Cooperative Fund of New England and Cooperative Capital Fund:
An Equity/Debt Package to Grow the Cooperative Economy

—Disclaimer—

The content of this paper is the result of the collaborative efforts of Opportunity Finance Network and the Cooperative Fund of New England. We can not guarantee the validity of the opinions or the accuracy, reliability, or completeness of the information over time.

Acknowledgements

Opportunity Finance Network would like to thank Rebecca Dunn and Mary O’Hara of the Cooperative Fund of New England for composing this Innovation Guide. We would also like to thank the MetLife Foundation for making this series of Opportunity Finance Network Innovation Guides possible through its generous support.
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The Cooperative Fund of New England and Cooperative Financing

The Cooperative Fund of New England (CFNE) is a nonprofit 501(c)3–certified community development financial institution (CDFI) that makes loans and provides technical assistance to cooperative businesses, worker-owned enterprises, and community-based nonprofit organizations in New England. The CFNE serves a low-income targeted population in the six New England states and eastern upstate New York.

The Cooperative Fund is 3 years old. Over the last three decades, starting with $5,000 thousand in first loss money, it has raised over $14 million from social investors to make over 400 loans to new or expanding businesses. Total assets are almost $6 million and the loan portfolio revolves entirely at least every 3 years. Borrowers have used these loans to create or sustain over 5,400 jobs, 2,700 units of housing, and thousands of membership and business ownership opportunities. In addition, the businesses CFNE has financed have brought necessities such as food, education, and health care into underserved rural and urban communities throughout New England.

Cooperatively-owned businesses flourish in the New England market and provide jobs, business ownership opportunities, affordable housing options, and goods and services in underserved markets. Cooperatives are by definition inclusive, bringing together diverse members to achieve a common goal. They are a grassroots form of democracy in which one member and one vote can change the course of a community. Agricultural cooperatives are prevalent in rural New England, where they can provide access to markets and volume pricing discounts usually reserved for large agribusinesses. Other cooperative niches in New England include child care, grocery and natural food stores, commercial fishing, manufactured housing, and co-housing.

CFNE finances and supports those cooperatives and worker-owned businesses that create jobs for low-income people, provide affordable housing options, bring goods and services to underserved communities, and foster community change at all levels by empowering owners and members. CFNE also finances community-based nonprofit organizations with missions that benefit low-income people and communities and assist in meeting basic human needs for health care, food, and shelter.

Thirty years of lending to cooperatives revealed that one of the key barriers to cooperative enterprise start-up, sustained growth or intermittent expansion, and conversion from corporate ownership is a lack of equity capital. Cooperatives, like corporations and sole proprietorships, need equity capital in order to (a) fund the “soft costs” of establishing and growing a business, such as market studies, architecture and engineering, organizational costs, training, and legal and other professional services; (b) establish a working capital/cash flow cushion to carry the business operation through a start-up, expansion, or conversion period; and (c) leverage debt from banks, vendors, landlords, and so on. Cooperative members, typically groups of workers, farmers, or consumers, rarely have the collective wealth to contribute all the equity that is needed to start or grow their cooperative, or buy out an owner.

Unlike corporations and sole proprietorships, cooperatives cannot access venture capital, angel investors, or even friends and family for equity investment. In standard venture capital investments, businesses must issue large amounts of common stock ownership and/or subordinated convertible debt, give up Board seats, and recognize an outside active hand in business management. Often, outside investor motivations, specifically the short- or intermediate-term “exit strategy” that produces a high return, are at odds with the cooperative ideals of long-term asset building for members and the community. CFNE’s staff and Loan Committee found that lack of equity was even a barrier for CFNE; there were times they were unable to finance cooperative opportunities they believed could be viable. CFNE’s challenge was to provide capital that was patient, noncontrolling, and fair to the investor.
Members of the Loan Committee raised the issue of equity capital for cooperative businesses at the February 2005 Board meeting. Lack of equity capital, particularly for sustaining growth and enabling business expansion, resonated with many of the Board members. Clearly the issue was increasingly being discussed in cooperative Boardrooms, at cooperative conferences, and within cooperative membership meetings throughout New England and the nation.

In commemoration of CFNE’s 30th anniversary, the Board voted to commit Board and staff resources to research and develop a patient, equity-like capital product for new and expanding cooperatives in its target market. The goal was to develop a product that would augment CFNE’s current loan products and provide a new capitalization option for businesses with democratic ownership structures.
The Innovation

The Need
Cooperatives are unique in that they often raise capital from their members through membership fees collected when a member first joins the co-op and annually thereafter. These fees are usually $100–$200 at joining and just $15–$50 per year thereafter. Even with a large membership, this capital cannot fully support most co-ops’ capital needs. Many co-ops have successfully raised capital through member loans for an expansion or building project, but there are limits to member capital, especially for cooperatives in low-income communities.

There is little opportunity for cooperatives to obtain equity and/or microequity in the market, primarily due to the ownership constraints of a cooperative structure. The two structural issues that prevent traditional equity investments are the not-for-profit nature of many co-ops and the “one member, one vote” ownership structure. Cooperatives are formed for the benefit of their members, rather than for the benefit of stockholders or investors. By their very nature, most co-ops do not offer the return that traditional and even community development venture capitalists require. Additionally, venture capital investors cannot have an ownership stake in or management control of cooperatives without upsetting the “one member, one vote” structure that is essential for cooperative incorporation. Occasionally, co-ops can issue preferred stock to investors, but even this does not allow for the level of management control that most venture capitalists require, and in some cases it produces legal and/or tax complications as well. Exit strategies create an additional challenge for cooperatives. Whereas most venture capital firms expect an exit via a buyout or sale, cooperatives want to keep the ownership of the business in the hands of member-owners and/or employee-owners and therefore do not and cannot pursue these outside options.

First Steps
Over many years, the ideal of an equity-like product was discussed informally among the Board and staff of CFNE, and with and among various members of the New England and national cooperative community. As early as 2001, CFNE was part of a regional discussion group on the issue.

Local and national industry groups, revolving loan funds, and state and federal governments have long recognized the need for an innovative equity product supporting cooperatives. In 2006, the National Cooperative Business Association formed an equity task force to examine the issue and recommend action. The executive director of CFNE is a member of the task force, which is still researching the issue nationally.

The external need and the internal interest within CFNE were growing. CFNE had received many worthy loan requests that did not fully meet underwriting standards, and in most cases the issue was one of limited capitalization and collateral. The staff and Board believed that limited capitalization was the largest issue facing new cooperatives, as well as struggling or growing cooperatives, and that this was preventing the cooperative economy from achieving scale and sustainability in the United States. In 2005, as CFNE celebrated 30 years of growth and innovation, CFNE formed an ad hoc committee of Board and outreach consultants to consider the potential of an equity-like product. The committee was diverse and included Board members from the cooperative community as well as those with venture capital, lending, and marketing backgrounds. The committee began its work with a series of basic questions:

- Would CFNE’s market observations about the need for equity capital be confirmed by cooperative businesses around New England? If so, what would it take to transform market “need” into market “demand”? How much equity would make a difference to a start-up, or to a co-op growing rapidly or poised for an expansion, or in a worker buyout situation?

- If CFNE were to offer an equity product, how should the product be structured—subordinated debt, preferred stock, semi-secured debt? What terms would be attractive? How would this work with existing CFNE lending?
 Should CFNE begin making equity investments from within the structure of CFNE, outside CFNE, or something in between? What should the legal structure be?

 Would investors have an appetite for equity investment in cooperative enterprises? What would be an attractive risk/return profile? What concerns would current or future investors have about the new product or its impact on CFNE? How would CFNE market this new opportunity to investors?

**Funding and Marketing Studies**

Based on the research questions above, and relying on their own significant experience and expertise, the Equity Fund Committee members compiled lists of possible sources of market information, and called on their own contacts and resources, including the following:

- Past and current CFNE borrowers and past and current CFNE investors
- Cooperative businesses throughout the country that had successfully or unsuccessfully raised equity for growth
- Fellow cooperative lenders such as the Local Enterprise Assistance Fund (LEAF), Northcountry Cooperative Development Fund (NCDF), and the National Cooperative Bank (NCB)
- Fellow CDFIs that had experience with venture capital investment or had experimented with equity-like subordinated debt products
- Previous CFNE market studies, cooperative business data, cooperative research, and cooperative publications that address the cooperative business market’s needs

Initial research quickly revealed the need for a third-party, professional market study. The committee wanted access to unbiased qualitative and quantitative information on both the cooperative market and the investor market. It also became clear that the committee’s work was being “staffed” by CFNE’s executive director and outreach contractors. To offset these expenses, CFNE’s Board agreed to seek grant funding to support the committee’s work.

CFNE turned first to one of its long-standing religious investors, the Episcopal City Mission’s Pelham Fund for Economic Justice, which not only invests in regional economic development but occasionally makes grants for special projects. The Pelham Fund’s Investment Committee requested an in-person presentation on the equity product and, attracted by the catalyst nature of a grant at such a critical early phase and the potential impact equity capital could have among cooperative businesses, granted the initial seed money of $0,000 to CFNE’s equity project.

As research and development got under way, CFNE was also awarded $93,000 in technical assistance funds from the U.S. Treasury CDFI Fund. The CDFI Fund award supported CFNE’s efforts to build capacity, secure technical assistance from other community development venture capital (CDVC) funds, and obtain specific funding for two market studies, a portion of the legal costs, and staff time for product research and development.

With funding in hand, CFNE was able to invest in two market studies: CFNE engaged a national market research firm with a strong reputation among CDFIs and broad expertise in alternative financial products to measure the cooperative investee/borrower market; and CFNE engaged a second national firm, one that works closely with CFNE, to conduct a series of “key informant” interviews with existing and potential investors to determine investor appetite and risk-versus-return tolerance for a cooperative equity product. The results of both market studies were encouraging.
Key findings from the cooperative investee/borrower market research included the following:

- 93.1% of respondents, many of whom had received credit elsewhere in the past, reported that a patient capital loan would be of interest to them.

- Respondents indicated that they would use a patient capital loan to leverage anywhere from $10,000 to $500,000 in additional debt from CFNE or other sources, which would contribute greatly to business expansion and job creation.

- Of those businesses that reported having been turned down for a loan, the most frequent reason for denial was insufficient collateral and insufficient equity.

- A patient capital product, which does not have collateral requirements and acts like equity, addresses both insufficient collateral and insufficient equity.

- Primary users of the product would likely be from CFNE’s existing cooperative market, and this product would complement and expand CFNE’s addressable market.

The results of the investor market research were very instructive:

- Large cooperatives with capital to invest and socially responsible investors who are already interested in cooperatives and alternative economic structures (fair trade, sustainability, local economy, and so on) are enthusiastic about an equity product for cooperatives.

- Nonaligned investors are not likely to invest.

- The risk/return profile of venture investment requires stock market returns plus a premium, and sellout exit strategies—neither of which matches cooperative capital needs.

- The risk/return profile of a fixed-rate, credit-enhanced investment pool can carry a low commercial market rate and equity-to-debt exit strategies—a much better match for cooperative capital needs.

**Business Model**

While the market survey was in process, the Equity Fund Committee developed a business model and began to write the business plan. Given the lack of any clear predecessor, the committee was forced to look at many different models.

First, it looked at and spoke with several Northeast and national funds that attempted to combine venture capital and social investing, to see what it could learn about their structures and investment processes. The committee found that most funds operate like conventional venture capital funds, in that they take a large percentage of ownership, take part in management of the enterprises, and seek an exit plan with relatively large returns. These funds were formed as limited liability companies and marketed to qualified investors (largely banks) under private offerings with large minimum investments. Most were sized over $10 million, which was far beyond the $1 million–$2 million fund CFNE was contemplating. From CFNE’s perspective, the only difference between these social capital funds and straight venture capital was that their investments were in places, industries, or companies that offered social returns as well as financial returns. These funds took what they considered to be lower rates of return (15%–20%) because of those social returns.

The committee also looked inward at the setup and operations of CFNE as a mature nonprofit revolving loan fund. As a successful revolving loan fund, CFNE could be creative, but CFNE was primarily an asset-based lender. At the time, CFNE had a capital base of 10% of outstanding loans and a 3.5% loan loss reserve that compared favorably to a historically small actual loss rate of less than 1.5%. The social investors in CFNE were not necessarily prepared to
invest in a fund that might alter CFNE and bring about unforeseen risk. This new product would have a different risk profile, which could be mitigated but could never be as safe as that of CFNE. While CFNE might leverage operations, staff, and volunteers, CFNE recognized the need for a separate entity with outside directors who would be more risk tolerant and would bring the interests, expertise, and business perspective of the cooperatives in CFNE’s market to the Board and investment committee tables.

CFNE also recognized that it would be important for cooperatives and individuals to take part as investors on equal footing with other religious, foundation, and bank investors. Each stakeholder group should have a place in the funding of the new product, though CFNE anticipated that cooperatives with capital to invest would take the lead.

From this entire research and development process, the committee established preferred principles for the business model. These included the following:

- Equity investments that would not infringe on the cooperative model,
- Low minimum investment thresholds, and
- A legal status that would enable all sectors of the potential investor base to be included. Federal and state security laws restrict investments in for-profits more severely than in nonprofit entities. Also, laws vary from state to state; adopting a nonprofit structure gives the equity fund the widest possible investor pool.

The committee wanted to develop a new entity that could leverage and augment the CFNE organization, but with a separate nonprofit corporate charter to keep expenses separate and allow for direct charitable contributions.

The committee worked hard on financial assumptions, a range of investor rates and investee returns, anticipated losses, the timing and size of incoming and outgoing investments, and the costs of operation. The committee modeled several different-sized funds, ranging from $500,000 to $5,000,000. Given CFNE’s history of sustaining operations almost entirely through earned revenue, the committee focused on what it would require to build a self-sustaining equity corporation. In all the modeled scenarios, CFNE would have to subsidize operations. The committee determined that even the smallest-size equity fund, with operating expenses of approximately $400,000, would need operating subsidy. As a result, the committee included a request for subsidization of up to $13,000 annually from CFNE in its final report to the Board of CFNE. CFNE’s Board approved the request as part of the unanimous vote to begin the operations of the new equity fund in fall 2007. CFNE’s Board determined that the benefits of the equity fund to the cooperative market, and the expected growth in the Cooperative Fund’s core business due to the equity fund’s activities, will more than cover the operating subsidy.

Ultimately, the Equity Fund Committee combined parts of the closed-end venture capital model, in which a set time frame is established for obtaining a specific and limited amount of investments, with the CFNE nonprofit model to bring about a rather unique entity: a revolving loan fund model in which money comes in and goes out at various times in the life of the fund. It was incorporated as the Cooperative Capital Fund of New England, Inc. (CCF), a separate nonprofit that will offer one or more equity funds, each segregated from the others and segregated from CFNE of New England, Inc. As an affiliate of CFNE, it has filed for recognition as an affiliated public charity under 501(c)3, allowing it to potentially receive direct charitable contributions.

CCF decided to fund its investments with social investment notes from individuals, cooperatives, and organizations utilizing a federal nonprofit securities exemption and state exemptions where available. Fortunately, all six New England states have these exemptions in place. A junior class of notes, first loss notes, would be offered only to qualified and institutional investors, and would form an initial loss reserve. It is anticipated that these first loss notes will largely come from grants received by CFNE and from gifts from banks, large co-ops, and religious organizations to CCF directly. The initial fund would have a minimum of $400,000 and a maximum of $1,100,000. This is small
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when compared to other CDVC funds, but large enough for a first fund as a proof of concept. Furthermore, the fund is of a size that CFNE can easily deploy within three years.

CCF will make equity investments with varying terms, structures, and payments to suit the receiving cooperatives. In some cases, they might be subordinated notes; in other cases, preferred stock, usually with little or no collateral. CFNE anticipates that many of these investments will be made concurrently with CFNE loans. It is important to note that in most cases, these investments will ultimately convert to loans, and full repayment is expected within 7 to 10 years. In some cases, the interest rate may increase over time; in others, CFNE may look for a royalty-type payment that is based on gross sales. While CCF’s investment will carry an annual interest charge, interest payments will vary depending on the loan structure and business cash flow. CCF will not be involved in the profits, management, or ownership of the receiving cooperative.

In September 2007, CFNE was awarded another grant from the U.S. Treasury CDFI Fund. This grant comprised a $64,000 in a Technical Assistance Award and a $143,000 in a Financial Assistance (FA) Award. CFNE will invest the FA and its nonfederal match in CCF as first loss money to attract investors and protect the fund against early losses. CFNE will use the technical assistance award to help pay for marketing CCF and CFNE and to build the capacity of both organizations. In addition to the CDFI Fund award, CFNE has secured donations and grants from Citizens Bank, New Alliance Foundation, Bank of America, and two large, high-profile cooperatives: Equal Exchange of Canton, Massachusetts, and Cabot Creamery Cooperative of Cabot, Vermont.

CFNE intends to leverage the CDFI Fund grant with up to $350,000 from nonfederal sources to capitalize the fund. CFNE will use this capital to make at least 10 patient capital loans to new or expanding cooperatives, increase loan volume by 9% per year, and create 68 jobs in low-income communities during the three-year period. As these businesses grow and become stronger, CFNE anticipates that they will reinvest some of their profits in CFNE, CCF, and other community organizations.
Current Status

On October 19, 2007, at the home of Boston’s Episcopal City Mission, CFNE formally announced and launched the Cooperative Capital Fund with a gathering of over 100 cooperative members, social investors, borrowers, and friends.

CFNE is currently completing its prospectus for its offering of social investment notes to individuals and organizations in eligible areas. Once the prospectus is complete, CFNE will market CCF’s social investment notes to raise a minimum of $400,000 and a maximum of $1.5 million. CCF’s capitalization plan projects a one-year capitalization period.
Benefits and Challenges of the Program

Benefits to CFNE are the following:

- Increased opportunities for CFNE to make more loans to new and thriving cooperative enterprises.
- Additional risk mitigation and leverage for CFNE. CCF investments are a credit enhancement and, as such, will strengthen CFNE loans and attract capital from other sources such as banks and community loan funds.
- Increased corporate capacity for CFNE. CCF pushed CFNE to develop grant-writing capacity and introduced the organization to grant makers. Prior to launching CCF, CFNE was operationally self-sufficient and used investment loans to capitalize the loan fund.
- Increased investment in CFNE. New investors will be drawn to CFNE as well as to CCF.
- A new opportunity to market CFNE. CCF provided an opportunity to remarket CFNE with a new and “exciting” message.

Benefits to CFNE’s constituency are the following:

- Access to a unique and previously unavailable form of equity capital for start-up and expanding cooperatives in New England.
- A unique opportunity for cooperatives and cooperative members to invest directly in the growth of the cooperative economy.
- Expansion of the social returns of the cooperative economy to new members, investors, and communities.

Challenges

The challenges to planning and implementation include the following:

- Lack of a preexisting model to replicate. There was no predecessor to the fund, so its form had to be created from different business types. With limited historical data for the product, many estimates had to be modeled, supported, and applied to a long-term business plan.
- Representing a relatively small market and seeking social returns. The venture capital world starts at $0 million, and it was difficult to obtain advice from those inside, as most venture analysts and investment advisors could not fully comprehend a fund of such small size and of such modest financial returns.
- The effect upon the day-to-day operations of the existing fund, CFNE. It required excess energy from the Board, the volunteer committee, and CFNE’s existing personnel, especially the executive director, to develop and implement this initiative. Approximately 25% of the executive director’s time was devoted to CCF during the last 12 months.
- Obtaining staff buy-in. CFNE did not anticipate the amount of CFNE staff time and energy needed to develop this product. In retrospect, CFNE should have planned better to find other resources to replace the executive director’s time while she worked on this project.
- Reliance on volunteers. Volunteers, both long term and newer, all took time from their own occupations and families over many months.
- Reliance on funders and investors. CFNE relies on investors to fund its loan portfolio but has been operationally self-sufficient. For this product, CFNE needed to develop new funding sources for grants and develop competencies relating to raising grant funds, especially for operations and first loss capital. After that, CFNE must convince social investors to provide nonrecourse, below-market debt to support a new, unproven product.

- Legal expertise and related expenses. CFNE has spent $14,000 on legal fees for this product to date. While some of those fees were and will be covered by the CDFI Fund technical assistance awards, CFNE has paid many of the fees up front, which has placed a financial burden on the sponsoring entity.

**Program Replication**

It should be noted that although CFNE has formally launched the Cooperative Capital Fund, the model is untested and many questions remain unanswered at this time. CCF is in a proof-of-concept stage that might have very different results than CFNE could predict—positive or negative. CCF has yet to complete its capitalization or make its first investment, and CFNE is in the process of vetting CCF’s prospectus and writing policies and procedures for the fund.

However, this innovation can be shared by other CDFIs that focus on businesses with issues of limited capital, although CFNE would expect that the form, methods, and processes might vary with different business segments and the intricacies of the fund.

CFNE was able to establish CCF with minimal out-of-pocket costs because it was primarily funded by grant monies and the volunteer efforts of its Board, executive director, and outreach personnel. There was, however, a much larger investment in time and business resources than CFNE had initially projected. CFNE found that, due to the innovativeness of the idea as well as the relatively small size of the fund, the participation of skilled volunteers—Board members and others—was vital to the process. The costs of CCF’s formation (the research, market studies, and so forth) were at times removed by and other times mitigated by those individuals. Any CDFI that takes on a project like this should consider the depth it has in staff and volunteers, as well as the effect the time commitment might have on the CDFI’s day-to-day activities.

The legal work required to establish the new entity and the infrastructure needed to make and receive investments is also substantial and should be budgeted into any plan to create an equity-like product.