



# Cooperative Equity Fund Feasibility Report September 2009

## Executive Summary

### Purpose

To create a national cooperative equity fund that will accept investments from individuals, businesses, foundations and others to invest exclusively in cooperatively owned organizations to assist in the growth and development of the best business model for economic and social progress.

### Background

The National Cooperative Business Association (“NCBA”) embarked on a process to identify and develop new sources of capital for cooperatives. On the basis of an NCBA Task Force recommendation, the NCBA Board agreed to move ahead with a feasibility study on the concept of a national equity fund for cooperatives. Calvert Social Investment Foundation (“Calvert”) was engaged by NCBA to complete a feasibility study on the concept of a national equity fund for cooperative businesses (the “Fund”).

### Proposal

Calvert concludes 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. 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. With appropriate structuring, this investment vehicle could be financially viable without external subsidies.

Calvert made the following recommendations as to structure, size, governance and capitalization.

**Regulatory/ Legal/Tax Structure:** Calvert recommends that the Fund entity have fewer than 99 investors to qualify for the exemption under the Investment Company Act of 1940. Further, the Fund should raise its capital as private offerings that will be exempt from regulation under the Securities Act of 1933. While the preference is to have the fund structured as a cooperative, Calvert recommended either a cooperative (owned by those benefitting from the fund) or a limited liability corporation (“LLC”). Those involved in the next phase will have to decide which structure makes the most sense given the needs and demands of investors and beneficiaries of the fund.

**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. 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.

**Management:** Due to the substantial costs associated with developing and maintaining in-house management for a fund of the size envisioned, Calvert recommends that the Fund hire an outside firm to manage the fund. Fees for private equity fund management range from 1% - 3% depending on the size of the fund, with larger fees associated with smaller funds. Tasks such as 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.

A Fund focused exclusively on cooperatives would provide investment features that would appeal to fund managers that focus on social as well as financial returns. Given NCBA's potential limitations such as an absolute commitment to avoiding forced exit strategies, such as demutualization, and the potentially complex (but smaller) transactions that the Fund would require, Calvert recommends against for-profit private equity funds from consideration for the fund management role and suggested a few options for the Fund's Board to consider.

**Capital Structure:** Calvert agrees that the Fund will be making investments of patient capital in various types of cooperatives. Since this equity-like and equity capital will be somewhat riskier than collateralized senior lending, 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, there is a need to appeal to retail investors, different investor appetites and cooperative ownership. To accommodate these goals, Calvert recommends that the Fund be capitalized at \$6 million with a combination of debt (senior and subordinated) and equity.

- **Low-Cost Retail Capital:** A critical component of the capital structure will be the ability to raise \$2.5 million from retail investors at credit unions and other entities. Calvert assumes that this \$2.5 million of senior debt could be raised over the first two years of the Fund's operations. Senior debt will be raised primarily from retail investors through a nonprofit intermediary, exempt from costly federal registration requirements. This could be done through the sale of Co-op Investment Notes in small denominations, e.g., \$1000, developed by registering an offering at the state level by a nonprofit affiliated with NCBA, e.g., CDF, and sold by credit unions through CUNA Mutual brokers and others. In addition, there is a CD Donation Program being developed by credit unions through the Filene Institute, which would provide funds through the contribution by CD holders of a portion of the interest.
- **Subordinated Debt & Equity:** 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. 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 organizations and others 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. Calvert assumes 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.

**Public Sources of Capital:** Calvert recommends that more research be done on bringing in public sources of capital. Though promising, programs such as New Market Tax Credits, Small Business Investment Company and the USDA Business and Industry Loan Guarantee Program all have certain targets and requirements that have to be met in order to qualify.

**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.

**Quantifying Social Outcomes:** 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.

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

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

