 20% in common/member equity investments.

To protect investors against potential losses, the model reserves for loan losses on the following schedule: senior debt investments at 5.0%, sub-debt investments at 6.0%, preferred equity at 10% and common equity at 15%. Loan loss reserves help protect investors in the Fund by providing a cushion in the event that a loan or equity investment goes bad or depreciates in value.

The assumed yield for the Fund’s portfolio segments is as follows: senior debt investments at 6.0%, sub-debt investments at 7.0%, preferred equity at 8.0% and common equity at 11.0%.

In addition to cooperative investments, the fund will carry a cash balance, which is assumed to yield 2.0%. Once the portfolio is fully deployed, the cash balance will not be a significant portion of the Fund’s balance sheet.



In addition to operating costs, the Fund will incur management fees that the fund manager will charge for underwriting and originating loans, monitoring the portfolio for risk and servicing loans (billing and collecting principal, interest and dividend payments). Most managers will charge a flat basis point fee on assets under management. However, this model makes certain assumptions about origination and servicing costs and applies those directly. Originations are assumed to cost \$6,000 for debt and \$8,000 for equity. Servicing costs are assumed to be \$1,200 per asset.

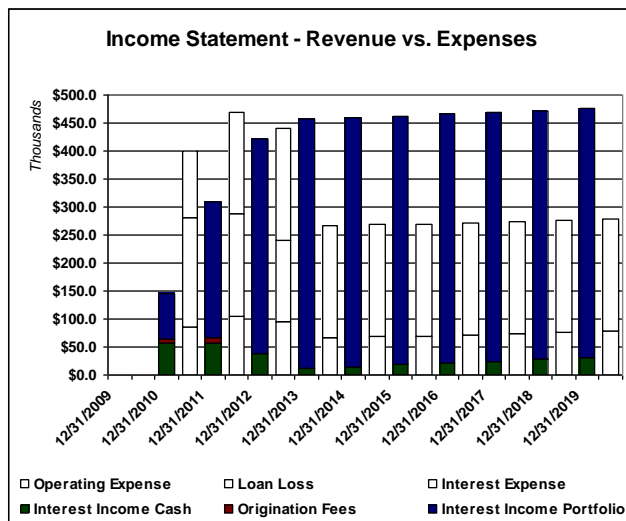
Managing risk for an equity fund is quite different from debt funds. Non-public equity investments are very illiquid compared to debt, so having a clear picture of the risk of such an investment will not necessarily improve the financial performance of the fund. Instead, many private equity investors play an active role in guiding and managing portfolio companies to improve their performance. For these reasons, risk management expenses have not been priced into this model.

Financial Results

The model suggests that the Fund could begin to have positive cash flow in year four after the fund is fully deployed. The first three years of operations will result in negative cash flows due to the combination of high loan loss expenses (as the portfolio is initially deployed) and a lower balance of outstanding investments.

Once the fund is fully deployed, however, loan loss expenses will level off, and there will be enough investment income from the full portfolio to cover financial and operating expenses. After year three, the net finance margin (financial revenues minus financial expenses) levels off at around 56% and the net operating margin (revenues minus all expenses) levels off at round 41%.

In terms of leverage, the Fund reaches its maximum leverage in year three at a debt to equity ratio of 10.4 x and then gradually de-levers to 3.1 x by year ten as the retained earnings balance grows. This leverage can also be managed by the Fund by adjusting the dividend payout levels to equity investors. The Fund could maintain a higher leverage level if it chooses to pay out a greater amount of dividends or lower its leverage by paying lower dividends.



Under the model's current assumptions, the rate of return to equity investors would be 6.54%. However, this return can also be increased by paying out a greater amount in dividends. Paying greater dividends, however, could be risky as the fund will have to manage its liquidity in order to have enough cash on hand to pay its debt investors.

Equity Fund Feasibility Analysis



Preliminary NCEF Financial Model

National Cooperative Business Association
National Cooperative Equity Fund, LLC (NCEF)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Balance Sheet											
Assets											
Cash	2,915,000.00	2,841,115.00	1,963,898.30	590,046.91	750,123.13	911,420.86	1,073,905.13	1,237,538.47	1,402,280.86	1,568,089.56	1,734,919.05
Portfolio											
Debt Investments	-	201,500.00	391,800.00	541,800.00	541,800.00	541,800.00	541,800.00	541,800.00	541,800.00	541,800.00	541,800.00
Sub-Debt Investments	-	403,000.00	783,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00
Preferred Equity Investments	-	1,007,500.00	1,959,000.00	2,709,000.00	2,709,000.00	2,709,000.00	2,709,000.00	2,709,000.00	2,709,000.00	2,709,000.00	2,709,000.00
Common Equity Investments	-	403,000.00	783,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00	1,083,600.00
Total Portfolio	-	2,015,000.00	3,918,000.00	5,418,000.00	5,418,000.00	5,418,000.00	5,418,000.00	5,418,000.00	5,418,000.00	5,418,000.00	5,418,000.00
Loan Loss Reserve	-	(195,455.00)	(380,046.00)	(525,546.00)	(525,546.00)	(525,546.00)	(525,546.00)	(525,546.00)	(525,546.00)	(525,546.00)	(525,546.00)
Total Assets	2,915,000.00	4,660,660.00	5,501,852.30	5,482,500.91	5,642,577.13	5,803,874.86	5,966,359.13	6,129,992.47	6,294,734.86	6,460,543.56	6,627,373.05
Liabilities											
Debt											
Senior Debt	1,000,000.00	2,000,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00
Junior Debt	1,000,000.00	2,000,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00	2,500,000.00
Total Debt	2,000,000.00	4,000,000.00	5,000,000.00	5,000,000.00	5,000,000.00	5,000,000.00	5,000,000.00	5,000,000.00	5,000,000.00	5,000,000.00	5,000,000.00
Equity											
Paid-in Capital	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00
Additional Paid-in Capital	-	-	-	-	-	-	-	-	-	-	-
Retained Earnings	(85,000.00)	(339,340.00)	(498,147.70)	(517,499.09)	(357,422.87)	(196,125.14)	(33,640.87)	129,992.47	294,734.86	460,543.56	627,373.05
Total Equity	915,000.00	660,660.00	501,852.30	482,500.91	642,577.13	803,874.86	966,359.13	1,129,992.47	1,294,734.86	1,460,543.56	1,627,373.05
Total Liabilities & Equity	2,915,000.00	4,660,660.00	5,501,852.30	5,482,500.91	5,642,577.13	5,803,874.86	5,966,359.13	6,129,992.47	6,294,734.86	6,460,543.56	6,627,373.05

Income Statement											
Interest Income Portfolio		82,615.00	243,253.00	382,776.00	444,276.00	444,276.00	444,276.00	444,276.00	444,276.00	444,276.00	444,276.00
Interest Income Cash		58,300.00	56,822.30	39,277.97	11,800.94	15,002.46	18,228.42	21,478.10	24,750.77	28,045.62	31,361.79
Origination Fees		5,000.00	10,000.00	-	-	-	-	-	-	-	-
Total Revenue	-	145,915.00	310,075.30	422,053.97	456,076.94	459,278.46	462,504.42	465,754.10	469,026.77	472,321.62	475,637.79
Interest Expense - Senior Debt		45,000.00	67,500.00	75,000.00	75,000.00	75,000.00	75,000.00	75,000.00	75,000.00	75,000.00	75,000.00
Interest Expense - Junior Debt		75,000.00	112,500.00	125,000.00	125,000.00	125,000.00	125,000.00	125,000.00	125,000.00	125,000.00	125,000.00
Loan Loss Reserve Expense		195,455.00	184,591.00	145,500.00	-	-	-	-	-	-	-
Total Financial Expenses	-	315,455.00	364,591.00	345,500.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00
Net Finance Margin	(169,540.00)	(54,515.70)	76,553.97	256,076.94	259,278.46	262,504.42	265,754.10	269,026.77	272,321.62	275,637.79	275,637.79
		-116.2%	-17.6%	18.1%	56.1%	56.5%	56.8%	57.1%	57.4%	57.7%	58.0%
Operating Expenses											
Start-Up Expenses	75,000.00	-	-	-	-	-	-	-	-	-	-
Origination Expense		54,000.00	67,980.00	57,288.60	26,225.45	27,012.21	27,822.58	28,657.26	29,516.97	30,402.48	31,314.56
Loan Servicing Expense		10,800.00	21,012.00	28,007.76	28,847.99	29,713.43	30,604.84	31,522.98	32,468.67	33,442.73	34,446.01
Investor Servicing Expense		5,000.00	5,150.00	5,304.50	5,463.64	5,627.54	5,796.37	5,970.26	6,149.37	6,333.85	6,523.87
Capital Sourcing Expense	10,000.00	10,000.00	5,000.00	-	-	-	-	-	-	-	-
Legal, Board and Other		5,000.00	5,150.00	5,304.50	5,463.64	5,627.54	5,796.37	5,970.26	6,149.37	6,333.85	6,523.87
Total Operating Expenses	85,000.00	84,800.00	104,292.00	95,905.36	66,000.71	67,980.73	70,020.15	72,120.76	74,284.38	76,512.91	78,808.30
Net Operating Income	(85,000.00)	(254,340.00)	(158,807.70)	(19,351.39)	190,076.23	191,297.73	192,484.26	193,633.34	194,742.39	195,808.70	196,829.49
		-174.3%	-51.2%	-4.6%	41.7%	41.7%	41.6%	41.6%	41.5%	41.5%	41.4%
Equity Dividend	-	-	-	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00
Net Income After Dividend	(85,000.00)	(254,340.00)	(158,807.70)	(19,351.39)	160,076.23	161,297.73	162,484.26	163,633.34	164,742.39	165,808.70	166,829.49

Statistics											
Debt Investments		0	1	1	1	1	1	1	1	1	1
Sub-Debt Investments		1	2	2	2	2	2	2	2	2	2
Preferred Equity Investments		7	13	18	18	18	18	18	18	18	18
Common Equity Investments		1	1	1	1	1	1	1	1	1	1
Total		9	17	22	22	22	22	22	22	22	22
Total Originations		9	11	9	4	4	4	4	4	4	4
Debt to Equity Ratio	2.2 x	6.1 x	10.0 x	10.4 x	7.8 x	6.2 x	5.2 x	4.4 x	3.9 x	3.4 x	3.1 x
Net Finance Margin		-116.2%	-17.6%	18.1%	56.1%	56.5%	56.8%	57.1%	57.4%	57.7%	58.0%
Net Operating Margin		-174.3%	-51.2%	-4.6%	41.7%	41.7%	41.6%	41.6%	41.5%	41.5%	41.4%
Gross Portfolio Yield		7.2%	7.9%	7.8%	8.4%	8.5%	8.5%	8.6%	8.7%	8.7%	8.8%
Cost of Debt		4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Financial Spread		324 bps	391 bps	379 bps	442 bps	448 bps	454 bps	460 bps	466 bps	472 bps	478 bps
Equity IRR	6.54%										

NCEF Model Assumptions

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
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	2009	2010	2011
Paid-In Capital			
Senior Debt	1,000,000.00	1,000,000.00	500,000.00
Junior Debt	1,000,000.00	1,000,000.00	500,000.00
Equity	1,000,000.00		

Capitalization	
	Rate
Senior Debt	3.00%
Junior Debt	5.00%
Equity	
Target Dividend	3.00%
Max % Net Inc.	50.00%
<i>Sourcing Fees</i>	
Senior Debt	0.00%
Junior Debt	1.00%
Equity	0.00%

Other Costs / Inputs	
Start-Up Costs	75,000.00
Investor Servicing	5,000.00
Legal, Board and Other	5,000.00
Inflation Rate	3.00%

Portfolio Mix

Debt Investments	10.00%
Sub-Debt Investments	20.00%
Preferred Equity Investments	50.00%
Common Equity Investments	20.00%

LLR %

Debt Investments	5.00%
Sub-Debt Investments	6.00%
Preferred Equity Investments	10.00%
Common Equity Investments	15.00%

Portfolio	
	Yield
Debt	6.00%
Sub-Debt	7.00%
Preferred Equity	8.00%
Buy-Outs	11.00%
Cash	2.00%
Variable Rates?	NO
<i>(See Portfolio Tab)</i>	
Origination Fee	1.00%
Av. Inv. Size	
Debt	500,000.00
Sub-Debt	500,000.00
Preferred Equity	150,000.00
Common Equity	750,000.00
Ave. Investment Term	
	5 years
Portfolio Turnover	
	20.0%
Orig. Cost Debt	
	6,000.00
Orig. Cost Equity	
	8,000.00
Servicing Cost / Loan	
	1,200.00