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Hybrid transactions in the US social capital market

Steven Godeke

The US social capital market is the largest in the world, with the affordable and supportive housing sector representing a key asset class. Common Ground, the leading developer of supportive housing in the US, has recently completed an innovative debt transaction which will enable its continued expansion in the competitive New York real estate market. The deal provides some insights into the US market and how hybrid transactions, which blend philanthropic and commercial funds, can serve as useful tools for social entrepreneurs.

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The boundaries between philanthropy and investment have become increasingly porous, with investors incorporating social, environmental and ethical considerations into their investment selections. According to the US Social Investment Forum's 2005 Trends Report, financial assets totalling $2.29 trillion are managed using screening, shareholder advocacy or community investing. These assets – held by pension funds, foundations, religious organizations and community development financial institutions — account for 9.4 per cent of the total $24.4 trillion held in equity and fixed income securities in the US. While these numbers would suggest a vibrant social investing sector, over 99 per cent of these are publicly traded securities, which have limited value as capital for social entrepreneurs.

The community investment sector

The $20 billion in community investment represents an essential source of funding for social entrepreneurs, despite its small size relative to other strategies. Community investing makes it possible for local organizations to provide financial services to low-income individuals and to supply capital for small businesses and community services, such as affordable and supportive housing, childcare and healthcare. Outside the US, this strategy includes investments in microfinance institutions. Although some equity products exist in this sector, the majority is debt. These products can earn market rates or reflect governmental risk management or subsidy programmes.

Key roles of banks and intermediaries

The Community Reinvestment Act (CRA) encourages financial institutions to meet the credit needs of low- and moderate-income (LMI) communities. Every government-insured depository institution is subject to the CRA, and institutions with more than $1 billion in assets are subject to a CRA Investment Test, which measures the extent to which they engage in community investing. Banks are estimated to be the largest contributors of capital to the community investing sector. Originally, CRA was the regulatory response to banks not lending in LMI communities, but many banks now approach community development finance as a business.

As the US housing and banking markets have become increasingly national, intermediaries have become important aggregators and distributors of capital to the affordable and supportive housing markets. The two largest intermediaries for affordable housing, the Local Initiatives Support Corporation (LISC) and Enterprise, have networks of local partners around the country. There are a number of other financial intermediaries that package and then resell affordable housing and small business loans from a number of different lenders. These pools of loan products are then sold to investors, including banks looking for CRA credit and social investors interested in building a secondary market for community investment products.

Market-rate funds

Economically targeted investments (ETIs) are market-rate investments which also provide long-term economic benefits to targeted communities and sectors. Many state and local public pension plans in the US use ETIs to strengthen their local economies. These mission-related investments in sectors such as 'domestic emerging markets' may target strictly commercial investors. In fact, some funds have de-emphasized the social aspects of their activities as they seek to tap larger pools of 'agnostic' market-rate capital.

PRIs from foundations

Programme-related investments (PRIs) are below-market rate investments used by foundations to support charitable activities by using loans, guarantees, and even equity investments in charitable organizations and for-profit businesses. A PRI counts as a 'qualifying distribution' in the year in which it is made; that is, it counts against the US tax authorities' requirement that foundations pay out at least 5 per cent of their asset value annually. As below-market rate instruments, PRIs play a crucial role in hybrid transactions such as that involving Common Ground.

Hybrid capital structures

The US social capital market involves both for-profit and non-profit organizations pursuing financial and social returns while utilizing both philanthropic and financial investment strategies. In some cases, investors in these hybrid transactions receive different rates of return even though their risks are identical. These hybrids seek to enable social entrepreneurs to customize their capital structures while also reflecting the preferences of specific investors regarding risk, return and impact.

Sectors with hard assets can be more readily financed, while other non-asset based sectors, such as human services, may need to demonstrate predictable revenues from fees if they are to be 'bankable'.

US social capital market – lessons learned

Social entrepreneurs seeking finance must first understand how investors will assess their business and social impact. Sectors with hard assets can be more readily financed, while other non-asset based sectors, such as human services, may need to demonstrate predictable revenues from fees if they are to be 'bankable'. Capital tends to flow to larger, better-capitalized organizations, while other highly effective social enterprises may not operate at a financially efficient scale.

Hybrid structures typically raise issues of subsidies among public, philanthropic and commercial players. Even in the Common Ground transaction, where there is no direct public support, the source of permanent financing is public funding or private funding supported by public subsidies. Philanthropic investors should not just mitigate the risk of commercial investors, but need to advance their

COMMON GROUND'S LAND ACQUISITION FACILITY

Common Ground is a New York City-based non-profit which seeks to solve homelessness both through preventive programmes and through initiatives that place homeless people directly in permanent housing. In its supportive housing, formerly homeless people, many of whom have mental illness or AIDS, live in settings that provide social services on site such as mental health and substance abuse counselling, and job training. It has developed and currently manages seven buildings that house over 1,700 people in permanent and temporary residences.

New York City and New York State have agreed to support the creation of 12,000 units of supportive housing over the next ten years. As part of this effort, Common Ground wants to build 1,000 units of new supportive housing in the city by 2007 and an additional 3,000 by 2014.

The problem

Over the past decade, most of the city-owned land and buildings, many of which were acquired in the early 1970s during New York's real estate depression, have been sold or otherwise developed. This has meant dramatically increased competition for a shrinking supply of land. Common Ground's lack of capital has hindered its ability to compete with for-profit developers on desirable sites and has resulted in several lost opportunities. Even when Common Ground has been the successful bidder on a property, its lack of capital has prevented it from fast-tracking pre-development activities.

The solution

In order to achieve its 3,000 unit goal, Common Ground has structured a $10 million debt facility to enable it to purchase land for its projects, compete with for-profit developers, and reduce the time required to complete a project. The debt facility can also be used for pre-development 'soft' costs, thus allowing Common Ground to react more quickly. As pre-construction financing, borrowings under this facility will be refinanced by permanent financing from government and private sources. This facility is a renewable source of capital that can be used in many projects.

The facility leverages $2 million of higher-risk debt from philanthropic investors with $8 million of senior commercial financing provided by 11 corporations, financial institutions and real estate companies. The $2 million loan from the philanthropic lenders (Robin Hood, Altman and MetLife Foundations, and the AXA Life Insurance Company) is unsecured, with a below-market interest rate of 2 per cent and a term of 7 years. The $8 million 5-year senior revolving facility, led by Deutsche Bank, is secured by the properties acquired by Common Ground and has a floating interest rate (currently 7.5 per cent).

The flexible philanthropic funds enabled Common Ground to raise further capital by providing credit enhancement to the senior lenders. The philanthropic lenders are also grantmakers to Common Ground and were comfortable with its management and business plan. The facility provides Common Ground with flexible growth capital at a critical stage in its development. For many of the senior lenders, this transaction was their introduction to Common Ground, and it is expected that these relationships will expand in the future. Common Ground is currently bidding to acquire a property which will be the first use of the facility.

For more information www.commonground.org charitable goals. Cumbersome transaction structures may reflect the requirements of investors and funders rather than the social entrepreneur's needs. Social initiatives are typically designed to maximize value in the long term, while investors tend to have shorter time horizons. The negotiations among these parties can slow deal closings and increase costs. Nevertheless, it is through these risk-sharing mechanisms that hybrid structures can create additional value for social entrepreneurs by improving the terms and increasing the amount of available capital.

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To lower costs, this market needs more standardized documentation, better syndication and co-investment opportunities, and legal and financial advisers with expertise in such deals. The opportunity also exists to apply financial engineering solutions. The challenge remains how to build a sound capital structure and to attract capital from commercial investors when transactions do not reflect the typical trade-off between risk and return. However, the increase of specific templates, such as the Common Ground structure, can provide a roadmap for how non-profits can finance their missions beyond grant support and project-specific loans. @

CASE STUDY

Calvert Foundation's Community Investment Note

Historically, investors have had the option to either give money away or maximize their financial return. In fact, there are a broad range of investment opportunities that, while sustainable and creditworthy, do not generate commercial yields. Such 'soft' capital is needed to finance small business, affordable housing, community facilities, fair trade, and other efforts. Until recently, the only way investors could reach these high-impact social sectors was to give capital away – yet the need for affordable, flexible investment capital is real. To respond to this need, the Calvert mutual fund company, together with the MacArthur, Ford and Mott Foundations, launched Calvert Foundation in 1995.

Organized as a separate non-profit organization, Calvert Foundation is dedicated to popularizing financial products and services that provide investors with a blended social and financial return. To make this possible, it launched the Calvert Community Investment Note.

This fixed income security is sold to the general public directly by the Foundation and by third-party broker-dealers, making it possible for ordinary individuals to invest in the non-profit sector. Investors may select returns of 0–3 per cent, for terms of 1, 3, 5, 7 or 10 years. In over 10 years, Calvert Foundation has leveraged more than $100 million from over 2,400 investors (at an average cost of 2.5 per cent). This capital is then lent to nearly 200 community finance intermediaries and social enterprises (with losses of less than 0.2 per cent).

The Foundation earns a spread of 1.5 per cent to cover its operating expenses and is presently 80 per cent self-sufficient, with the remaining support coming from the Calvert mutual fund company and other foundations.

In Calvert Foundation's experience, blended value financial products operate quite differently from conventional securities. The difference in investor motives has profound implications for the structure of note offerings, how they are sold, and how they are administered. For example:

- The financial markets have sought to depersonalize and standardize transactions, offering the same class of investors the same return. The social capital market allows each investor to seek the return that matches their social objectives.
- In the conventional marketplace, the investor is seeking exclusively to maximize financial return, whereas in the social capital marketplace, social impact and a control for losses may be paramount.
- Liquidity, a key concern of the conventional investment market, is a less pronounced need in the social capital marketplace.
- The very framework in the formal financial markets can be depersonalized. In the social capital arena, the investor will earn less than a risk-adjusted return but expects the instruments to conform more explicitly to their own social impact agenda.

For more information

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