Equity with a Twist:
The Changing Capital Needs
of the Community Development Field

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I. INTRODUCTION

Twenty-five years ago, the concept of community development was fairly limited. The mission of community development was seen as upgrading the physical infrastructure of communities and engineering economic reversals of distressed areas. The human service providers down the block – the job training agency, community health care provider or child care provider – were considered less a part of community development and more rooted in the original War on Poverty.

Community developers' demand for capital was, similarly, fairly modest. Before 1980, when community developers needed financing, they turned to private financial institutions which, in turn, depended on long term federal contracts for their security. Specialized community development capital sources barely existed; just a few philanthropic programs had created "portfolios" of loans for housing projects or small businesses for economic development in distressed neighborhoods or regions. And while the Local Initiatives Support Corporation (LISC) had emerged as a capital and technical assistance provider for community development corporations, its lending activities were limited.

Now that community development is a more mature field, the challenges and opportunities we now face are quite complex:

- federal housing production programs for the most part have been eliminated;
- the Low Income Housing Tax Credit (LIHTC) has emerged to provide a major catalyst to community development;
- the Community Reinvestment Act, significantly strengthened in 1995, has now become a major part of the scene;

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- comprehensive strategies for community development have emerged which embrace multiple approaches, including housing, job training, child care, health care services, small business development and other social services;

- community development organizations have steadily accumulated a stable of properties, requiring much more sophisticated management techniques and more complex organizational structures

- Community Development Financial Institutions (CDFIs) have emerged with real strength and dynamism across the country and are growing at a phenomenal rate.

This paper argues for the creation of a new form of capital to fit the emerging needs of complex, multi-purpose, highly successful community development organizations. What is needed now is an innovative form of equity – long-term, patient but highly flexible capital, where yield is measured in social returns, as well as financial returns.

II. How Has Community Development Changed?

Prior to 1980, federal programs supported most new low-income housing production. Today, those federal programs have dried up, as have their packages of development funding and a fairly standard process for development. State of the art housing development is much more entrepreneurial; new housing production requires highly complex development and financing relationships. Finally, the use of the Low Income Housing Tax Credit has forced community developers to learn how to deal with capital markets, investors and complex legal structures. While these changes have provoked a higher level of sophistication within the field, they have also meant that getting a project done is more complicated and labor intensive. As our skills and entrepreneurial talents have increased, so have the transaction costs of doing business: pulling together the patchwork of financing and subsidy needed to makes deals work has added measurably to the cost of the ultimate product.

Over the years, community developers also have come to own numerous properties and almost unconsciously have become landlords and asset managers – and these are often new and uncomfortable roles. These groups must grapple with property management issues, as well as business management issues, as properties under their management blossom into a portfolio of assets. They are finding that previous informal systems for maintaining financial and business control must yield to more sophisticated management techniques and more formal internal controls. They are discovering that problem properties not only drain staff time, but also put a strain on their financial resources. Moreover, as the portfolio of properties and assets accumulate, the community development parent organization must expand its staff, its management information systems and its financial tracking systems. Executive directors face a host of predictable but thorny problems that come with growth, ranging from issues of organizational structure, staff development, and

personnel management to threshold issues of financial stewardship. Says Steve Clare, an Executive Director of a community development group in Venice, California, "Ten years ago we had one project and no full-time staff, just activist volunteers. Today we have a raft of properties and a raft of new problems. Business is not only bigger, it is far more complex than I ever envisioned."

Simultaneously, leading community developers have expanded their vision of what they want to do. Community developers now recognize that no single strategy will resolve the problems of poverty and neighborhood disinvestment. They have begun to seek comprehensive solutions, with multiple program thrusts. Experimentation with multi-dimensional programs has been underway for a decade or more, and has become commonplace today. Low-income housing developments are often now the site of childcare centers, health services, learning centers, after school programs and job readiness programs. Community development venture capital is the newest entrant into this rich agenda of programs, talent and expertise.

Throughout the past fifteen years, as the program agenda has become more complex, the community development world has experienced its own version of the merger and acquisition trends seen in the private sector. Small scale, limited geography, often neighborhood level organizations faced much greater challenges in reaching economies of scale than organizations operating with a broader geographic reach. Each of these changes and challenges stimulated community development organizations to evolve, innovate and become far more sophisticated. Not surprisingly, their capital needs also grew in strength and complexity. At first, foundations and socially motivated insurance companies responded by providing loans for individual projects. Later, several large, national organizations -- LISC and the Enterprise Foundation – began to assemble capital to make loans to these local groups and projects.

Simultaneously, in the mid-1980s, a third more grassroots effort arose in the form of "community loan funds." This loan fund movement stands on the shoulders of the work started over 20 years ago -- early loan funds sponsored with public sector support back in the late 1970s, as an outgrowth of the War on Poverty. Much of the loan fund movement has its roots in publicly funded capital pools started during the height of the era of anti-poverty programs. Public sector experimentation and support has been crucial in creating the ideas and capacity of the community development finance field, as we know it today. Community loan funds are locally based organizations, which appeal to private, socially motivated investors. They take small individual investments or larger philanthropic investments and combine them into professionally run capital pools. Community loan funds then provide capital to community development projects or other capital-using efforts of importance to a local community. Because these loan funds earn interest and fees on their lending activity, they generate a significant share of their operating budgets, limiting the ultimate need for fundraising.

The community loan fund movement in the United States started humbly, but has grown consistently for the past 15 years. In fact, its rate of growth is not too different from Silicon Valley start-ups. In 1985, there were 21 community loan funds with combined capital resources of $29 million. Today, there are more than 550 community development financial institutions (CDFIs) with combined resources of ***$6 billion***. Each year, these loan funds invest $***750 million*** in community projects ranging from low income housing to small businesses to childcare centers. Many of these community capital providers are now organized within the umbrella of the National Community Capital Association, which provides training, best practices coaching, data about the industry and information about national political trends affecting the community loan funds.

My organization, the Low Income Housing Fund (LIHF), grew out of this third, community-based track of activity. LIHF is a 15 year old organization which has provided over $200 million in loans and technical assistance to community development organizations. LIHF lends across the full spectrum of borrower need, from working capital to predevelopment loans, to construction and permanent loans. The organization began with a focus on the poorest of the poor and has maintained its vision of poverty alleviation throughout the years. About 10 years ago, however, LIHF's initial focus on housing gave way to a more comprehensive strategy of building healthy communities and people. LIHF's work now includes child care financing, providing capital for workforce development organizations and a recent interest in financing educational facilities. This expanded focus gained a real head of steam in 1998 with the creation of the Child Care Facilities Fund – a $15 million fund of highly flexible capital ranging from grants and recoverable grants to senior debt on "normal" LIHF terms.[2]

All told, LIHF has moved in the last 10 years from about 95 percent of its lending devoted to housing to about 70 to 80 percent today. Child care centers, charter schools, workforce development centers, non-profit office facilities, and community facilities (including multi-purpose centers, health facilities and so forth) make up the rest. Given that LIHF does an annual volume of $25-$30 million, this is a substantial amount of capital invested in non housing activities. However, nearly all of this is real estate lending, with collateral and assets to back it up. Virtually all of LIHF's work is project-specific financing.

III. MEETING FUTURE CHALLENGES: EQUITY WITH A TWIST

As organizations like LIHF gained strength and expertise, so have their customers – those changing and dynamic community development nonprofits. Whereas before, these organizations needed financing for discrete projects, today, project by project financing now longer serves all their needs. They need something more akin to equity or corporate financing: flexible, patient capital for their overall operations, working capital needs and the

[2] Normal for LIHF is anything but normal for typical capital markets. LIHF will make loans on projects with up to 100% loan-to-value ratios and 1.05 debt service coverage ratios; private sector lenders usually limit their exposure to 75% loan-to-value and 1.15 debt service coverage ratios.

multiple projects under their management. Because of their nonprofit status, they have not built up the financial reserves of for profit businesses. Moreover, the nature of the projects they undertake – those serving the lowest income sectors in the country – work against the creation of high levels of net operating income. Yet, the social return generated is enormous, even if the financial return is lower than typical equity investment standards. The solution? Equity, but with a twist: patient investments in high performing social institutions, where return is measured in a double bottom line – a decent financial return combined with a social yield, measured in the improved productivity and output of the organization. This new product can be thought of as the equity equivalents for nonprofit organizations, or it can be thought of as near equity, that is, debt with equity features and equity functions. In other words, it would require scheduled repayments like debt (and unlike real equity), but it would take on much higher levels of risk than is usually true with debt. Unlike equity, it would not build up an organization's net worth, but it would perform a similar function to net worth by providing a source of flexible working capital.

We learned from the private sector that innovating new capital products unleashes the capacity of businesses, enhances their productivity and their profitability. Capital plays the same role in community development. But, here productive capacity is expressed in high social impact, rather than in high financial returns. If we fail to innovate the products needed by these community development customers, we will strangle the field and hold it back from achieving its potential.

What is the exit strategy? Repayment comes from the net earnings of the borrowing organization. As the operations of the organization grow and achieve greater scale, the ability to repay would also grow. The investor in this new equity-like capital could establish financial covenants that would keep the borrower focused on the bottom line and strong financial performance. The repayment schedule would be based on the borrower's ability to repay and a repayment plan established given prior financial performance. The return on the capital would vary according to the situation and the sector receiving support, but in today's environment might be as low as three percent or as high as eight percent. There might even be cash kickers given extraordinarily strong performance. The focus here is less on the metrics of capital return and more on the social gain in combination with an efficient capital return structure.

This new capital product will be structured so that it must be repaid and will yield modest financial returns to investors. However, it also must be willing to absorb higher levels of risk than traditional financing. And again, this risk will be rewarded with social returns, rather than high levels of financial return.

Who are the likely investors in this new form of capital? Social investors motivated by performance and impact would be attracted to this idea. Combined financial and social returns are the inducements for the investor, and could be measured as frequently as quarterly. The financial returns would be paid in cash, but the social returns would be

reported as performance against benchmarks. In particular, there is an important role for public sector, which continually searches for performance-based funding approaches. This new approach is based not only on performance, but it offers a high degree of accountability. It also has the potential of bringing in new players, unfamiliar with capital markets and capital market techniques.

For example, for several years now, there has been an effort to create a federal legislation to respond to the capital needs of child care providers. Last year, HR 3610 and its companion S. 1539 proposed $50 million in grants administered by the Department of Health and Human Services over five years for child care providers. The "equity with a twist" model offers an attractive alternative to grants, because it provides for capital recovery and would support the growth and development of the child care industry, while also requiring accountability and social performance. It offers a financial instrument with both accountability and performance expectations.

Similarly, there is recent attention from the Department of Education to the capital needs of charter schools. Again, an instrument that offers the potential for repayment and recovery, but with the patience of equity, would add an important tool to the current thinking. Especially with a more conservative administration in Washington, techniques that require measurement of the "return on taxpayer's investment" would be popular.

At present, the community development financing system has not created this new type of investment product. Yet, this is the natural next step to support the "winners" in the industry – those organizations that are high performers and high yield social impact providers.

At present, the CDFI field has been capitalized with relatively short-term funds, and therefore, can only make loans with shorter terms. The venture capital portion of the field is focused on seeking out profit-making enterprises that yield an acceptable bottom line for their investors. This source of capital cannot serve the needs of the nonprofit community developers that are combining a variety of social strategies to increase the economic mobility of very poor individuals. Rubicon Programs in Richmond, California, is a case in point.

IV. RUBICON PROGRAMS: WHAT IS NEEDED, AND WHAT IS POSSIBLE

Rubicon Programs is a 27-year-old organization helping the homeless and other at-risk populations achieve employment, long-term stability and economic independence. Rubicon provides three main types of services:

- Integrated counseling services, including mental health counseling, substance abuse counseling, and others

- Transitional and permanent housing

- Job training and placement services

Over the last five years, Rubicon has trained 2,000 individuals and placed them in permanent jobs. Rubicon's record of success is one of the strongest in the US, with between 70 and 80 percent of its trainees[3] remaining employed one year later. Rubicon is widely believed to be one of the most effective workforce development organizations in the country, using integrated strategies to help the hardest to serve populations become economically self-sufficient.

Rubicon developed its formula of success over many years of experimentation. It started as a mental health counseling agency, but over time realized that mental health services without other critical stabilizing inputs would not take hold. Affordable housing was quickly identified as a cornerstone need, and Rubicon tried its hand as a housing developer. It is now the proud owner of nearly 100 units of affordable housing, with a pipeline of 52 units under development. However, even with housing to stabilize families and mental health counseling to sustain them day-to-day, economic independence could not be realized. Rubicon then added a third leg to its social programs, namely job readiness programs. But, Rubicon realized that it could not simply provide classroom training and expect success. It needed to create real, but supportive, employment situations – where a paycheck encouraged and also disciplined performance – to transfer skills.

So, in 1982, Rubicon started its first business, a building grounds and landscaping enterprise. In 1993, Rubicon also started its now-famous bakery, selling cakes and pastries to high-end supermarkets, such as Whole Foods and Molly Stone's in San Francisco. Appealing to the high-end market generated sufficient revenue (in a standard business, this would be profits) to cover the heavy investment of time in training and coaching Rubicon's homeless clientele, working with them to overcome their disabilities.

In a standard business setting, Rubicon's enterprises would be highly profitable. The businesses would employ workers without the challenges of Rubicon's clients and business productivity would improve dramatically. In short, profits would rise, but for the plowback of revenue into Rubicon's labor force. Rubicon's model re-invests those profits in the workers themselves, and, as a result, has a huge social impact. Rubicon serves 3,000 people annually, operates three businesses, manages nearly 100 housing units and provides integrated counseling services to over 1,000 individuals annually. Rubicon's three programs combine to make a measurable and real difference in the lives of the hardest to serve. Even though the enterprise component of Rubicon's work yields financial returns,

[3] This retention rate applies to individuals who have worked in Rubicon's supportive work settings. The data for individuals receiving only job counseling and placement services is still being developed.

they are modest, and support the social services that are integral to the success of the workforce development programs.

Rubicon operates a $14 million annual budget and employs 275 individuals. It has evolved into a complex medium scale business operation, requiring sophisticated internal management systems and high-level financial management techniques. Yet, the social success of its programs requires it to operate on a break-even basis, with net operating margins averaging two to three percent, rather than a profitable basis. Even in the best of years, its net operating margin might reach a high of five percent. This means that Rubicon is not building up much in net worth or internally generated working capital. The result is that as Rubicon has grown, it has become cash starved. Rubicon is now operating a $14 million annual budget with less than $150,000 of cash in hand. Cash flow is the issue of the hour and expansion capital is the issue of the day.

A for-profit enterprise would seek investors to provide the working capital needed to support growth. However, Rubicon could not be successful in this strategy, because its social impact creates returns that are unattractive even to socially motivated business investors. The CDFI industry offers short-term loans, which lack the patience or the equity-style features to fuel Rubicon's future success. Yet, the situation Rubicon faces is ***financible.*** Rubicon can repay invested capital at a reasonable rate. It does not require grants or even recoverable grants. What is needed is a new form of financing, unavailable in either the private capital markets or in the community development financing world. This new form of financing would be available to long-standing, high producing, well-managed non-profits yielding very high social returns, but only modest economic returns. Developing capital tools that support this success story is an important new challenge for the community development finance field. Indeed, creating capital structures that support this growth is key to the continued vitality of social programs in the United States. This is especially true because high producers like Rubicon pack a tremendous bang for the buck -- a bang measured more in social impact than in any traditional measure of financial return. In the last year, LIHF has experimented with "equity with a twist" with an investment in Rubicon Programs. While the investment was really a working capital loan, bearing a normal interest rate of 7.5% and did not carry social performance "yield" covenants, it was a first step in the direction suggested by this paper. The loan grew out of LIHF's long history with Rubicon.

In the past, LIHF supported Rubicon with small project-by-project loans and close monitoring of individual draw requests. Over the years, Rubicon has become LIHF's largest and most frequent borrower, maintaining an excellent history of repayment. When its cash flow needs threatened to choke its operations, Rubicon approached LIHF for relief. Until then, LIHF had made only short-term working capital lines of credit to its borrowers – loans that were generally disbursed for identifiable projects and/or contracts, with a date certain for incoming revenues to repay the loan. Rubicon had established itself as a well run and dependable borrower of such funds.

Like most private financial institutions, LIHF's working capital loans required an annual "clean up" or repayment, before any future draws could be made. However, given Rubicon's strong track record and financial growth, LIHF agreed to structure a new type of loan for Rubicon. The loan would provide nearly $500,000 for working capital purposes. Like most working capital lines of credit, it would be unsecured; however, draws would not be closely underwritten or monitored. Moreover, the loan would have a three-year repayment term, rather than a one-year term. LIHF has also made working capital loans with terms up to **10 years**, with self-amortizing structures.

These are unusual capital structures that go beyond the boundaries of traditional capital tools. They serve a purpose unique to the nonprofit nature of the community development field, and do not have immediate analogues in private capital markets. Yet, the need for innovation in this area is emerging with force. Capital products like these are necessarily limited to organizations with a strong and reliable track record. They depend on financial performance covenants agreed to by the lender and the borrower.
Capital instruments like the one described above – and many variations on this approach – are needed to take successful community developers to the next stage in their evolution. To do this, experimental programs are needed to test new products and to develop reliable underwriting parameters and performance metrics. Moreover, experimentation and testing are needed to determine appropriate pricing and yield levels, as well as social impact "returns." However, after a reasonable period of development and trials, a new approach to capital and a new calculus for measuring social return could be available to community developers. The result could be a second revolution in community development and anti-poverty programs.

V. Conclusion

Community development is an industry that has experienced explosive growth and extraordinary levels of innovation over the past fifteen years. A cadre of nonprofit social entrepreneurs have grown up in the community development movement and come of age. A decade ago, the field was populated with "one-project-at-a-time" organizations. Today, a sizeable number of high producers, high social impact institutions have emerged. Yet, their social mission prevents them from building up substantial reserves. The community development revolution is now at a crossroads. The complexity of today's community development organizations, and their expanded goals and operations require capital, NOT for individual project development, but to support the full breadth of their activities. In the private sector, such capital would be equity and successful investments would be rewarded with high financial returns. However, for these innovative social entrepreneurs, success should be measured in social impact rather than financial returns. That will take a revolution in thinking.

The community development finance field has not yet crafted all the needed financial instruments to support the many capital gaps in the field. Standard venture capital models

do not work for organizations like Rubicon because the financial returns are not compelling. Rather, what is needed is patient working capital products with modest financial returns and a willingness to take a high level of risk. The Low Income Housing Fund has begun to experiment with such a financial instrument, but its underlying capital structure – short term, low-risk debt – is poorly suited for such experimentation. In addition, the systems to measure and record the social "return" of such investments is lacking. Both pose significant challenges – and the next frontier of innovation – for the rich and varied community development field.